The Basics of ESOP
Corporate Governance

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Corporate Governance

Shareholders — Board of Directors

Trustee

Officers/Management

Plan Administrator/Administrative Committee

ESOP Appraiser

Employees/ESOP Participants

Third Party Administrator (TPA)
Corporate Governance

- Identifying the Parties
- Shareholder Responsibilities
- Board Responsibilities
  - Plan Administrator Responsibilities
    - Administrative Committee
  - Plan Trustee Responsibilities
  - Officer Responsibilities
- ESOP Control
- Process and Documentation
- Fiduciary Obligations
Fiduciary Duties of an ERISA Fiduciary

- DOL regulations
- The Exclusive Benefit Rule
  - Solely in the interest of plan participants
  - Defraying reasonable plan expenses (due diligence)
- The Prudent Person Rule
  - Act with the care, skill, prudence, and diligence under the circumstances of a prudent man acting in a similar capacity
- Diversification
  - ESOPs are designed to invest primarily in qualifying employer securities
- Follow the Plan Documents
Ongoing Duties of an ESOP Trustee

• Voting ESOP Shares to Select the Board of Directors
• Managing Assets of the ESOP Trust
• Establishing the Annual ESOP Stock Price
• Following Plan Documents
• Satisfying ERISA Fiduciary Responsibilities
• Documenting the process
Corporate Fiduciary Duties

- **State Law**
- **Fiduciary Duties of Shareholders**
  - Protect all shareholders, including minority shareholders
- **Fiduciary Duties of Board of Directors**
  - Duty of Care to act prudently
  - Duty of Loyalty to act in good faith and in the interests of the company and its shareholders
  - Duty of Obedience to remain faithful to the purpose of the company
  - Minutes should reflect conflicts of interest and solution to conflict
- **Fiduciary Duties of Officers**
  - Share financial information with shareholders
Roles and Responsibilities

• Board of Directors
  • Establishes the strategic vision and direction of the company
  • Oversees the CEO and Management
  • Enhance shareholder value – must keep within the company’s core values
Roles and Responsibilities

• ESOP Trustee
  • Engage with the Board of Directors to be sure the ESOP’s best interests are being met
  • Represent the interests of the ESOP as a whole
  • Protect the best interest of the ESOP participants
Roles and Responsibilities

• Management of the company
  • Guided by the CEO
  • Implement strategic vision and direction
  • Keep within the bounds of the company core values
Roles and Responsibilities

• The board is responsible for managing the business of the corporation

• The Board acts in a fiduciary capacity with respect to all shareholders
Board Duties

- Due Care –

- Loyalty
  - Good Faith
  - Full and Fair Disclosure
  - Oversight
Board as an ERISA Fiduciary

• Board are ERISA fiduciaries
  • Exercise control over plan assets
  • Discretionary authority over plan management or administration
• Appoint an ESOP named fiduciary – Trustee or Plan Administrator
ERISA Fiduciary

- Solely in the best interest of plan participants
- With the care, skill and prudence that a prudent person acting in a like capacity familiar with such matters would use under the same circumstances
- In accordance with the plan documents
Approving Stock Value

- ESOP stock value is determined by the trustee
- Is supported by the valuation firm
- ESOP can pay no more than fair market value
- Must be valued annually and as of the date of any sale or purchase
Pass through Voting

- May be required by the plan – check it out!
Mirror Voting

• May be required with pass through vote
ESOP Fiduciaries

- Operate the ESOP within the terms of the plan document and ERISA
- Trustee is the legal owner of the stock and other assets held by the ESOP
Transaction

- Purchase and or Sale of Stock
- Involves:
  - Board of directors
  - Selling shareholders (non-ESOP) and advisors
  - Company and advisors
  - Trustee and advisors
    - ESOP does not pay more the fair market value
    - Financing terms are no more than the market will bear
    - Overall transaction is fair to the ESOP
Internal Trustees and Valuation

• Selection of the Trustee
  • Committees vs. Sole Trustee
• The Appraiser
• Due diligence
• Read and Understand the Valuation Report
  • Is narrative correct
  • Understand assumptions and methodologies
• Document correspondence with valuation firm
• Trustee ultimately determines value
Potential Pitfalls

- Self dealing / conflicts of interest
- Qualifications and Independence of appraiser
- Inconsistencies in the report
- Does the narrative match the actual financials
- Projection vs. historical achievement
- Are standard methodologies employed
- Consideration of deferred comp and other equity instruments
- Justification of premiums or discounts
- Repurchase obligation considered
Being Prudent

• Hold regular meetings
  • Document the minutes of the meetings
  • Address tough issues

• Develop a written review policy
  • What steps are taken on an annual basis to approve valuation

• Regular correspondence with advisors of key events
• If a decision is to be made and don’t understand the impact to value…ask
Corporate Governance:
The Legal Perspective
Traditional Corporate Governance

Shareholders

Board of Directors

Officers
ESOP Governance

ESOP Trustee (Shareholder) → Board of Directors → Officers
Can the circularity of the Trustee and Board of Directors cause issues?

Short Answer: On rare occasions, yes.
Other Corporate Governance Questions/Tips

1) Find your Articles of Incorporation and Bylaws and read them (shares authorized, Board seats, etc.)

2) Who are your Officers? Are there Board Resolutions naming them?

3) Is there a Board Resolution naming the Trustee(s)?
QUESTIONS?
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