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JUL 24 1980

Mr. A. Carl Kaseman, III
Pepper, Hamilton & Scheetz
1776 F Street, N.W.
Washington, D.C. 20006

Re: Consolidated Rail Corporation Employee Stock Ownership Plan
Identification Number: F-1528A

Dear Mr. Kaseman:

This is in response to your request of April 23, 1980, on behalf of Consolidated Rail Corporation (Conrail), in which you seek certain advisory opinions under the Employee Retirement Income Security Act of 1974 (ERISA) concerning the Consolidated Rail Corporation Employee Stock Ownership Plan (ESOP) which Conrail proposes to adopt.

Your request contains the following facts and representations. Conrail is a for-profit corporation organized and operating under the laws of the Commonwealth of Pennsylvania. The formation of Conrail was specifically required by the Regional Rail Reorganization Act of 1973 (Rail Act). A substantial part of the financing of Conrail is furnished by the United States Railway Association (USRA), a governmental agency charged with overseeing the formation, financing and operation of Conrail.

Section 216(f) of the Rail Act requires Conrail to establish an employee stock ownership plan meeting certain requirements as a prerequisite to USRA investing the final \$345,000,000 of the additional investment authorized by the United States Railway Association Amendments Act of 1978. Among the terms specified by the Rail Act is the requirement that each participant's right to securities contributed to the employee stock ownership plan must be subject to "defeasance" after ten years if Conrail has not attained the "Financial Benchmarks"¹ described in the Rail Act.

The Rail Act also requires Conrail to adopt such terms and conditions governing the securities to be transferred to the plan (including limitations on voting rights) as USRA determines are necessary to protect the interests of the United States.

You indicate that the Internal Revenue Service has determined that the ESOP which Conrail proposes to adopt is a tax qualified plan under section 401(a) of the Internal Revenue Code (the Code).

For the purpose of adopting its ESOP, Conrail, with the preliminary approval of representatives of USRA, proposes to incorporate Conrail Equity Corporation (CEC) under Pennsylvania law. CEC will be capitalized with \$44,200 and 4,411,760 shares of issued and outstanding Conrail common stock. In exchange, Conrail will receive one share of CEC common stock and 4,411,760 shares of CEC preferred stock.

Under the provisions of the ESOP, Conrail will contribute 441,176 shares of CEC preferred stock to the ESOP for 1980 and for each of the next nine years. In the event the Financial Benchmarks as defined in the Rail Act are determined to have been met at the end

¹ The Financial Benchmarks are met if no later than January 1, 1991, Conrail shall have obtained for two consecutive quarters positive net income and a freight labor cost to freight revenue ratio equal to the average such ratio for all Class I railroads in 1977.

of the ten year period beginning on or about July 1, 1980, each share of CEC preferred stock will be redeemed by CEC for one share of Conrail common stock.² If the Financial Benchmarks are determined not to have been met, Conrail will terminate the ESOP effective as of January 1, 1991, and make distributions in full and fractional shares of CEC preferred stock. At the option of its holder, the CEC preferred stock may then be redeemed at its par value of one cent per share.

According to the Trust Agreement, the trustee will maintain a separate account for each participant. Each participant's interest in the ESOP will be fully vested and nonforfeitable at all times. Conrail contributions and any income or losses of the ESOP will be allocated to the accounts of participants in accordance with the plan instrument. Benefits distributed to an individual participant in the form of Conrail or CEC stock will be based on the balance credited to his or her account.

Based on these facts and representations, you have requested opinions with respect to the following:

- (1) that the CEC preferred stock will comprise "qualifying employer securities" under section 407(d)(5) of ERISA and section 4975(e)(8) of the Code;
- (2) that the ESOP will not violate section 407 of ERISA by acquiring and holding exclusively CEC preferred stock;
- (3) that the contribution of CEC preferred stock to the ESOP and the ultimate redemption of the CEC preferred stock by CEC will not constitute a prohibited transaction under section 406 of ERISA;
- (4) that the redemption of CEC preferred stock by CEC will not result in a forfeiture under section 203(a) of ERISA; and
- (5) that the redemption of CEC preferred stock by CEC will not violate section 403(c)(1) of ERISA.

Section 406(a)(1)(A) and (E) of ERISA prohibits a fiduciary with respect to a plan from causing the plan to engage in a transaction if he knows or should know that such transaction constitutes a direct or indirect sale or exchange, or leasing, of any property between a plan and a party in interest; or an acquisition, on behalf of the plan, of any employer security or employer real property in violation of section 407(a). Section 3(14) of ERISA defines the term "party in interest" to include a fiduciary, an employer any of whose employees are covered by the plan and a corporation of which 50 percent or more of the combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of the corporation is owned by a participating employer.

Further, section 406(a)(2) of ERISA provides that no fiduciary who has authority or discretion to control or manage the assets of a plan shall permit the plan to hold any employer security or employer real property if he knows or should know that holding such security or real property violates section 407(a). Section 407(a) of ERISA, in pertinent part, imposes a general 10 percent limitation on the acquisition and holding of qualifying employer securities by a plan. Section 407(b)(1) of ERISA, however, provides, in pertinent part, that the 10 percent limitation of section 407(a) shall not apply to the acquisition or holding of qualifying employer securities by an eligible individual account plan.

Section 407(d)(1) of ERISA defines the term "employer security", in pertinent part, to mean a security issued by an employer of employees covered by the plan, or by an affiliate of such employer. Under section 407(d)(7) of ERISA, a corporation is an affiliate of an employer if it is a member of any controlled group of corporations (as defined in section 1563(a) of the Code, except that "applicable percentage" shall be substituted for "80 percent" wherever the latter percentage appears in such section) of which the employer who maintains the plan is a member. For purposes of the preceding sentence, the term "applicable percentage" means 50 percent or such lower percentage as the Secretary may prescribe by regulation. Section 407(d)(5) of ERISA defines the term "qualifying employer security" to mean an employer security which is stock or a marketable obligation. Since Conrail will retain ownership of the one issued share of CEC (voting) common stock, it is the Department's view that CEC and Conrail are affiliates as defined in section 407(d)(7) of ERISA.³ Accordingly, because CEC preferred stock is stock issued by an affiliate of an employer of employees covered by the ESOP, we have determined that such stock constitutes "qualifying employer securities" with respect to the ESOP for purposes of section 407(d)(5) of ERISA.

In addition, you inquire whether CEC preferred stock is a "qualifying employer security" under section 4975(e)(8) of the Code. In this regard, section 101(a)(7)(C) of the Technical Corrections Act of 1979 (P.L. 96-222) has amended section 4975(e)(8) to provide, in relevant part, that "the term 'qualifying employer security' means any employer security within the meaning of section 409A(1) [of the Code]." Accordingly, you may wish to direct your inquiry to the Internal Revenue Service.

² The Articles of Incorporation of CEC specify that each share of CEC preferred stock will be redeemed for one "Exchange Unit". An Exchange Unit is defined to consist of one share of Conrail common stock and/or a pro rata portion of such other securities, property or cash that may have been substituted or added to the Conrail common stock prior to the time of redemption, pursuant to distributions or other change's that may affect Conrail common stock resulting from a reorganization, recapitalization or other restructuring of Conrail.

³ Under the CEC Articles of Incorporation, CEC preferred stock will be nonvoting except with respect to the right to vote as a class on certain amendments to the Articles of Incorporation which adversely affect the rights of CEC preferred stockholders.

Section 3(34) of ERISA defines an “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.

On the basis of your representations and the information contained in your submissions, it is the Department’s opinion that the ESOP is an “individual account plan” within the meaning of section 3(34) of ERISA.

Section 407(d)(3)(A) of ERISA defines an “eligible individual account plan” as 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 ERISA and which on such date invested primarily in qualifying employer securities. Upon consideration of the representations, we have determined to consider the “ESOP” described in your submissions as a “stock bonus” plan for purposes of section 407(d)(3)(A) of ERISA.⁴ Section 407(d)(3)(B) provides, in pertinent part, that, notwithstanding section 407(d)(3)(A), a plan shall be treated as an eligible individual account plan with respect to the acquisition or holding of qualifying employer securities only if such plan explicitly provides for acquisition and holding of qualifying employer securities. Because your proposed ESOP is an individual account plan which is a stock bonus plan, and because the ESOP explicitly provides for the acquisition and holding of CEC preferred stock, we have determined that the ESOP is an “eligible individual account plan” within the meaning of section 407(d)(3) of ERISA.

Accordingly, because the ESOP is an eligible individual account plan under section 407(d)(3), which explicitly authorizes the trustee to acquire and hold an unlimited percentage of plan assets in CEC preferred stock, we have determined that the ESOP is not subject to the 10 percent limitation of section 407(a) and may, pursuant to the plan instrument and the requirements of the Rail Act, invest up to 100 percent of its assets in CEC preferred stock.

With respect to your inquiry concerning the contribution of CEC preferred stock to the ESOP and the redemption of the CEC preferred stock by CEC, section 408(e) of ERISA states, in pertinent part, that:

Sections 406 and 407 shall not apply to the acquisition or sale by a plan of qualifying employer securities (as defined in section 407(d)(5)) –

- (1) if such acquisition or sale is for adequate consideration,
- (2) if no commission is charged with respect thereto, and
- (3) if-
 - (A) the plan is an eligible individual account plan (as defined in section 407(d) (3))....

Regarding the first condition of section 408(e), section 5.02(a) of ERISA Procedure 76-1 (41 FR 36282, August 27, 1976) provides that the Department ordinarily will not issue an advisory opinion whether certain consideration constitutes adequate consideration. For that reason, the Department will offer no opinion as to whether the transactions described in your submissions will be for “adequate consideration”. Your submissions do not indicate whether a commission will be paid with respect to any of the proposed transactions. Accordingly, we express no opinion whether the second condition of section 408(e) will be met.

⁴ Section 407(d)(6) of ERISA provides that the term “employee stock ownership plan” means an individual account plan-

- (A) which is a stock bonus plan which is qualified, or a stock bonus plan and money purchase both of which are qualified, under section 401 of the Code, and which is designed to invest primarily in qualifying employer securities, and
- (B) which meets such other requirements as the Secretary of the Treasury may prescribe by regulation.

A substantially similar definition is contained in section 4975(e)(7) of the Code. The Department notes that although you describe your proposed plan as an ESOP, the plan document accompanying your submission does not contain provisions designed to comply with relevant regulations issued under sections 407(d)(6) of ERISA and 4975(e)(7) of the Code. Accordingly, it appears to us that your proposed plan designated an ESOP is in form a stock bonus plan.

Based on the foregoing, it is the opinion of the Department that section 408(e) would exempt the contribution of the CEC preferred stock to the ESOP and the ultimate redemption of the CEC preferred stock (should the Financial Benchmarks be met) if the transactions are for adequate consideration and if no commissions are charged.⁵

Section 203(a) of ERISA, in pertinent part, states that each plan must provide that an employees right to his normal retirement benefit is nonforfeitable upon the attainment of normal retirement age. Under Reorganization Plan No. 4 of 1978 (43 FR 47713, October 17, 1978), effective December 31, 1978, the authority of the Secretary of Labor to issue rulings under section 203 of ERISA has been, with certain exceptions not here relevant, transferred to the Secretary of the Treasury. Accordingly, you may wish to direct your inquiry to the Internal Revenue Service.

Section 403(c)(1) of ERISA provides, in relevant part, that the assets of a plan shall never inure to the benefit of any employer and shall be held for the exclusive purpose of providing benefits to participants in the plan and their beneficiaries and defraying reasonable expenses of administering the plan.

The question of whether plan assets inure to the benefit of an employer depends on the particular facts and circumstances surrounding the transaction. Accordingly, we express no opinion on this question. We note, however, that the requirements of the Rail Act would be important factors in making a determination under section 403(c)(1).

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,

Alan D. Lebowitz
Assistant Administrator for Fiduciary Standards
Pension and Welfare Benefit Programs

cc: John F. Fansmith, Jr., Esquire
Consolidated Rail Corporation
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Philadelphia, Pennsylvania 19104

⁵ It should be noted that any employer security acquired by the ESOP in exchange for CEC preferred stock must constitute a “qualifying employer security” within the meaning of section 407(d)(5) of ERISA.