

U.S. DEPARTMENT OF LABOR
LABOR-MANAGEMENT SERVICES ADMINISTRATION
Pension and Welfare Benefit Programs
Washington, D.C. 20216



NOV 13 1978

Mr. Robert E. Falb
Silverstein and Mullens
1776 K Street, N. W.
Washington, D. C. 20006

OPINION 78-25 A

407

Dear Mr. Falb:

This is in reply to your letter concerning certain provisions of section 407 of the Employee Retirement Income Security Act of 1974 (ERISA). I regret that our heavy workload has resulted in a delay in responding to your letter.

Specifically, you request the following advisory opinions, which relate to a proposed transfer of common stock of Katz & Besthoff, Inc. (the Employer) to the Employer by the Katz & Besthoff Employee Savings and Retirement Plan (the Plan) in exchange for cash and promissory notes of the Employer:

1. That the Employer's common shares owned by the Plan are qualifying employer securities (as defined in ERISA section 407(d)(5)) because the shares are securities within the meaning of section 2(1) of the Securities Act of 1933 and because the common shares were issued by the Employer, some of whose employees are covered by the Plan;

2. That the Employer's promissory notes, to be issued to the Plan in exchange for the common shares, are also qualifying employer securities (as defined in ERISA section 407(d)(5)) because the promissory notes are a marketable obligation (as defined in ERISA section 407(e)) since (i) the notes are obligations acquired by the Plan directly from the issuer (i.e., the Employer) at a price not less favorable to the Plan than the price paid currently for a substantial portion of the same issue by persons independent of the Employer, and (ii) immediately following the Plan's acquisition of the promissory notes, (A) the Plan will hold not more than 25 percent of the aggregate amount of the \$6,314,849 in promissory notes issued or to be issued by the Employer to reacquire its common shares, (B) at least 50 percent of the aggregate amount of the promissory notes issued by the Employer to reacquire its common shares will be held by persons independent of the issuer, and (C) not more than 25 percent of the Plan's assets will be invested in the Employer's promissory notes; and

3. That the Plan is an eligible individual account plan (as defined in section 407(d)(3) of ERISA) because it is an individual account plan within the meaning of section 3(34) and because it is a thrift or savings plan within the meaning of section 407(d)(3)(A)(i).

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Information Submitted

The first paragraph of the Plan states:

In order to encourage its employees to save and to further assist them in a regular savings program by which they might provide more adequately for their future, Katz & Besthoff, Inc., a Louisiana Corporation, does hereby constitute, establish and adopt the following Savings Retirement Plan for Employees, . . .

Articles III through VI of the Plan provide that each eligible employee of the Employer or its subsidiaries may participate by contributing a percentage (ranging from two to six percent) of his total compensation to the Plan. In turn, the employer of each participant will contribute an equal amount to the Plan on behalf of the participant. Employer and employee contributions are credited to separate accounts maintained for each participant. These amounts are held and invested by trustees pursuant to a separate trust agreement. Earnings on investments and changes in the value of investments of the trust fund are credited to each participant's account. Distributions from the Plan are made in the event of a participant's death, retirement, termination of employment, or complete withdrawal from the Plan and equal the full amount or a specified portion of the amount credited to the employee's accounts under the Plan.

Neither the Plan nor the trust agreement explicitly provides for the acquisition and holding of qualifying employer securities or qualifying employer real property. However, you state that the Plan will be amended, in accordance with section 407(d)(3)(B) of ERISA, to provide expressly that the Plan is entitled to acquire and hold qualifying employer securities.

The Plan's financial statements for the year ended December 31, 1976, show that the Plan held 5,540 class A voting common shares and 27,440 class B non-voting common shares of the Employer, together constituting approximately 22 percent of the Plan's total assets (\$4,750,787) at that date. You state that the Employer is authorized to issue 250,000 class A shares, of which at November 4, 1976, 105,000 shares were issued and 73,688 shares were outstanding with the balance of 31,312 held in the Employer's treasury, and that the Employer is also authorized to issue 750,000 class B shares, of which 374,400 shares were issued at November 4, 1976 and 154,716 were outstanding, and 219,684 were treasury shares. The Employer's schedule of stockholders of record as of November 4, 1976, shows that Sydney J. Besthoff, III, who is one of the trustees of the Plan, and his relatives owned 101,283 shares of both classes A and B shares (58,360 class A (voting) shares, or 79.19 percent, and 42,923 class B (non-voting) shares, or 27.73 percent), or 44.36 percent of the total of these shares

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outstanding; that the Plan owned 14.445 percent of the total of these shares outstanding; and that the K&B Foundation (the Foundation) owned 20.936 percent of these shares outstanding. You state that the Foundation is a private foundation exempt from Federal income tax under section 501(c)(3) of the Internal Revenue Code of 1954. An appraisal in February 1977 of these shares by Howard, Weil, Labouisse, Friedrichs, Inc., (HWLF) concludes, "The fair market value of a Class A or Class B common share representing a minority ownership of Katz & Besthoff, Inc. has been determined to be \$32.00 as of September 30, 1976." HWLF's evaluation states that HWLF had no interest in the common stock of the Employer at that time and that HWLF has experience in the securities markets, in investment analysis and appraisal, and related corporate finance activities.

The Stock Redemption Agreement (the Agreement) dated March 15, 1977, between the Plan and the Employer provides for the sale to the Employer of all of the above-mentioned class A and class B shares held by the Plan for a total redemption price of \$1,055,360 (\$32 per share). Items 3 through 5 of the Agreement show that 27 percent of this amount will be paid in cash on the closing date (30 days after receipt of a favorable opinion that the proposed sale will not violate ERISA) and that the balance shall be represented by a promissory note of the Employer, dated as of the closing date, bearing interest at the rate of seven percent per annum from the closing date on the unpaid principal balance due, and payable in installments, the first installment to equal 13 percent of the total redemption price and due one year after the closing date, and the remainder plus interest payable in equal quarterly amounts over the succeeding 13 years. Item 6 of the Agreement provides, in part, that the unpaid balance of the purchase price, at the Plan's option, may become due and payable in the event that the aggregate interest of Sydney J. Besthoff, III, and his wife and descendants, should fall below 65 percent of the total shares of stock they now own of the Employer. The Agreement also contains covenants and agreements on the part of the Employer designed to assure that the Employer will maintain sufficient net worth to discharge the notes timely. Page 1 of the Agreement explains that the Plan believes it is now in its best interest to sell all of its shares in the Employer because the liquidity resulting from such sale will more readily aid the Plan to pursue its objectives and the Employer is presently willing to redeem the shares for the appraised price and on terms more favorable than could be obtained from any other party and which are similar to recent arm's length transactions of such shares. A copy of a resolution dated March 15, 1977 of the Employer's board of directors explains that the Employer is willing to acquire these shares to prevent them from falling into the hands of disinterested parties or parties who would be hostile to the best interests of the Employer.

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You advise that the terms and conditions of the Agreement are substantially similar to those of (1) the Stock Redemption Agreement dated September 27, 1976, between the Employer and S.J. Besthoff, et al and (2) the Stock Redemption Agreement dated March 15, 1977, between the Employer and the Foundation. You explain that the S.J. Besthoff involved in the September 1976 agreement (Mr. Besthoff, Jr.) is the father of Sydney J. Besthoff, III, who is an officer and the controlling shareholder of the Employer and one of the trustees of the Plan. You represent that under both of these other stock redemption agreements, the total sales price, the percentage thereof payable in cash, the due date of the cash payment, the percentage of the total sales price payable under a promissory note, the relative amounts and due dates of installment payments under the promissory note, and the interest rate are the same as under the Agreement with the Plan, except that under the agreement with the Foundation the interest rate was only six percent per annum and the promissory notes are secured until December 31, 1979 by an irrevocable letter of credit drawn on a national bank. You also advised (by telephone on February 3, 1978) that the Internal Revenue Service has issued a favorable ruling regarding the transfer of common shares of the Employer under the agreement with the Foundation.

Regarding the September 1976 agreement with Mr. Besthoff, Jr. and his relatives, you represent that the agreement was negotiated at arm's length between the parties over a period of two years and resolved a protracted family and shareholder disagreement respecting the Employer's management and operating policies, which at one point caused filing of a shareholders' derivative action against the Employer, and that all parties to the September 1976 agreement were represented by separate counsel. Although Mr. and Mrs. Besthoff, Jr., are not named as plaintiffs in the complaint, you state that it has always been the belief of the Employer and Sydney J. Besthoff, III, that Mr. and Mrs. S.J. Besthoff, Jr., were sub silentio plaintiffs in the suit but caused the suit to be brought by their daughters (sisters of Mr. Besthoff, III) as a matter of strategy. You also state that the Employer repurchased a total of 202 shares for cash on November 3, 1976, at a price of \$32 per share, from attorneys representing the Besthoff family members who sold their shares.

The table below summarizes the information submitted regarding the amount of holdings of the Employer's promissory notes under all three stock redemption agreements described above.

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Holder	Amount (Rounded to Nearest \$100) of Promissory Notes (73% of Total Redemption Price)	Approximate Percentage of Promissory Notes Issued
Plan	\$ 770,400	12%
Mr. Besthoff, Jr. <u>et al</u>	4,427,700	70%
Foundation	<u>1,116,600</u>	<u>18%</u>
TOTALS	<u>\$6,314,800</u>	<u>100%</u>

First and Second Issues

Section 407(d) (5) of ERISA defines the term "qualifying employer security" as an employer security which is stock or a marketable obligation (as defined in section 407(e)). "Employer security" is defined in section 407(d) (1) as a security issued by an employer of employees covered by the plan, or by an affiliate of such employer, excluding contracts described in section 408(b) (5) (which is not relevant to this case). Section 3(20) states that the term "security" has the same meaning as such term has under section 2(1) of the Securities Act of 1933. As this office has no authority to interpret the Securities Act of 1933, we cannot issue an opinion whether the Employer's common shares are securities within the meaning of section 2(1) of that Act. However, since the class A and B shares in this case are stock issued by an employer of employees covered by the Plan, we conclude that if they are securities within the meaning of section 2(1) of the Securities Act of 1933, they are also qualifying employer securities within the meaning of section 407(d) (5) of ERISA.

Section 407(e) of ERISA states, in relevant part, that for purposes of section 407(d) (5), the term "marketable obligation" means a bond, debenture, note, or certificate, or other evidence of indebtedness (obligation) if (1) such obligation is acquired directly from the issuer, at a price not less favorable to the plan than the price paid currently for a substantial portion of the same issue by persons independent of the issuer (section 407(e) (1) (C)); (2) Immediately following acquisition of such obligation--(A) not more than 25 percent of the aggregate amount of obligations issued in such issue and outstanding at the time of acquisition is held by the plan, and (B) at least 50 percent of the aggregate amount

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referred to in (A) is held by persons independent of the issuer; and (3) immediately following acquisition of the obligation, not more than 25 percent of the assets of the plan is invested in obligations of the employer or an affiliate of the employer.

Section 3(15) of ERISA defines the term "relative" as a spouse, ancestor, lineal descendant, or spouse of a lineal descendant. Since Mr. and Mrs. Besthoff, Jr., are relatives within the meaning of section 3(15) of an officer and the controlling shareholder (Sydney J. Besthoff, III) of the Employer, they would not be deemed to be independent of the issuer (the Employer) for purposes of section 407(e) (1)(C) and (2)(B), even though they were parties to a protracted family disagreement respecting the Employer's management and operating policies. (In this regard, compare 26 CFR 1.503(e)-1(b)(3) of the Federal Income Tax regulations under section 503(e) of the Internal Revenue Code of 1954 (the Code), which is virtually identical to section 407(e) of ERISA. Section 1.503(e)-1(b)(3)(i)(d) of these regulations states that a controlling shareholder of a corporation which is the issuer is not considered to be independent of the issuer. Section 1.503(e)-1(b)(3)(ii) states, in part, that if the aggregate amount of stock in a corporation owned by an individual and by the spouse, ancestors, lineal descendants, brothers, and sisters of the individual is 50 percent or more of the total combined voting power of all voting stock or is 50 percent or more of the total value of all classes of stock, then each of these persons shall be considered as the controlling shareholder of the corporation.) See also, H.R. Rep. No. 93-1280, 93d Cong., 2d Sess. 317 (1974).

Similarly, because the Foundation was created by and may receive contributions from the Employer, the Foundation would not be deemed to be independent of the issuer for these purposes. Therefore, we conclude that none of the promissory notes described above were issued to persons independent of the issuer, contrary to the requirements of section 407(e) (1)(C) and (2)(B). Accordingly, we conclude further that the promissory notes are neither marketable obligations nor qualifying employer securities within the meaning of section 407(e) and (d)(5) of ERISA.

Section 408(a) of ERISA permits the Department to grant exemptions from the prohibited transaction restrictions of sections 406 and 407(a) if the Department finds that such exemptions are administratively feasible, in the interests of the plan and of its participants and beneficiaries, and protective of the rights of participants and beneficiaries of such plan. If you wish to apply for an exemption under section 408(a) regarding the proposed sale described above, please see the enclosed copy of ERISA Procedure 75-1 (exemption procedure).

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Since section 407(e) of ERISA is virtually identical to section 503(e) of the Code, we have conferred with representatives of the Internal Revenue Service and they concur in the views set forth above as they would apply to that section.

Third Issue

Section 407(d) (3) of ERISA states:

(A) The term "eligible individual account plan" means an individual account plan which is (i) a profit-sharing, stock bonus, thrift, or savings plan; (ii) an employee stock ownership plan; or (iii) a money purchase plan which was in existence on the date of enactment of this Act and which on such date invested primarily in qualifying employer securities. Such term excludes an individual retirement account or annuity described in section 408 of the Internal Revenue Code of 1954.

(B) Notwithstanding subparagraph (A), a plan shall be treated as an eligible individual account plan with respect to the acquisition or holding of qualifying employer real property or qualifying employer securities only if such plan explicitly provides for acquisition and holding of qualifying employer securities or qualifying employer real property (as the case may be). In the case of a plan in existence on the date of enactment of this Act, this subparagraph shall not take effect until January 1, 1976.

Section 3(34) of ERISA defines the term "individual account plan" as a pension plan which provides for an individual account for each participant and for benefits based solely upon the amount contributed to the participant's account, and any income, expenses, gains, and losses, and any forfeitures of accounts of other participants which may be allocated to such participant's account.

Since neither the Plan nor the related trust agreement explicitly provides for the acquisition and holding of qualifying employer securities or qualifying employer real property, contrary to the requirements of section 407(d) (3)(B) of ERISA, we conclude that the plan in its present form does not constitute an eligible individual account plan within the meaning of section 407(d) (3). However, since the Plan is a savings plan which provides for individual accounts for each participant and for benefits based solely upon the amount contributed to the participant's accounts and any income, expenses, gains, losses, and forfeitures allocated to such

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accounts, we believe that the Plan is an individual account plan within the meaning of section 3(34), which meets the requirements of section 407(d)(3)(A)(i), and if it were amended to include the provisions required by section 407(d)(3)(B), would constitute an eligible individual account plan as of the date of such amendment.

This letter constitutes an advisory opinion under ERISA Procedure 76-1. Accordingly, this letter is issued subject to the provisions of the procedure, including section 10, relating to the effect of advisory opinions.

Sincerely,

Ian D. Lanoff
Administrator
Pension and Welfare Benefit Programs

Enclosure