What is Corporate Governance?

The process of allocating duties and authority among a company’s shareholders, Board of Directors and management.

What Does Corporate Governance Mean in an ESOP Context?

A well structured, competent and involved Board of Directors, working appropriately with the independent ESOP Trustee, is one of the most effective means of protecting the interests of employee-owners in an ESOP company.
What is Different in an ESOP Company?

- Trustee-owner’s actions are governed by ERISA law in addition to corporate law
- The Board of Directors will also have certain duties governed by ERISA, such as the appointment and monitoring of the Trustee
- Employees have expectations as beneficial owners
- The interaction of these multiple legal rules in ESOP company corporate governance can:
  - Enhance value (the “perfect recipe”) or
  - Lead to problems (“spoiling the broth”)

What is the ESOP’s Role in Corporate Governance?

The ESOP is Represented by the Trustee

Trustee (on behalf of Shareholders) Elect The Board Of Directors

The Board of Directors is the elected Body Responsible for the Direction of the Company

ESOP TRUSTEE IS:
- Appointed by the Board of Directors
- A Fiduciary
- Either an Institution or One or More Individuals
- The Legal Owner of Shares
- The Entity Which Votes Shares on All Matters
- Allowed to Solicit Voting Instructions from Participants on Major Issues

Board of Directors

In order to Operate the ESOP or Assist Communication, the Board May Make Use of Various Committees

Appoints Officers & Determines Compensation of Company Leadership

Officers and Extended Leadership Team Manage the Company Day to Day

- ESOP Administration
- Communications
- Other Committees
Role of the Board of Directors

- Make business judgments intended to grow shareholder value
- Set corporate strategic goals and business strategy
- Appoint officers and ESOP Trustee
- Advise CEO and management
- Evaluate and approve significant corporate transactions, including complete sale of the company or its assets
- Balance the interests of corporate constituents – creditors, employees, management, shareholders, including the ESOP

Role of the Board of Directors (cont’d)

- Review corporate financial statements
- Evaluate management performance
- Facilitate succession planning
- Determine management compensation
- Establish corporate standards and rules of conduct
Role of the Board of Directors (cont’d)

• Declare C Corporation dividends or S Corporation distributions
• Adopt, amend, and/or terminate ESOP and other qualified plans
• Determine contributions to ESOP and other qualified plans
• Appoint ERISA fiduciaries and provide oversight to ESOP and other qualified plan fiduciaries
• Retain independent advisors to Board of Directors and its committees

Key Board of Directors Committees

• Audit Committee
• Executive Compensation Committee
• Governance Committee
• Nominating Committee
• Executive Committee
• All committees are not always applicable or possible in all ESOP companies
Governance Practices at Carl Warren

Board of Directors
- Majority are OUTSIDE directors (i.e. independent)
- Audit Committee are ALL OUTSIDE directors – CFO then issues reports to them and is invited to present
- Compensation Committee are ALL OUTSIDE directors – CEO issues reports and makes recommendations to them

Board Meetings
- Three weeks after quarter end to report out results, discuss challenges, opportunities and seek GUIDANCE
- Certain key managers of the Company will do presentations based on current and emerging issues

FBTS: Board Understanding of the ESOP – Utilize a “State of the ESOP” Presentation to the Board

Educating the Board with respect to the meaning of the ESOP Repurchase Obligation guides prudent corporate decisions to benefit the ESOP.

• Strategic Level Overview (not administrative detail) on rebalancing, reshuffling decisions, the impact of installment payments versus lump sum

• Valuation Procedures to allow the Board focus on drivers to value

• Goal: Dialogue between the Trustee and the Board that creates an open line of communication
How do you Find The Perfect Recipe?

• Write it Down:
  _ Use a Calendar
• Memorialize the Changes Needed:
  _ This Mandates an Annual Review
• Label the Calendar a Time and Responsibility Schedule to ensure the parties involved pay attention to their role and the deadlines.
<table>
<thead>
<tr>
<th>DATE COMPLETED</th>
<th>DUE DATE</th>
<th>TASK</th>
<th>RESPONSIBLE PARTY</th>
</tr>
</thead>
<tbody>
<tr>
<td>12</td>
<td></td>
<td>TPA completes testing and compliance requirements for COMPANY benefits plans</td>
<td></td>
</tr>
<tr>
<td>13</td>
<td></td>
<td>TPA completes ascension process, annual ascension test and coverage test and sends &quot;sample participant statement&quot;</td>
<td></td>
</tr>
<tr>
<td>14</td>
<td></td>
<td>COMPANY reviews &quot;sample participant statement&quot; and sends changes to TPA</td>
<td></td>
</tr>
<tr>
<td>15</td>
<td></td>
<td>TPA completes participants statements and sends to COMPANY</td>
<td></td>
</tr>
<tr>
<td>16</td>
<td></td>
<td>TPA sends ESOP package for audit to COMPANY (manuals/notebooks for FYE)</td>
<td></td>
</tr>
<tr>
<td>17</td>
<td></td>
<td>Distribute participant statements and all other required disclosure materials</td>
<td></td>
</tr>
<tr>
<td>18</td>
<td></td>
<td>COMPANY begins to prepare for ESOP audit</td>
<td></td>
</tr>
<tr>
<td>19</td>
<td></td>
<td>Begin Repurchase Liability Study</td>
<td></td>
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<tr>
<td>20</td>
<td></td>
<td>Independent Audit firm begins audit fieldwork</td>
<td></td>
</tr>
<tr>
<td>21</td>
<td></td>
<td>Transfer Cash to ESOP Bank Account for Interest Contribution</td>
<td></td>
</tr>
<tr>
<td>22</td>
<td></td>
<td>COMPANY files corporate tax returns</td>
<td></td>
</tr>
<tr>
<td>23</td>
<td></td>
<td>ESOP Financial Statement issued (FINAL VERSION)</td>
<td></td>
</tr>
<tr>
<td>24</td>
<td>7/30/2011</td>
<td>File 5500 tax return for 2009 or Extension</td>
<td></td>
</tr>
<tr>
<td>25</td>
<td></td>
<td>Repurchase Liability Study completed</td>
<td></td>
</tr>
<tr>
<td>26</td>
<td>9/15/2011</td>
<td>Transfer Cash to ESOP Bank Account</td>
<td></td>
</tr>
<tr>
<td>27</td>
<td></td>
<td>Complete Resolution Confirming Contribution</td>
<td></td>
</tr>
<tr>
<td>28</td>
<td>9/15/2011</td>
<td>Transfer Cash to ESOP Bank Account</td>
<td></td>
</tr>
<tr>
<td>29</td>
<td></td>
<td>Record ESOP contribution accrual and release of shares</td>
<td></td>
</tr>
<tr>
<td>30</td>
<td>10/17/2011</td>
<td>File 5500 tax return (IF UNFILED)</td>
<td></td>
</tr>
<tr>
<td>31</td>
<td></td>
<td>ESOP Plan document review and amendments, if necessary</td>
<td></td>
</tr>
</tbody>
</table>
How Does Corporate Governance Apply in Third Party Transactions?

- Example of Open Communications:
  - Reaction to an Informal Indication of Interest

- Pass-Through Direction Procedures:
  - Best practices mandate confidentiality of participant directions in providing pass-through directions

Corporate vs. ERISA Fiduciary Standards

- Corporate law generally presumes good faith by members of the Board of Directors making a Business Judgment, applying a gross negligence standard of review
  - Business Judgment Rule (Delaware): The court presumes that the directors’ actions were informed, in good faith, and in honest belief that they were in the best interests of the company
  - Burden of proof is on the shareholder to overcome presumption (i.e., they must show that the directors violated duties of care, loyalty, or good faith)
Corporate vs. ERISA Fiduciary Standards (cont’d)

- ERISA fiduciary is held to the highest standards of prudence, skill, and care and must act solely in the interests of participants and beneficiaries;
- Burden of proof is on the ERISA fiduciary
- Generally, a “rebuttable presumption” that an ERISA fiduciary has acted appropriately if the plan document is followed

What is Success in an ESOP Company?

- Business survival & growth
- Increase in stock value
- Repurchase of company stock from departing employees
- Adequate provision for employee retirement
- Employee participation in individual operational decisions to increase quality, productivity and profitability
How can these success factors be communicated to ESOP Participants?

- Employee owners need to understand the key performance metrics that drive the business
  - Monitor and track performance
  - Celebrate and reward wins

- Understanding and communicating the numbers
  - Education and communication drive overall business literacy
  - There is a “line-of-sight” between hitting targets and succeeding as a company

- Managing the business is a shared responsibility amongst all employee owners
  - The best companies try to do a better job of looking forward
  - Everyone needs to get involved

- Reinforcing the message
  - Results drive the size of the pool and compensation incentives
  - Earnings growth is the primary factor that drives company value and stock appreciation

Questions?
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