ESOP GOVERNANCE/DUTIES OF THE INTERNAL TRUSTEE

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ESOP GOVERNANCE

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What is Corporate Governance?

Corporate Governance is a framework for allocating authority and responsibilities among the shareholders, Board of Directors (BOD) and management to achieve the growth and success of the Company.

- Subject to State Law
- Subject to Articles of Incorporation and By-laws
Responsibilities in Corporate Management

• **Shareholders:** Elect Board of Directors, vote on fundamental corporate matters.

• **Board of Directors:** Responsible to shareholders to grow value: establish corporate objectives; establish standards of conduct and governance; hire, compensate, monitor and advise management and committees; approve significant transactions, review finances.

• **Management:** Oversee day-to-day operations, execute Board strategy.
Corporate Governance Standards

Determined under State Law (13-C MSRA 831, 832)

• **Standards of Conduct:** obligation to act in good faith and in a manner believed to be in the best interests of the corporation.

• **Standards of Liability:** no liability to corporation or shareholders for action or inaction, except for:
  - Conduct not in good faith;
  - Conduct involving self-interest, not in the best interest of the corporation,
  - Failure to attend to business of corporation;
  - Unlawful financial benefit.

• **Burden of Proof:** Shareholders bear burden.
How is an ESOP Corporation Different?

• The ESOP is a shareholder of the Company.
  • The Trustee is the legal owner of the shares and exercises most shareholder rights.
  • The participants are the beneficial owners of the shares. They are entitled to share in profits and appreciation and to certain participant rights under ERISA.

• The ESOP is a qualified plan subject to the Internal Revenue Code and an employee pension plan subject to the Employee Retirement Income Security Act of 1974, as amended (ERISA).
How is an ESOP Corporation Different?

- Two additional layers of management.
  - ESOP Trustee (fiduciary): exercises shareholder rights on behalf of participants.
    - insider or independent
    - Discretionary or directed by the ESOP Committee
  - ESOP Committee (fiduciary) – Responsible for plan administration, direction of Trustee, communications with participants and BOD.

- ESOP maintained for exclusive benefit of participants.

- ERISA imposes highest fiduciary standards on fiduciaries responsible for the Plan.
Who is an ERISA Fiduciary?

- **Named Fiduciary.** Fiduciaries named in the Plan documents. Typically, the Plan Administrator, the ESOP Committee and the Trustee.

- **Functional Fiduciary.** Anyone who exercises discretionary authority and control over the management or disposition of plan assets. ERISA 3(21)(A). Includes anyone who selects, monitors, influences or exerts control over a fiduciary. May include:
  - Members of the Board of Directors,
  - Officers,
  - Members of the ESOP Committee depending their allocated responsibilities.
ERISA Fiduciary Standards

Fiduciary Responsibilities:

• Act solely in the interest of participants and beneficiaries;
• Act for the exclusive purpose of providing benefits to participants and beneficiaries and defraying reasonable expenses;
• Undertake fiduciary action with the care, skill, prudence and diligence expected of an ESOP Fiduciary (the prudent expert standard or highest standard of care);
• Act in accordance with the Plan document and ERISA.
ERISA Fiduciary Standards and Enforcement

Prohibited Transactions: Fiduciaries must protect Plan against engaging in non-exempt “prohibited transactions” under ERISA.

- Named transactions between the Plan and “parties in interest” (Company, owners, directors, officers, employees, fiduciaries);
- Fiduciary actions involving the self-interest.

Enforcement: Breaching fiduciaries may be sued by participants and the Department of Labor and are subject to personal liability for restoration of losses, other equitable remedies, penalties and interest.
Fiduciary Functions of the BOD

• Select, appoint and monitor qualified ESOP Trustee
  • Trustee may be “insider” or independent
  • Trustee may be “directed” or “discretionary”
• Select, appoint and monitor qualified ESOP Committee members
  • Determine if ESOP Committee will direct Trustee
  • Determine scope of responsibility
  • Determine if ESOP Committee will be ERISA Plan Administrator
• Due Diligence required. Document process.
Settlor Management Functions of BOD

• Design, establishment, amendment and termination of ESOP is not a fiduciary function.

• Lending to ESOP, establishment of contribution levels and management of repurchase obligations are not fiduciary functions.
Fiduciary Functions of ESOP Committee

• **Named “Plan Administrator”**
  • Oversee Plan Administration, follow the Plan Document;
  • Interpret the terms of the Plan;
  • Comply with requirements of Internal Revenue Code and ERISA;
  • Satisfy ERISA reporting and Disclosure obligations.

• **Other delegated Fiduciary Functions.**
  • Select, engage and monitor providers to Plan;
  • If Directed Trustee, provide instruction to Trustee with respect to fiduciary issues;
  • Communicate with participants.

• **Other.**
  • Advise the Board on Plan design, ESOP transactions, valuations, repurchase obligations.
Fiduciary Responsibilities of Trustee

- Responsible for the prudent investment of Plan assets.
- Ensure that Plan is operated “for the exclusive benefit of plan participants” to provide benefits and defray reasonable expenses;
- If directed, determine whether a direction is proper, i.e., in accordance with the Plan and not in conflict with ERISA;
- Be sensitive to related-party transactions;
- Exercise shareholder rights on behalf of participants;
- Engage and monitor appraiser, prudently evaluate appraisal;
- Establish annual ESOP share value;
-Respond to tender offers;
- Negotiate ESOP purchases and sales prices; Evaluate loan terms;
- Vote shares in accordance with Plan and best interest of participants;
- Monitor executive and Board compensation; issuance of synthetic equity; stock issuances and redemptions, repurchase liability.
ESOP Trustee Duties/Shareholder Rights

- Attend meetings of the Board;
- Call special meetings;
- Vote to elect or remove directors;
- Subject to participant pass through voting rights, vote ESOP shares with respect to corporate merger or consolidation, recapitalization, reclassification, liquidation, dissolutions, sale of substantially all assets of business;
- Vote ESOP shares on other extraordinary changes to the corporation: amendment of the articles of incorporation;
- Respond to tender offers;
- Review annual financial statements, including reports by accountant or finance committee;
- Bring derivative shareholder action against third parties.
What are typical ESOP Trustee/fiduciary concerns?

- Determining that the ESOP pays no more than fair market value for any stock it acquires,
- Making sure Plan loans are reasonable;
- Hiring qualified advisors;
- Voting shares in accordance with the Plan and ERISA rules that do not require pass through voting;
- Deciding how whether to follow participant voting instructions and how to vote unallocated shares;
- Responding to legitimate offers to purchase the Company;
- Acting to protect plan interests when corporate interests conflict with the interests of Plan participants.
Multiple Hat Problem

- Shareholders, family members and “management insiders” serve on the Board and as officers of the Company.

- Shareholders, former shareholders, family members and management insiders serve on the ESOP Committee and/or as ESOP Trustee.

- Corporate (Settlor) functions are governed by corporate legal standards. Primary objective is to maximize shareholder value.

- Fiduciary functions governed by ERISA. Primary objective to maintain Plan for exclusive benefits for participants in compliance with ERISA.

- Corporate Decisions may conflict with Fiduciary Responsibilities.
ESOP Company Structure

ESOP Trustee/Shareholder (named fiduciary)

Board of Directors (functional fiduciary if BOD appoints fiduciaries)

Votes for

Officers

ESOP Committee (named and/or functional Fiduciary)

Appoints

Directs

ESOP GOVERNANCE
Potential Areas of Conflict

Common Areas of Conflict
• Stock Valuations
• Corporation Acquisitions
• Bona Fide Purchase Offers
• Executive Compensation

Know what hat you are wearing.
Related party conflicts: engage an independent Trustee.
Suggestions for Fiduciary Prudence

Stock Valuations
• Prudent selection of valuation firm: qualifications, background, independence
• Confirm adequacy, accuracy and reasonableness of data provided to valuation firm.
• Review assumptions and methodology.
• Document selection of valuation firm and review of valuations.

Corporate Acquisitions: Risk versus reward evaluation.
• Engage in independent investigation of transaction.
• Engage advisors.
• Independently negotiate price and terms.
• Review contracts.
• Document process.

Bona Fide Purchase Offers
• Fiduciary is responsible to participants and beneficiaries for benefits (long term objective).
• Sale may not be required even if purchase price is greater than sale price.
• Compare sales price to Board growth projections.
• Document due diligence.

Executive Compensation
• Necessary to attract and maintain key management.
• Must be reasonable. Should not waste corporate assets.
ESOP Governance Best Practices

- Obtain basic understanding of ERISA;
- Read Plan document, Trust Agreement, Articles of Incorporation and Bylaws;
- Clearly define roles; Know what hat you are wearing;
- Maintain clear communications between BOD, management, ESOP Trustee and other fiduciaries;
- Obtain sufficient information to make a prudent, informed decision;
- Engage qualified experts when necessary; question experts
- Appoint independent Board members;
- Appoint independent Trustee when conflicts of interest arise between the Board/management and the Trustee;
- Consider Company indemnification;
- Maintain D&O and fiduciary liability insurance;
- **Due Diligence and Documentation!**
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Internal Trustee

A Plan Fiduciary

Duty of loyalty - To Act Solely in the Interest of Participants

Exclusive Purpose rule - for the exclusive purpose of providing benefits

Duty of prudence - prudent expert standard (process v. result)

Avoid Conflicts of Interest
Conflicts of Interest

Officers or directors of sponsor may serve as trustee, plan administrator, or ESOP committee member

Duty to all shareholders as officer/director, but ERISA fiduciary duty is “solely” to and for participants

General: ESOP’s interests may conflict with management’s

Solution for conflict – Special Fiduciary or Independent Trustee
DUTIES OF THE INTERNAL TRUSTEE

Duties of the Internal Trustee

Maintain Assets of the Trust in Separate Accounts

Establish the Stock Price

Review Annual Allocation Report

Review Form 5500

Perform Distributions and Tax Reporting

Vote Shares Held Within ESOP

Conduct Communication Meetings
DUTIES OF THE INTERNAL TRUSTEE

Maintain Assets of the Trust in Separate Account

Account should serve to collect and maintain trust assets

Separate ESOP account for cash assets

Safekeep stock certificates

If leveraged, loan payments should be reflected on bank statement
Establishing the Stock Price

Develop Process for Approving Report

The Trustee is Responsible for Setting the Value.

Interview the appraiser – ask questions and take notes.

Appraiser familiar with ESOPs?

What methods are used to determine value – consistent with last year?

Narrative sufficiently describe company/asset being valued?

Company trends consistent with valuation result?
Review Allocation Report

If leveraged ESOP, verify that share release is accurate

Review to make certain annual compliance tests are performed

Verify that assets in report match trust assets maintained by the internal trustee
DUTIES OF THE INTERNAL TRUSTEE

Review Form 5500

Make certain plan assets are stated correctly

Fidelity bond coverage
DUTIES OF THE INTERNAL TRUSTEE

Perform Distributions & Tax Reporting

Issue distributions from the Trust

Tax reporting – Federal and State (if required)
DUTIES OF THE INTERNAL TRUSTEE

Vote ESOP Shares

Document the process

Plan document voting language

Pass-through the vote
  - participants should be given adequate information
  - participant voting instructions should be kept confidential
  - how will unvoted shares be handled

Directed by committee
  - letter of direction

Trustee discretion
DUTIES OF THE INTERNAL TRUSTEE

Communication Meetings

May participate in communication meetings with employees
- foster an ownership mentality
- helps participant understanding of how ESOP works
Scenario No. 1

You are the CFO of the Company and directed ESOP Trustee. Majority Shareholder decides to sell additional shares to ESOP.

Selling Shareholder, CEO and COO are members of the ESOP Committee. ESOP Committee engages Company accountant to establish share price and actively participates in the valuation process. ESOP Committee accepts valuation and directs you to purchase shares at appraised value on behalf of ESOP.
Scenario No. 2

You are the CFO and a member of the Board of Directors of 100% ESOP owned S-Corporation. Other Board members are the former shareholder, his spouse, an accountant and the CEO. You are also a member of the ESOP Trustee Committee.

Company maintains performance based executive compensation arrangement. At CEOs requests BOD to establish a generous Stock Appreciation Rights Plan for senior management that will amount to 45% of the Company equity.
Scenario No. 3

You are directed ESOP Trustee. You receive a tender offer from a competing Company.
Scenario No. 4

You are the CFO and ESOP trustee of a partial ESOP owned Company. The CEO recommends to the Board that the Company purchase business real estate the outside shareholder. The CEO proposes that the Company fund the transaction by borrowing funds from a bank and selling additional treasury shares to the ESOP in exchange for an ESOP note. The Board has asked you to approve the transaction.
Scenario No. 5

You are a member of the ESOP Trustee Committee along with the CFO and the CEO. You become aware that the CEO and his accountant have purchased all of the assets of a competing Company.