

# Repurchase Liability Funding for ESOP (The requirements; the choices)

by

ATI Capital Group, Inc.  
222 West Las Colinas Blvd. West #1346-E  
Irving, TX 75039  
Ron J. Lint, A.S.A. (Retired)

**E**mployee Stock Ownership Plans (ESOPs) were legislated into existence as part of the Employee Retirement Income Security Act of 1974 (“ERISA”). An ESOP is, therefore, a qualified employee defined contribution plan that invests primarily in the stock of the sponsoring corporation. The purpose of ESOPs is to encourage broad based employee ownership in the private corporate sector. In order to entice company owners to offer ESOPs as an employee benefit, several powerful tax advantages were granted to companies and sellers who would agree to sell their stock, in whole or in part, to an ESOP, including tax deductible principal and interest for the company on ESOP loans,<sup>1</sup> the ability for a company to deduct dividends paid to an ESOP,<sup>2</sup> the avoidance of capital gains tax on the proceeds of the stock sale to the seller,<sup>3</sup> the ability to purchase capital goods (including, for example, an office building) for 66 cent dollars,<sup>4</sup> the ability to purchase another company for 66 cent dollars,<sup>5</sup> and restructuring of existing debt, allowing for the repayment of same with 66 cent dollars.<sup>6</sup> The tax and financial advantages of a properly instituted ESOP are significant and merit serious consideration by company owners and financial advisors alike.

Advantages are also provided for the employee/participant. Upon death, permanent disability, retirement, or separation from service following vesting of benefits, employees have the right to ‘Put’ the company shares held in their qualified plan accounts to the company, and the company must repurchase the shares at the current fair market value, as determined by an independent valuation expert. The ‘Put’ is required by law.<sup>7</sup> The sponsoring company must repurchase the stock, and in order for the plan to be in compliance (thus enjoying the tax advantages), the company must provide “adequate security” for this repurchase obligation.<sup>8</sup> If “adequate security” is not provided, the plan could lose its tax-exempt status.<sup>9</sup>

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<sup>1</sup> IRC §404(a)(9)(A) and §404(a)(9)(B), respectively.

<sup>2</sup> IRC §404(k)(1).

<sup>3</sup> IRC §1042.

<sup>4</sup> IRC §404(a)(9) and IRC §404(k)(1).

<sup>5</sup> See Footnote #4.

<sup>6</sup> See Footnote #4.

<sup>7</sup> IRC §409(h) and Reg. §54.4975-7(b)(10).

<sup>8</sup> IRC §503(a)(1); §1.503(b)-1(b)(1) of the Income Tax Regulations; IRC §409(h)(5)(B); IRS Announcement 95-33; §408(b)(1) of ERISA; §2550.408b-1 of the DOL Regulations; Internal Revenue Manual 4.72.4.2.8 (08-13-2001) and 4.72.4.2.8.1 (08-13-2001); IRS Letter Ruling 9438002, April 29, 1994; Revenue Ruling 80-269.

<sup>9</sup> IRC §401(a)(23) and §409(h).

As a result of improperly installed ESOPs, ESOP scams (particularly with regard to 'S' corporation ESOPs), and the current environment following ENRON, the Department of Labor ("DOL") and the Internal Revenue Service ("IRS") are vigilant about ensuring that ESOPs are structured properly and that they, indeed, can honor the 'Puts' as they occur. We, as practitioners, are equally serious about proper structuring and not being associated with any ESOP transaction that does not, whether by design or by inaction, provide a properly planned funding mechanism for honoring 'Puts' as they come due. Likewise, the sponsoring corporation should be even more acutely aware of the need to provide a funding program for the market that they created for company stock by installing an ESOP. This employee benefit must be honored; employees must be paid. Setting up an ESOP, which immediately benefits the Seller (usually the founder of a private company) and, by its very existence, creates a market for private-company stock, but then fails to adequately fund that market, is avaricious and particularly repugnant to all that is fair and just in dealing with one's employees.

**The Invisible Liability:** The question being asked about funding mechanisms is: How should a company fund for this emerging liability, which, by the way, the AICPA (American Institute of Certified Public Accountants) does not require be booked on the financial statements of the sponsoring corporation? Because GAAP (Generally Accepted Accounting Principles) does not require the booking of this liability (a real liability, not a contingent one), and because repurchase liability can be put off for the duration of the original ESOP loan, with respect to vested terminations, company management often becomes lulled into a false sense of security. Unfortunately, practitioners often encourage this counterfeit sense of well-being, followed by a protracted lack of good ole common sense business planning. Practitioners and sponsoring company management alike seem to think that this future challenge will somehow take care of itself. Management often makes the statement: Well, that problem won't occur for a number of years; we'll be able to self-fund by that time. I'll worry about it later. The fact is that if an ESOP company does not immediately start funding for this emerging liability, and continue a reasonable program from that point on, it will not be able to catch up, and the company could subsequently be destroyed by inaction. This is the source of much of the yellow journalism about ESOPs. It's not the ESOP that causes the problem; it's the inaction and prevarication of management, often exacerbated by inept professional advice. An unfunded ESOP is like two freight trains (one, an unwary company; the other, unaware employees) dead-heading toward each other on the same track. A devastating collision will occur at some point.

It is often the case that management does not fully realize just how significant the repurchase liability can become. Take, for example, a \$10 million ESOP transaction. Then suppose that the company does not grow at all over the next twenty years. A Repurchase Liability Study (an actuarial study estimating the extent of the liability over a twenty-year period) will then show that the company will have to come up with \$10 million over that twenty-year period in order to honor 'Puts.' Where is the money coming from? Now assume that the company grows reasonably, which it probably will, and the Repurchase Liability Study indicates that the company will have to come up with, say, \$20 million over the next twenty years. Again, where is the money coming from? To

further exacerbate the problem, some participants may die, or become permanently disabled, thereby becoming 100% vested and eligible to receive a payout from the company. In addition, ESOPs have diversification rules that allow qualifying participants to require the ESOP to diversify a significant portion of their account balances, as certain milestones are reached. Again, where is the money coming from? These unplanned payouts can occur at the most inopportune time, from a corporate financial point of view. Most ESOP companies are not aware of the critical nature of repurchase liability and they don't plan for it in any methodical or reasoned manner.

**Adequate Security Defined:** Having established the legal requirement for a 'Put Option' in every ESOP plan established by a non-publicly-traded company, and having shown that 'Puts' must be "adequately secured,"<sup>10</sup> the question remains as to the definition of "adequate security." Neither §4975(e)(7), nor §409(h) of the Internal Revenue Code of 1986, as amended ("the Code"), to include the regulations there under, define the term "adequate security." However, the regulations under §503 of the Code do provide an instructive definition. Section 503 of the Code denies exempt status to certain organizations, including those described in §4975(g)(2) or (3) of the Code (certain governmental and church plans), that engage in prohibited transactions. ESOP transactions not properly designed to include "adequate security" could clearly result in the denial of exempt status, or the loss of all tax advantages, and the possible imposition of interest and penalties.

The Income Tax Regulations<sup>11</sup> and the DOL Regulations<sup>12</sup> provide that something more than the company's promise to pay is required. In order to support the claim of "adequate security," something else must be pledged that can be sold, foreclosed upon, or otherwise disposed of to pay off the debt to the plan participant. The regulations go on to state that "*the value and liquidity of which security is such that it may reasonably be anticipated that loss of principal or interest will not result.*" Therefore, the regulations clearly require more than a promise to pay by the company:

*Additional security must be pledged, and that security must be tangible and accessible. It must be saleable, or foreclosable, and the security must not be subject to any unreasonable loss of principal or interest. In addition, it is necessary that a chattel mortgage, or some other proof of claim be recorded and that property be clearly identified.<sup>13</sup> Furthermore, a Put Option is not "adequately secured" by the promissory note of a company, even if secured by the full faith and credit of the company.<sup>14</sup> (Emphasis added.)*

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<sup>10</sup> See Footnote #8.

<sup>11</sup> §1.503(b)-1(b)(1) of the Income Tax Regulations.

<sup>12</sup> §2550.408b-1 of the DOL Regulations.

<sup>13</sup> Rev. Rul. 80-269, and §1.503(b)-1(b)(1) of the Income Tax Regulations.

<sup>14</sup> Rev. Rul. 80-69; IRS Announcement 95-33.

So far, we have determined that “adequate security” must be tangible, accessible, saleable, foreclosable, and not subject to the unreasonable loss of principal or interest. Moreover, we have learned that a chattel mortgage, or some other proof of claim, be recorded and that the security be clearly identified. A chattel is a personal possession, including tangible goods. A chattel mortgage is a recorded mortgage on a movable item of property (not real estate). We have also learned that the promissory note of the company, even if secured by its full faith and credit, is not sufficient to be considered “adequate security.”

In an attempt to more clearly understand the definition of “adequate security” as intended by the IRS, we now turn to Part 4 of the Internal Revenue Manual, which states that a Put Option is not “adequately secured” if it is not secured by tangible assets.<sup>15</sup> The Manual goes on to offer examples of “adequate security,” including: an irrevocable letter of credit, a surety bond issued by a third party insurance company rated “A” or better by a recognized insurance rating agency, or a first priority perfected security interest against company assets capable of being sold, foreclosed upon, or otherwise disposed of in case of default. Moreover, the insufficiency of notes secured by the company’s full faith and credit is made clear.

Note that in two of the three examples proffered, the IRS intends that the security be guaranteed by a third party (a bank or an insurance company). In the third example, a perfected security interest in the company’s assets is required. Moreover, it is clear that the assets must be tangible and have real value in the open market. “Adequate security,” therefore, must possess the following eight attributes:

1. Tangible
2. Accessible
3. Saleable
4. Foreclosable
5. Possess real cash value
6. Not subject to any unreasonable loss of principal or interest
7. Supported by a formal recording or chattel mortgage
8. Preferably guaranteed by a third party

**Examples Proffered by the IRS:**

An irrevocable letter of credit

A surety bond

A perfected interest in the company’s hard assets (recorded)

It is clear from the examples suggested by the IRS that ‘Puts’ must be secured by real assets that are set apart for one purpose only: payments to participants. And, it is clear that the IRS intends that these ‘Puts’ be paid. Notice, however, that the examples proffered by the IRS are problematic. Two of the three examples provided are neither saleable nor tangible (surety bonds and irrevocable letters of credit). Moreover, private companies involved in a leveraged ESOP transaction rarely have the capacity to

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<sup>15</sup> IRS Manual Part 4, §4.72.4.2.8.1, ¶3.

obtain an irrevocable letter of credit. Furthermore, a company with a highly leveraged ESOP will almost always have a loan agreement that precludes the company from giving anyone but the lender a security interest in the tangible assets of the company. To complicate the problem further, at this writing, there is no company in the United States that offers surety bonds for leveraged ESOPs. We are left with uncertain guidance from the IRS in terms of the examples offered; however, the goal is clear: 'Puts' must be paid. It is necessary, therefore that each ESOP company design a funding mechanism that satisfies the intent of the IRS requirements.

**The Quantification of Puts:** We have established that repurchase liability is a real and emerging liability. We have established that the 'Puts' that create this liability must be paid, and that the resources must be set aside to honor this obligation. However, in order to honor this obligation, one must know the amount of the obligation. This brings us to yet another great failing of many Plan Sponsors, Trustees, or other plan administrators. Rarely are studies done to determine the extent and amount of the repurchase liability. Sometimes an attempt is made to determine the extent of the liability, but it is sophomoric at best, usually produced on a spreadsheet showing anticipated retirements. A real Repurchase Liability Study is a sophisticated actuarial study showing anticipated cash needs over a twenty-year period. The study takes into account various labor tables to determine terminations, ages and gender of all participants, growth expectations of the company, interest rates, distributions due to age and time in the plan, disability, retirement, and death.

Once a proper study is completed, the company and the Plan Trustee can easily determine cash needs for repurchase liability for many years to come. Armed with this knowledge, the company can then build a funding plan that makes sense – one that is not over or under funded.

**Methods of Funding for Repurchase Liability:** There are seven basic methods of addressing the issue of repurchase liability. We do not consider a blended approach to be a separate method. Each will be discussed in light of IRS and DOL requirements, and specifically the eight attributes previously listed. A grade will be assigned based upon the number of attributes violated: four or more attributes violated = F; three attributes violated = D; two attributes violated = C; one attribute violated = B; no attributes violated = A. Note that attributes #4 and #7 appear to be closely associated, in a legal sense. For purposes of this analysis, however, no attempt is made to tie them together, or to specifically define their differences from a legal perspective.

1. **Pay-As-You-Go Method:** Under the pay-as-you-go method, the company will implement a strategy of paying future distributions resulting from the ESOP out of future cash flow of the company, or future borrowing. The company will need to properly and accurately budget for the projected repurchase liability. If the company does not adopt other funding methods, the valuation professional will probably discount the value of the stock of the company because of the lack of set-aside funds to cover the coming repurchase liability.

Analysis:

- a. This is an excellent example of “I’ll worry about it later.” Companies that adopt this method normally exacerbate the problem by not engaging a repurchase liability study. There is literally no planning, trusting instead on the good fortunes the future will surely hold. In essence, management has decided to do nothing.
  - b. Since the company is not setting aside funds, no income tax advantages are available. The company will be purchasing stock with after-tax dollars.
  - c. The company will be devalued due to the unfunded liability.
  - d. With regard to the eight attributes, this method appears to violate all eight.
  - e. Overall grade:
2. **Sinking Fund Method:** The sinking fund can take many forms. For example, a company could decide to simply start a savings account and make regular payments to it. Similarly, a company could decide to make regular payments to an investment account that would then be invested into stocks, bonds, or mutual funds. All deposits are made with after-tax dollars.

Analysis:

- a. The sinking fund is an asset of the corporation; therefore, causing little diminution to equity.
  - b. All contributions to the fund are made with after-tax dollars.
  - c. All of the investment growth inside the sinking fund is subject to current taxation.
  - d. In that the sinking fund is an asset of the corporation, it is subject to the claims of creditors. This is especially true since companies rarely actually earmark such funds as belonging solely to the plan. Furthermore, the assets of the fund are rarely professionally managed.
  - e. Since the company is funding for the liability, the company will not be devalued.
  - f. With regard to the eight attributes, this method, as normally operated, appears to violate numbers 6, 7, & 8. If, however, the Board of Directors of the company properly and legally earmarks (sets aside) the sinking fund for the exclusive purpose of funding ‘Put’ obligations, and if the fund is professionally managed, then this method appears to violate only number 8, due to the improved operation.
  - g. Overall grade: D (in the normal operation), or C/B (in the improved operation).
3. **S-Corporation Method:** Beginning on January 1, 1998, earnings from an S-Corporation owned by an ESOP (“S-ESOPs”) are not subject to federal income tax. As a result, S-ESOPs have the ability to accumulate cash in a repurchase account inside the ESOP. This allows that none of the funds required to repurchase stock be subject to taxation.

Analysis:

- a. The unusually good tax treatment of S-ESOPs does not diminish the requirement to fund (set aside cash) for the repurchase liability. Therefore, if funds are not set aside, this method is not much better than the Pay-As-You-Go Method. Tax treatment is one thing; setting aside funds is quite another.
  - b. If the funds were set aside inside the ESOP, then they would not be subject to the claims of creditors. On the other hand, if the funds were set aside in the company, then they would be available to the claims of creditors.
  - c. If funds were not set aside, the company would be devalued due to a lack of funding for repurchase liability.
  - d. Assuming the funds were set aside inside the ESOP, Trustees often will have a problem agreeing to repurchase stock on an on-going basis. It is the fiduciary responsibility of the Trustee to determine if it is in the best interest of the participants to purchase additional company stock. Making this determination upfront is problematical.
  - e. With regard to the eight attributes, this method appears to violate numbers 6 (assuming a lack of professional investment management), 7 (assuming no legal requirement to set these funds aside to honor 'Puts'), & 8.
  - f. Overall grade: D (in the normal operation), or C/B (in the improved operation).
4. **Recycling Method:** Under the recycling method, the company would make cash contributions to the ESOP for the purpose of the ESOP purchasing all or some of the stock from terminated participants. Since the goals of the company are to retain and attract talented employees, and perpetuate the company, this method permits the ESOP to continue in existence by repurchasing shares of stock from departing participants. From the company's viewpoint, it would receive a tax deduction for contributions of cash made to the ESOP to the extent allowed under IRC §415. Additionally, the Trustee is making a fiduciary decision (upfront, without knowing the desirability of stock ownership in the future) to purchase the stock from all departing participants. In this case, the ESOP would have first right of refusal on honoring 'Puts.'

Analysis:

- a. The payments made to the ESOP are tax deductible to the corporation.
- b. The collection of funds by the ESOP is not subject to the claims of creditors.
- c. The payments made to the ESOP cause a diminution of assets and equity on the balance sheet of the company.
- d. Since the company is funding for the liability, the company will not be devalued for non-funding, although in some cases, where asset-based valuation methodologies are employed, the company may still suffer some loss in fair market value.
- e. This method is not in the best interest of the company in that the company gives up the ability to make certain decisions with regard to 'Put' shares. If the 'Put' goes to the company, management may decide on one of the following options: 1) retire the stock, once it is purchased into the Treasury, thus

- reducing the ownership of the ESOP; 2) sell the 'Put' shares to another party (i.e., management); or 3) contribute the 'Put' shares to the ESOP, taking another tax deduction, and extending the life of the ESOP.
- f. Often Trustees will have a problem agreeing to repurchase stock on an on-going basis. It is the fiduciary responsibility of the Trustee to determine if it is in the best interest of the participants to purchase additional company stock. Making this determination upfront is problematical.
  - g. With regard to the eight attributes, this method appears to violate number 5 (if timely contributions are not made), number 6 (if one assumes that the funds would be invested in the market, with the risks inherent therein, but not professionally managed), and number 8.
  - h. Overall grade: D (in the normal operation), or C/B (in the improved operation).
5. **Stock Option Method:** Under the stock option method, the company establishes a stock option program for its key employees (or, in some cases, all employees) permitting them to purchase stock of the company either as (1) the stock is repurchased by the company from participants of the ESOP (as a result of 'Puts' to the company), or as (2) the stock is made available to employees tied to the repurchase obligation of the ESOP. Under both scenarios, the company uses the cash received from such employees at the time of exercise of the stock option to satisfy its repurchase liability obligation.

Analysis:

- a. If the stock is purchased from the company by the optioning employee, following the company's purchase of the stock from the departing participant, there is no tax advantage to the company. Likewise, if the ESOP effectuates the initial purchase from the departing participant, there is no tax advantage to the company.
- b. This is another example of "I'll worry about it later." Companies that adopt this method also normally exacerbate the problem by not engaging a repurchase liability study. There is literally no planning, trusting instead on the good fortunes the future will surely hold with respect to the ability of various other people being financially capable and desirous of funding the repurchase obligation. In essence, management has decided to do nothing.
- c. The repurchase liability is actually not funded at all in that the potential purchasers cannot be required to purchase the stock 'Put' to the company or the ESOP. This system can be the cause of multiple lawsuits.
- d. Since the company is not setting aside funds, no income tax advantages are available. The company will be purchasing stock with after-tax dollars.
- e. The company will be devalued due to the unfunded liability.
- f. With regard to the eight attributes, this method appears to violate all eight.
- g. Overall grade: F.

6. **Qualified Plan Method:** Under the qualified plan method, the company would expand its profit sharing plan, and possibly its 401(k) plan, to invest in stock of the company.

Analysis:

- a. Under ERISA, qualified plans, other than ESOPs, are prohibited from purchasing stock in the sponsoring company beyond a small percentage of their overall portfolio. This method does not provide for repurchase liability at all.
  - b. The company will have no additional tax advantages using this method.
  - c. As in method #4, the repurchase liability is actually not funded at all in that the potential purchasers cannot be required to purchase the stock 'Put' to the company or the ESOP. This system can also be the cause of multiple lawsuits.
  - d. The company will be devalued due to the unfunded liability.
  - e. With regard to the eight attributes, this method appears to violate all eight.
  - f. Overall grade: F.
7. **Corporate-Owned Life Insurance Method:** Under the corporate-owned life insurance method (the "insurance method"), the company purchases life insurance contracts on the lives of selected company management personnel. The company is also the beneficiary of the policies. A select few of the top insurance companies have product lines particularly suited to ESOP transactions. The selection of a top-rated carrier, with ESOP experience and a thorough understanding of appropriate product lines for funding repurchase liability is essential. In general, the repurchase liability obligation is funded by the build-up of cash value inside the policies, which remains as an asset on the books of the corporation. As a result, the company experiences very little diminution in equity. Typically, the amount of life insurance purchased by the company is determined by a properly constituted Repurchase Liability Study, which will detail the amount of cash needed to fund 'Puts' over the next twenty years. The policies generally invest very conservatively, and sometimes contain an index feature, which ensures a minimum return on investment, thus protecting the corpus and guaranteeing that sufficient cash will be available for 'Puts.' This method insures the management of a qualified outside party, and the policies constitute a formal agreement. Moreover, all of the investment growth inside the policies is tax-deferred, although the initial purchase utilizes after-tax dollars. Unique to any other funding method, the life insurance method provides a death benefit at some point in the future. This added benefit, payable to the company, is not considered in the Repurchase Liability Study, which concentrates on the guaranteed build-up in cash value. Therefore, when a death benefit becomes payable, the inflow of funds into the company generally serves to offset all past and future cost of the ESOP program.

Analysis:

- a. The initial insurance contracts are purchased with after-tax dollars.

- b. There is a cost of insurance (administrative costs and commissions) associated with this funding mechanism that is not present in the other methods.
- c. All of the investment growth inside the policies is tax-deferred.
- d. The insurance method is generally backed by a formal Repurchase Liability Study to determine the amount of insurance necessary. Thus no over/under funding.
- e. In that the cash value is an asset of the corporation, it might be subject to the claims of creditors. However, insurance funding programs generally earmark the cash value of the policies specifically for the payment of 'Puts' presented by departing participants. A formal agreement is drafted between the ESOP and the company, setting the cash value aside for plan participants. This makes the claims of creditors much more difficult to perfect.
- f. The insurance contracts will eventually provide death benefits, which will serve to negate all past and most future program costs. It is this death benefit that overwhelms the previously mentioned cost of insurance, making this method of funding ultimately the least expensive by far. In addition, the death benefit will serve the added function of funding for the Key-Man purposes.
- g. Investments within the insurance contracts are professionally managed.
- h. Since the company is funding for the liability, the company will not be devalued.
- i. The funding mechanism provided by insurance contracts offers the much needed third-party guarantee of benefits, sometimes through an index arrangement that guarantees a minimum investment return.
- j. With regard to the eight attributes, this method appears to satisfy all eight requirements, and is the only funding program to do so.
- k. Overall grade: A.

**Conclusion:** It is clear from the Code and all the other citations provided that the IRS and the DOL intend that 'Puts' will be "adequately secured." We have also derived eight attributes of "adequate security." We have carefully analyzed all seven methods of repurchase liability funding and found that only one, the Insurance Method, appears to fully satisfy all eight requirements. Furthermore, it is our opinion that the Insurance Method is by far the least expensive method of funding, this due to the tax deferred growth of the investments within the policies, and the eventual death benefit that is paid to the company.

Whichever method is chosen, every company that already has an ESOP, and every company considering one must seriously ponder the issue of repurchase liability funding. The natural consequence of initiating an ESOP is to create a market for company securities. Moreover, initiating an ESOP brings with it a payment obligation to departing employees - the 'Put.' The 'Put' is a matter of law, being required in ERISA. The law requires that 'Puts' be paid in accordance with the plan document and ERISA. So, what do we have? We have a new market created for company stock, and the company must pay departing employees the fair market value of the stock in their account balances, in accordance with the requirements of the plan document. It logically

follows that the created market must be funded and “adequately secured.” To fail in this is to breach the fiduciary responsibilities of management and the Trustee.

ESOPs are perhaps the most powerful tool of corporate finance to have ever been created. Congress gave the private business world this gift in 1974, but it must be accepted realistically and effectuated with wisdom and business acumen. Properly installed, an ESOP program will save enormous tax dollars, as well as provide incentives for the working force that will effectively drive the ESOPed company to previously unimagined levels of success. But, you have to do it correctly, with no shortcuts!!

<b>Repurchase Liability Funding Methods - Graded</b>					
<b>Method</b>	<b>A</b>	<b>B</b>	<b>C</b>	<b>D</b>	<b>F</b>
Pay as You Go					<b>X</b>
Sinking Fund *		<b>X</b>	<b>X</b>	<b>X</b>	
S-Corporation *		<b>X</b>	<b>X</b>	<b>X</b>	
Recycle *		<b>X</b>	<b>X</b>	<b>X</b>	
Stock Option					<b>X</b>
Qualified Plan					<b>X</b>
Corporate-Owned Life Insurance	<b>X</b>				

\* = Grade depends upon compliance with the Eight Attributes.

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