

The Fall ESOP Forum

Best Practices in Employee Ownership

*September 17-18, 2019 | Salt Lake City, UT
With Preconference on September 16*



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TRUSTEE AS A SHAREHOLDER: CORPORATE GOVERNANCE ISSUES

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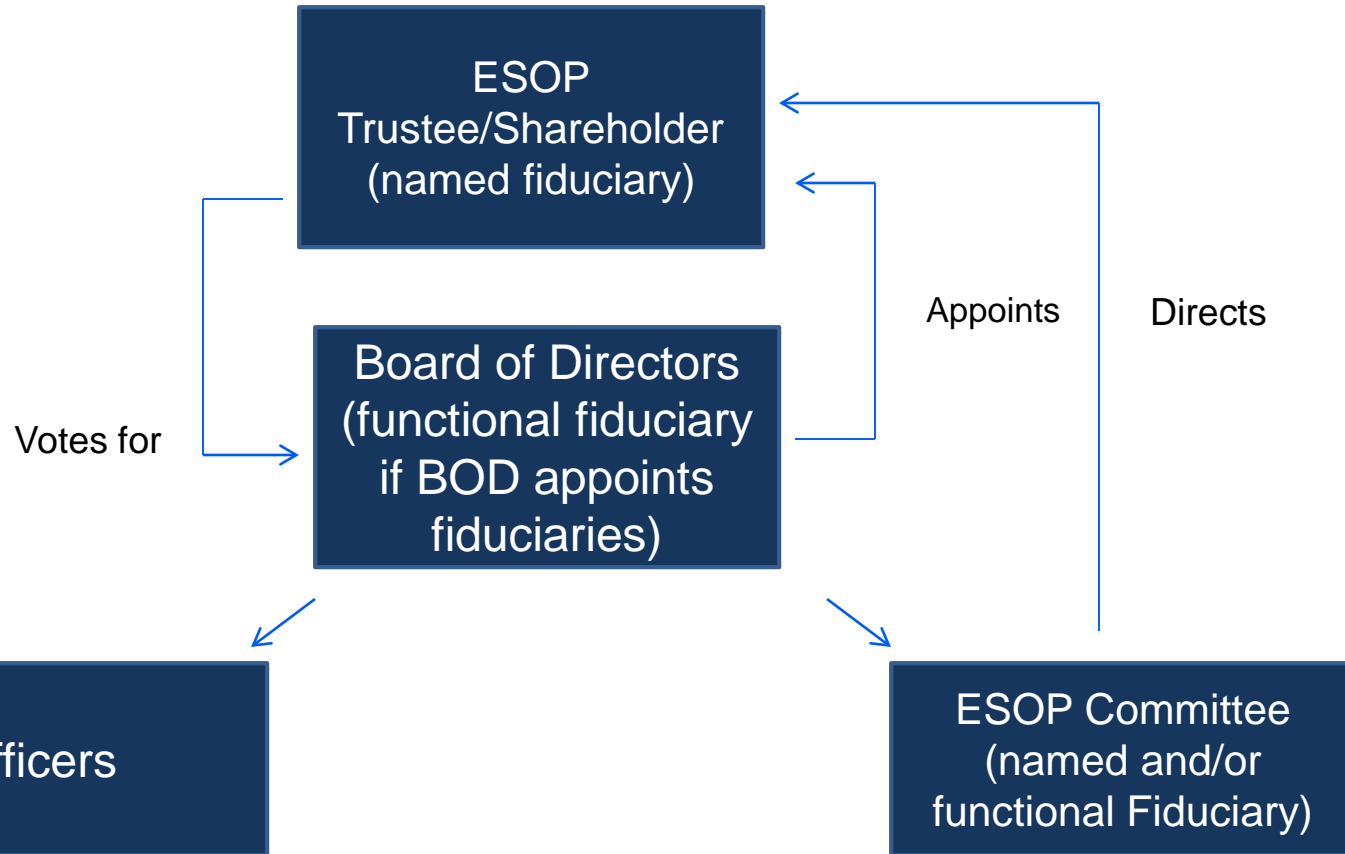
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ESOP Company Structure



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

- **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 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).
- 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.

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.

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!**

Questions ?

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