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## **U.S. Department of Labor Sues Cactus Feeders, Inc. for Millions Over ESOP Plan – What’s the Beef?**

**Roger A. McEowen**

**Kansas Farm Bureau Professor of Agricultural Law and Taxation  
Washburn University School of Law, Topeka, KS**

**and**

**Tax Director, Agribusiness and Cooperatives, Midwest Region  
CliftonLarsonAllen, West Des Moines, IA**

**roger.mceowen@washburn.edu / roger.mceowen@claconnect.com**

### **Overview**

In early March of 2016, the U.S. Department of Labor (DOL) filed a lawsuit in federal district court in Amarillo, TX, against Cactus Feeders, Inc., and various fiduciaries to the Cactus Feeders, Inc. Employee Stock Ownership Plan (ESOP) for allegedly causing the ESOP to pay tens of millions of dollars more than the DOL claims it should have paid for company stock. The court filing points out ESOPs require care in their implementation and usage to avoid government scrutiny and the possible fines and penalties, and revocation that can accompany failing to meet all of the technical requirements. Cactus Feeders, Inc., is the second largest cattle feeding operation in the United States, so the case is an important one to monitor for agricultural businesses that are utilizing ESOPs as an estate planning, business transition tool.

### **The Complaint**

The DOL alleges that Lubbock National Bank (the ESOP trustee) violated its fiduciary obligations under the Employee Retirement Income Security Act of 1974 (ERISA) when it caused the ESOP to overpay for company stock. The DOL also claims that Cactus Feeders, as the ESOP administrator and acting through its board of directors and designated ESOP committee members, knew of the trustee’s breaches of duty and didn’t stop them. The ESOP, which already owned 30 percent of corporate stock, bought the remaining 70 percent for \$100 million which DOL claims was too high of a price to pay because it failed to account for: (1) warrants and stock options that would dilute the ESOP’s equity from 100 percent to 55 percent when exercised; (2) a lack of marketability discount; and (3) a price adjustment for an investors’ rights agreement that allowed the selling shareholders to retain control over Cactus Feeders, Inc., for a 15-year period.

## What Is An ESOP?

In existence since the 1970s, an ESOP is a type of qualified retirement plan that is designed to provide employees with ownership in the company by investing (primarily) in shares of stock of the employer-company.<sup>1</sup> The ESOP shares are part of the employees' remuneration, and the shares are held in an ESOP trust until an employee either retires or otherwise parts from the company. When one of those events happens, the company either buys the shares back and redistributes them or voids the shares.<sup>2</sup> Basically, the company sets up an employee benefit trust funded by employer contributions of cash to buy company stock or the contribution of company shares directly.<sup>3</sup> The trustee is appointed by the company's board of directors to manage the trust, and can be an officer or other corporate insider. Alternatively, the trustee can be an independent person that is not connected to the corporation as an officer or otherwise.<sup>4</sup> The trustee has the right to vote the shares acting in a fiduciary capacity. However, the ESOP may require that certain major corporate transactions (i.e., mergers, reorganizations, and significant asset sales) involve the participation of ESOP participants in terms of instructing the trustee with respect to voting the stock shares that are allocated to their accounts.<sup>5</sup>

An ESOP is a qualified retirement plan that is regulated by I.R.C. §4975(e)(7) as a defined contribution plan. As such, ESOPs are regulated by ERISA which sets minimum standards for investment plans in private industry. Only corporations can sponsor an ESOP, but it is possible to have non-corporate entities participate in an ESOP. An ESOP must include all full-time employees over age 21 in the plan and must base stock allocations on relative pay up to \$265,000 (2016) or use some type of level formula. ESOPs are provided enhanced contribution limits, which may include the amount applied to the repayment of the principal of a loan incurred for the purposes of acquiring employer securities. Employers are allowed to deduct up to an additional 25 percent of the compensation paid or accrued during the year to the employees in the plan as long as the contributions are used to repay principal payments on an ESOP loan.<sup>6</sup> In

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<sup>1</sup> According to data from the National Center for Employee Ownership, there are about 7,000 ESOPs in the United States covering approximately 14 million employees.

<sup>2</sup> An ESOP participant is entitled to a distribution of their account on retirement or other termination of employment, but there can be some contingencies that might apply to delay the distribution beyond the normal distribution time of no later than the end of the plan year. For plan participants that terminate employment before normal retirement age, distributions must start within six years after the plan year when employment ended, and the company can pay out the distributions in installments over five years, with interest. If employment ceased due to death, disability or retirement, the distribution must start during the plan year after the plan year in which termination event occurred, unless elected otherwise. If the ESOP borrowed money to purchase employer securities, and is still repaying the loan, distributions to terminating employees are delayed until the plan year after the plan year in which the loan is repaid. In addition, no guarantee is made that the ESOP will contain funds at the time distributions are required to begin to make the expected distributions.

<sup>3</sup> An alternative approach is for the company to have the trust borrow money to buy stock with the company making contributions to the plan so that the loan can be paid back. Unlike other retirement plans, an ESOP can borrow money to buy stock. Consequently, an ESOP can buy large percentages of the company in a single transaction and repay the loan over time using company contributions.

<sup>4</sup> It is advisable that an external trustee be used to negotiate the terms and execute the transaction involving the purchase of shares of stock from a selling shareholder.

<sup>5</sup> I.R.C. §409(e)(3). It is important to note that ESOP participants do not actually own the shares, the trust does. Thus, an ESOP participant has only the right to see the share price and number of shares allocated to their account on an annual basis. They have no right to see any internal financial statements of the company.

<sup>6</sup> I.R.C. §404(a)(9)(A). In addition, an employer with an ESOP may deduct up to another 25 percent of compensation paid or accrued to another defined benefit contribution plan under the general rule of I.R.C. §404(a)(3).

addition, contributions made to the ESOP applied to the repayment of interest on a loan incurred for the purpose of acquiring qualifying employer securities are also deductible, even though in excess of the 25 percent limit.<sup>7</sup> These two provisions, however, do not apply to an S corporation.<sup>8</sup> As a qualified retirement plan, an ESOP must satisfy I.R.C. §401(a) to maintain its tax-exempt status. While an ESOP is not subject to the normal ERISA rules on investment diversification, the fiduciary has a duty to ensure that the plan's investments are prudent.<sup>9</sup>

### **How is an ESOP Established?**

In the typical ESOP transaction, the company establishes the plan (hopefully with competent tax and legal counsel) and appoints an ESOP trustee. The trustee then negotiates with a selling shareholder to establish the terms of the sale of the shareholder's stock to the ESOP. The company borrows the necessary funds from a third party lender on the ESOP's behalf and loans the funds to the ESOP which uses the funds to buy the stock from the selling shareholder with the seller receiving cash and taking a note for the balance. The company will make annual (tax-deductible) contributions of cash to the ESOP which the ESOP uses to repay the inside loan. The company uses the payment received from the ESOP to make payments on the third party loan.

### **What Are The Benefits of an ESOP?**

For C corporations with ESOPS, the selling shareholder avoids the "double tax" inherent in asset sales because the sale is a stock sale, and can potentially defer the gain on the sale of the stock to the ESOP.<sup>10</sup> Corporate contributions to the ESOP are deductible if the contributions are used to buy the shares of a selling shareholder. As a result, an ESOP can be a less costly means of acquiring a selling shareholder's stock than would be a redemption of that stock. Also, the ESOP does not pay tax on its share of the corporate earnings if the corporation is an S corporation.<sup>11</sup>

From a business succession/transition standpoint, an ESOP does provide a market for closely-held corporate stock that would otherwise have to be sold at a discount to reflect lack-of marketability of the stock, although the lack of marketability must be considered in valuing the stock. Indeed, one of the requirements that an ESOP must satisfy is that it must allow the participants to buy back their shares when they leave the company (a "repurchase obligation").

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<sup>7</sup> I.R.C. §404(a)(9)(B).

<sup>8</sup> I.R.C. §404(a)(9)(C).

<sup>9</sup> In addition to basic fiduciary duties designed to address the concern of an ESOP concentrating retirement assets in company stock, it is not uncommon for a company with an ESOP to also have a secondary retirement plan for employees.

<sup>10</sup> To achieve successful deferral, the technical requirements of I.R.C. §1042 must be satisfied and the ESOP, after the sale, must own 30 percent or more of the outstanding stock of the company and the seller must reinvest the sale proceeds into qualified replacement property (essentially, other securities) during the period beginning three months before the sale and ending 12 months after the sale. If the replacement property is held until the shareholder's death, the gain on the sale of the stock to the ESOP may permanently avoid tax.

<sup>11</sup> Thus, an S corporation ESOP is not subject to federal income tax, but the S corporation employees will pay tax on any distributions they receive that carry out the resulting gains in their stock value.

Compared to a traditional 401(k) retirement plan, ESOP company contribution rates tend to be higher,<sup>12</sup> and ESOPS tend to be less volatile and have better rates of return.<sup>13</sup>

## What the DOL Looks For

The DOL has a national enforcement project focused on ESOPS. The Employee Benefits Security Administration (EBSA) is an agency within the DOL that enforces the ERISA and is charged with protecting the interests of the plan participants. One of the primary concerns of the DOL is the belief that ESOPs suffer chronically from bad appraisals. As a result, the EBSA has increased its level of scrutiny of ESOP appraisals, and litigates cases it believes are egregious and could not be settled or otherwise resolved. In these situations, such as the Cactus Feeders, Inc. case, the basic allegation is that the fiduciaries of the ESOP didn't exercise adequate diligence in obtaining and reviewing the appraisals as part of the transaction process. Appraisals that are based on projections that are too optimistic can result in an overpayment by the ESOP in the transaction. This can be a particular problem when the appraisal is prepared by a party to the transaction – the same people that are selling the stock to the ESOP or who are subordinates of the sellers.<sup>14</sup> If the ESOP fiduciaries simply accept the projections without determining whether the projections are realistic that will likely constitute a breach of their fiduciary duties. So, simply plugging management projections into the ESOP appraisal without a critical review by the fiduciaries is problematic. Clearly, the fiduciaries of the ESOP should be communicating with the appraisers about the projections and asking questions. Similarly, if the appraisal incorporates a control premium when the ESOP is not really buying control, that will bring EBSA scrutiny because the result will be an enhanced stock value over what it should be in reality. Relatedly, an issue can arise where the ESOP pays full value for the stock but does not get all of the upside because of dilution caused by warrants, options, or earn-outs that are not considered in determining adequate consideration. That results in overpayment for the stock.<sup>15</sup> These issues are all highlighted in the DOL complaint against Cactus Feeders, Inc.

Also, EBSA looks for situations where the plan effectively owns the company, but is not exercising any of its ownership rights in the company. In other words, in this situation the claim is that company management is effectively “looting” the company of its value and the ESOP fiduciaries are doing little or nothing to protect the value of the corporate stock.

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<sup>12</sup> National Center For Employee Ownership, “Research on Employee Ownership, Corporate Performance, and Employee Compensation” (2015).

<sup>13</sup> Private Pension Plan Bulletin Historical Tables and Graphs, Department of Labor Employee Benefits Security Administration, Nov. 2012.

<sup>14</sup> I.R.C. §401(a)(28)(C) requires that all employer securities which are not readily tradable on an established securities market must be valued by an “independent appraiser.” An “independent appraiser” is a “qualified appraiser” as defined by Treas. Reg. §1.170A-13(c)(5)(i). For example, in *Churchill, LTD. Employee Stock Ownership Plan & Trust v. Comr., T.C. Memo. 2012-300, pet. for rev. den., No. 13-1295, 2013 U.S. App. LEXIS 11046 (8th Cir. May 29, 2013)*, the appraiser did not satisfy the requirements to be a qualified appraiser. The court also upheld the IRS determination to revoke the ESOP as a disqualified plan from 1995 forward (total of 15 years) for failure to meet certain statutory requirements (i.e., failure to timely amend plan documents necessitated by tax law changes and failure in addition to not having a qualified appraiser) to which ESOPs are subject.

<sup>15</sup> EBSA is also concerned about the use of out-of-date financials on which the appraisals are based which don't reflect current corporate reality.

## Conclusion

If an ESOP transaction is treated seriously, is minimally complex (e.g., the plan buys shares of common stock at fair market value), and the trustee considers how the structure of the transaction can either help or hurt plan participants, it is likely that the ESOP will avoid scrutiny. Clearly, the trustee should be communicating with the appraisers, analyzing company projections by comparing them with industry competitors and historical numbers, and determining whether the plan should be paying for control (it shouldn't when the plan can't control who manages the company or how it is managed). In addition, the use of an independent appraiser is required.

Certainly, ESOPS are useful primarily as a management succession vehicle for a closely held business. Also, they tend to work better for lower income, relatively younger employees compared to the typical company retirement plan. But, they are very complex and potentially dangerous. They do require meticulous compliance to avoid catastrophic results, and should never be used as a tax shelter for a closely-held business when the owner wants to maintain control. They require compliance with complex qualification rules on an annual basis, which requires significant legal and consulting bills. So, in the right situation, an ESOP can be useful and may even outperform a more traditional retirement plan. But, one would expect that result given the greater inherent compliance costs and risks.

The outcome of the Cactus Feeders, Inc. ESOP case will be important for the lessons that can be learned. But, the bottom line is probably this – for many small, closely-held farming and ranching operations, there are likely more efficient ways to accomplish estate and business planning goals than with an ESOP.