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Selling Closely-Held Stock to an Employee Stock Ownership Plan —How Adequate Must the Consideration Be?

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A recent Tax Court case illustrates the pitfalls involved when stock of a closely-held corporation is sold to an Employee Stock Ownership Plan ("ESOP"). In *Eyler v. Commissioner*,[1] the Tax Court determined that Gary Eyler, a majority shareholder of a closely-held corporation, sold stock in the corporation to the corporation's ESOP for inadequate consideration and was therefore liable for excise taxes of $12,500,000 under section 4975 of the Internal Revenue Code (the "Code").

An ESOP is a retirement plan which is designed to invest primarily in the employer's own securities and thus to provide employees with an ownership interest in their employer. A leveraged ESOP purchases employer securities through the use of a direct or indirect loan from a commercial lender. The employer subsequently makes contributions to the ESOP which are used by the ESOP to repay the loan.

Code section 4975(c) defines as a "prohibited transaction" any sale of property by an owner of 50% or more of the stock of an employer which maintains a plan, including an ESOP, to the plan. Code section 4975(a) imposes a mandatory "first tier" excise tax on a person who engages in such a prohibited transaction equal to 5% of the amount involved[2] for the year in which the prohibited transaction occurs and each subsequent year in which the transaction is not corrected. If the prohibited transaction is not corrected within the "correction period", Code section 4975(b) imposes an additional "second tier" excise tax equal to 100% of the amount involved.[3]

Code section 4975(d) provides various exceptions to the prohibited transaction rules. In particular, section 4975(d)(13) excludes any transaction which is exempt from the comparable restrictions on prohibited transactions under section 408(e) of the Employee Retirement Income Security Act of 1974 ("ERISA"). ERISA section 408(e) provides that the acquisition or sale by a plan of qualifying employer securities does not constitute a prohibited transaction if various requirements are met, including that the sale be for "adequate consideration".[4] ERISA section 3(18)(B) defines adequate consideration in the case of an asset for which there is no generally recognized market (*e.g.*, stock of a closely held corporation) as the "fair market value of the asset as determined in good faith by the trustee or named fiduciary pursuant to the terms of the plan and in accordance with the regulations promulgated by the Secretary [of Labor]."[5] *Eyler* considered how to determine fair market value and what constitutes a good faith determination for these purposes.

Eyler was the chief executive officer and chairman of the board of directors of Continental Training Services, Inc. ("CTS"), as well as its majority (and at times sole) shareholder. CST's primary business was operating vocational schools to train truck drivers and heavy equipment operators. In early 1986, Eyler decided to take CTS public through an initial public offering ("IPO") and retained underwriters to conduct a due diligence investigation of CTS in order to determine an estimated price range at which the CTS stock might be offered to the public. Based on the underwriters' investigations, a preliminary prospectus was filed with the SEC in September 1986 with an estimated offering price of between $13 and $16 a share. During October and up until the first week of November 1986, the underwriters attempted to market the CTS stock at the $13 to $16 range. Their efforts were not successful and they advised CTS to postpone the IPO until the market improved.

In December 1986, CTS formed an ESOP. The ESOP purchased 689,655 shares of CTS stock from Eyler (approximately 13.7% of CTS's outstanding shares) for $14.50 per share (a total price of approximately $10,000,000). In anticipation of this transaction, CTS negotiated a $10,000,000 loan from a bank to the ESOP, which would be guaranteed by CTS and secured by the shares sold to the ESOP. At its December 1986 meeting, the CTS board of directors (without the participation of Eyler) approved the terms of the loan and the use of the loan proceeds by the ESOP to purchase the CTS stock at $14.50 per share (the "ESOP transaction"). Under the agreement with the bank, CTS was obligated to make quarterly contributions of $500,000 to the ESOP in order to cover loan repayments from the ESOP to the bank.

At approximately the same time at which the ESOP was established, several members of the CTS board of directors purchased small amounts of shares at $14.50 per share from a CTS minority shareholder. In order to facilitate this purchase, Eyler provided unsecured interest-free bridge loans to the individuals purchasing these shares until they were able to obtain permanent financing.

During the years prior to and after formation of the ESOP, a number of events occurred which affected CTS's business. In April 1986, the Government changed the method by which guaranteed student loans were to be disbursed by lenders thereby negatively affecting CTS's cash flow. In July 1985, the California Division of Motor Vehicles filed an accusation against CTS alleging that CTS engaged in fraudulent practices and deceptive advertising with respect to its courses. In July 1986, the California attorney general concluded an investigation into CTS and indicated that he intended to file a civil suit against CTS seeking injunctive relief, restitution, and civil penalties for violations of the California Unfair Practices Act. In early 1986, the U.S. Department of Education commenced an audit and investigation of CTS similar in nature to the California investigation. As a result of the investigation, the U.S. Department of Justice filed a $366,000,000 lawsuit against CTS in 1988 and withdrew CTS's eligibility to participate in various government student loan programs thereby eliminating CTS's primary source of income. As a result of all of the foregoing events and subsequent unsuccessful investments made by CTS, CTS filed for bankruptcy in 1989. CTS was eventually liquidated, thus rendering the stock held by the ESOP effectively worthless.

Based on the facts described above, the IRS concluded that the sale of stock by Eyler to the ESOP had not been for adequate consideration (*i.e.*, it determined that the $14.50 per share price was excessive) and imposed first tier prohibited transaction excise taxes on Eyler equal to $500,000 per year (5% of the purchase price) for 1986 through 1990, as well as a second tier tax, for failure to "correct" the transaction, of $10,000,000 (100% of the purchase price). The issue before the Tax Court was whether the ESOP had received adequate consideration for the $14.50 per share paid to Eyler, *i.e.*, whether the price per share reflected the fair market value of the stock as determined in good faith by the ESOP's named fiduciary (CTS, acting through its board of directors).

The court began its analysis by stating that the adequate consideration test is focused on the conduct of fiduciaries in determining the price of an asset, not on the price itself, and that Eyler would accordingly prevail if he could prove *either* (1) that the fair market value of the CTS stock sold to the ESOP was at least $14.50 per share *or* (2) that the $14.50 per share price was determined by CTS's board of directors in good faith.[6]

With respect to the issue of whether $14.50 per share represented the CTS stock's fair market value in December 1986, Eyler argued that the price represented fair market value because $14.50 was the mid-point of the $13 to $16 range at which the underwriters attempted to market the stock in the attempted October 1986 IPO. He also argued that CTS's chief financial officer had opined at the meeting in which the directors approved the ESOP transaction that the stock was worth $14.50 per share. Finally, Eyler argued that other directors' purchase of CTS shares at $14.50 per share shortly after the ESOP transaction established the stock's fair market value.

In rejecting Eyler's arguments, the Tax Court noted that the underwriter's IPO price range was based upon certain assumptions not present at the time of the ESOP transaction. These assumptions included a public market for the CTS stock, a successful IPO resulting in capital infusion to CTS, and the absence of an ESOP with its inherent debt and contribution requirements. The court also noted that it was not required to accept a CTS officer's opinion as to the CTS stock value. Finally, the court found that the $14.50 per share paid by the CTS directors for the stock was not necessarily indicative of the stock's value because (1) the directors' purchases were nominal in relation to the ESOP transaction and (2) the sale of the shares to the directors were accomplished by unsecured interest-free bridge loans and, therefore, presumably not at arms' length.

The fact that $14.50 per share did not represent fair market value did not necessarily mean, however, that Eyler had engaged in a prohibited transaction. In order to determine whether a prohibited transaction occurred, the court also had to address the issue of whether the $14.50 per share price used in the ESOP transaction was determined in good faith by the board of directors.

The court concluded that the standard to be used in ascertaining whether a determination was made in good faith was the "prudence" standard of section 404(a) of ERISA.[7] In applying the prudence test, a court must consider whether, at the time the challenged transaction occurred, the fiduciaries used appropriate methods to structure the transaction, *i.e.*, an *objective* good faith standard. Thus, the fact that a fiduciary exercised *subjective* good faith in entering into a transaction would not mean that the fiduciary made a good faith determination for purposes of ERISA section 3(18)(B).

The court then concluded that the directors' actions in approving the ESOP transaction did not comply with the level of prudence required under ERISA. It was not enough for the directors to rely on their general belief that CTS's prospects were favorable. In particular, the court questioned the board's reliance on the price range set by the underwriters in connection with the IPO, noting that the fact that the IPO could not ultimately be carried out using the $13 to $16 price range should have alerted the directors to question the accuracy of the underwriters' estimated price range.[8] The court also questioned the directors' reliance on the opinion of CTS's chief financial officer and on the opinion of the law firm that represented CTS in the ESOP transaction.[9] The directors knew that the CTS was under investigation by both California and Federal authorities and the court found that the directors' knowledge of these facts placed upon them a greater duty to further investigate the stock's sale price in connection with the ESOP transaction. In analyzing the directors' prudence in determining the price of the CTS stock for purposes of the ESOP transaction, the court also noted that the fact that various investment banks had valued CTS at a wide range (*i.e.,* $50,000,000 to $120,000,000) should have alerted the board to question the true value of CTS. Moreover, Eyler wanted to complete the ESOP transaction by the end of 1986 in order to take advantage of favorable capital gains rates that would no longer be available after 1986; in view of the fact the ESOP was considered only after the IPO had failed in November 1986, it was questionable whether the board had sufficient time to evaluate independently the fair market value of the stock purchased by the ESOP. Thus, the court concluded that Eyler had failed to meet the burden of proving that the board of directors exercised prudence in determining the price of the stock for purposes of the ESOP transaction.

The conclusion reached by the Tax Court that Eyler was liable for a very substantial excise tax clearly indicates the extreme caution that must be used when closely-held stock is sold to an ESOP (or when other transactions occur involving "disqualified persons" and qualified plans). In valuing property sold to a plan, fiduciaries must make every effort to determine the property's fair market value as of the date of the transaction. This determination must reflect an objective, good faith *analysis* made, on the basis of all facts and circumstances existing at the time the valuation is made, and not merely a collation of financial opinions that may not be reflective of a full understanding of the facts or of the principles to be used in their application to the transaction in question. Given the potentially crippling excise taxes involved (as well as other penalties), every effort should be made to fully document adherence to the fair market value and good faith standards set by the Code and ERISA.

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1 TC Memo 1995-123.

2 Under Code section 4975(f)(4), the term "amount involved" generally means the greater of the consideration given or the consideration received in the transaction.

3 In order to avoid the second tier tax, the prohibited transaction must generally be corrected in the period beginning with the date on which it occurs and ending 90 days after the mailing of the notice of deficiency, extended by any period in which a deficiency cannot be assessed under Code section 6213(a). Thus, the correction period is extended while a petition in Tax Court is pending, since the tax may not be assessed during that time.

Both the first and second tier excise taxes also apply to a variety of other "disqualified persons" (*e.g.,* any plan fiduciary) and prohibited transactions (*e.g.,* the extension of credit between a plan and a disqualified person).

4 29 U.S.C. section 1108(e).

5 29 U.S.C. section 1002(18)(B). Subsequent to the transaction at issue in *Eyler*, the Department of Labor published proposed regulations (section 2510.3-18) defining adequate consideration. These proposed regulations were withdrawn effective February 1, 1995 (60 FR 23558).

6 The court also noted that the 1988 DOL proposed regulations, not applicable to this case, appeared to impose a stricter test and to require *both* that the price reflect actual fair market value *and* that it be based on a good faith determination.

7 Section 404(a) of ERISA provides that a fiduciary shall discharge his duties with respect to a plan solely in the interest of the plan's participants and beneficiaries and with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims. 29 U.S.C. section 1104(a).

8 The court again noted that the estimated price range assumed an infusion of cash as a result of the IPO and the absence of an ESOP with its inherent debt and contribution requirements.

9 The law firm's opinion specifically stated that it was not opining as to whether the ESOP's purchase of the CTS stock was for adequate consideration or whether the $14.50 per share price constituted fair market value.