



Is an ESOP Right for You? An In-Depth Look at Employee Stock Ownership Plans

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Fiduciary Issues

Presented by:

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CORPORATE GOVERNANCE

Allocating duties and authority among a company's shareholders, Board and officers

- Board of Directors – The company's governing body, responsible for hiring and evaluating senior management, particularly the CEO, and selecting the Trustee.
- Shareholders/Trustee – Trustee acts on behalf of ESOP as a shareholder. In a majority or 100% ESOP company, the ESOP is the controlling shareholder. In a minority ESOP company, the ESOP is often the single largest shareholder.
- Management – Runs the company's day-to-day operations.



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ROLE OF BOARD OF DIRECTORS

- **Grow shareholder value**
- **Set corporate goals and strategy**
- **Appoint officers and ESOP Trustee**
- **Appoint ESOP Plan Administrator**
- **Advise CEO and management**
- **Evaluate and approve significant corporate transactions, including sale of the company or its assets**
- **Review corporate financial statements**
- **Evaluate senior officers' performance**
- **Facilitate succession planning**
- **Determine senior officer compensation**
- **Establish corporate standards and conduct**



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CORPORATE FIDUCIARY STANDARD

- Board's duties determined under applicable state corporate law
 - Duty of Care
 - Duty of Loyalty
- Business Judgment Rule (Delaware and most other states)
 - Court presumes directors' actions were informed, in good faith, and made in honest belief that they were in the best interest of the company
 - Burden of proof is on challenger (shareholder) to overcome presumption



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KEY BOARD OF DIRECTORS COMMITTEES

- **Audit/Finance Committee – responsible for certified financials, audits, and financial projections**
- **Compensation Committee – responsible for compensation of Board and Executives comprised of outside Directors**
- **Governance Committee – responsible for committee structure, regulatory compliance and delineation of board and management responsibilities and director nominations**
- **All committees are not always applicable or possible in all ESOP companies**



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BOARD SELECTION OF ESOP TRUSTEE

- Who should serve as trustee?
 - corporate insider
 - board member
 - outside advisor/individual
 - institutional trustee
- More than one? (if not institutional)
- Dealing with conflicts of interest
- Directed vs. Discretionary trustees
- Monitoring of trustee



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ERISA FIDUCIARY STANDARDS

ERISA fiduciaries must act:

- Solely in the interest of plan participants and beneficiaries
- For the exclusive purpose of providing benefits to participants and beneficiaries
- With the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matter would use in the conduct of an enterprise of like character and with like aims
- In conformance with the Plan and Trust documents, as long as the documents are consistent with ERISA



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ROLE OF TRUSTEE

- Elect the Board of Directors
- Comply with ERISA fiduciary duties and avoid prohibited transactions
- Determine share value and monitor performance of ESOP's shares
- Hire independent qualified advisors, including Independent Financial Advisor
- Ensure plan is operated according to plan document
- Monitor Board and Officers' compensation



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VOTING

- Electing the Directors
- Directed vs. Discretionary Trustees
- Extraordinary transactions the Trustee acts as the Election Monitor
 - Pass Through required for corporate merger or consolidation, recapitalization, reclassification, dissolution, liquidation or sales of substantially all of the assets,



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MONITORING BOARD PERFORMANCE

- Representation on Board?
- General Review
 - meetings and minutes
 - financial statements
- Specific Areas of Concern
 - related-party transactions
 - executive compensation
 - stock issuances
 - acquisitions
 - repurchase liability



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VALUATIONS



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- ESOP must use an independent qualified appraiser
 - Due Diligence Meeting with Management
- Appraiser must report solely to the Trustee
 - Complete Independence
- Ultimate conclusion of value is the Trustee's responsibility
 - Draft Report to Company for review

REPURCHASE OBLIGATION



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- Company responsibility
 - How often should a study be done
 - Trustee should monitor
 - Recycling vs. redemption
 - Impact on valuation
 - Valuation Firm should get a copy of the study

MISCELLANEOUS: RECORDKEEPING/TRUST ACCOUNTING

- Maintain separate trust checking account
- Retain custody of Allocated ESOP stock certificates
- Submit annual report and accounting to company
- Monitor allocations
- Distributions
 - Tax Reporting
 - Lost participants



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SPECIAL ISSUES - OFFERS

- Sale of Business
 - Voting pass-through?
 - Fairness
 - price
 - other terms/relative fairness
- Purchase Offer to Trustee
 - Outside Offer
 - Redemption offer from plan sponsor
- Recapitalization



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SPECIAL ISSUES - OFFERS (CONTINUED)

Board considerations: fairness of transaction to corporation

- Whether terms are at least as favorable to corporation and shareholders as might be available from unrelated persons
- Whether transaction will further corporation's interests
- Whether approval process is fair
- Focus on effect on shareholders as a whole
- Confidentiality and disclosure



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SPECIAL ISSUES – EXECUTIVE COMPENSATION

- Board is responsible for setting executive compensation
- Trustee should review Board process and understand whether pay relates to performance
- Issues around compensation of outside directors
- Trustee involvement benefits all parties
- Outside compensation studies may be appropriate



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SPECIAL ISSUES – CONFLICTS



- **Potential Conflict Situations**
 - Board of Directors members' compensation
 - Dual roles of Director and Trustee
 - Individual is both a fiduciary and a shareholder
- **Conflict situations create heightened standard of review**
- **Possible Solutions**
 - Transparency; identify and disclose conflict
 - Hire independent fiduciary or remove conflicted person
 - Hire independent advisors
 - Document analysis and decisions

BEST PRACTICES

- Independent Directors
- Independent or other highly informed and engaged fiduciaries
- Compensation Committee of outside directors
- Informed Directors and Trustee
- Effective use of outside advisors
- Productive Board meeting with agenda and information distributed before the meeting
- Open communications between Trustee, Board, and Officers



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GOVERNANCE CONCLUSIONS

Successful governance in an ESOP company requires clearly defined roles and responsibilities, avoidance of conflict situations, and direct, open communication between the Directors, the Trustee, the officers, and other plan fiduciaries.



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Trustee's Annual Checklist

Note 1: the "Period" represents the time either Before (-) or After (+) First Day of Plan Year to complete the task

Note 2: specific due dates are for calendar year end. Dates marked with an "*" are date certain

	Period	Duty	Description
1	- 2 mos	Distribution	Ensure Diversification & RMD Distributions for current & next plan year
2	- 2 mos	Investment	Engage Valuation Firm
3	- 1 mos	Distribution	Engage Third Party Administrator
4	31-Jan *	Compliance	Last day to Prepare and Mail IRS Form 1099-R AND IRS Form 945
5	+ 1 mos	Distribution	Determine Participant Eligibility
6	28-Feb *	Compliance	Last day to Prepare and Mail IRS Form 1096
7	+ 2 mos	Distribution	Review Share Release Calculation & Allocation
8	+ 2 mos	Investment	Review Financial Statements of underlying Company
9	15-Mar	Compliance	Last day to Receive Company Contribution for prior plan year (unless corporate return is extended)
10	+ 3 mos	Investment	Read Valuation Report & Establish Price
11	+ 3 mos	Distribution	Review Allocation Report & Distribute Participant Statements
12	+ 3 mos	Compliance	Distribute Diversification Notices
12	1-Apr *	Compliance	Last day for RMD payments to any participant who turned 70½ in prior year
13	+ 4 mos	Distribution	Review & Prepare Participant Distributions
14	+ 5 mos	Corp Governance	Review Proposals & Nominated Directors
15	+ 5 mos	Corp Governance	Distribute Proxy Information to Participants
16	+ 6 mos	Compliance	Last day to Execute Diversification Elections
17	+ 6 mos	Corp Governance	Attend Annual Meeting
18	+ 6 mos	Corp Governance	Vote Proxy
19	+7 mos	Compliance	Last day to file 5500 (can be extended 2½ mos)
20	30-Sep	Compliance	Last day to Distribute Summary Annual Report (within 2 mos after filing tax return)
21	+10 mos	Distribution	Review Repurchase Obligation Study
22			
23	31-Dec *	Compliance	Last day for RMD distributions
24	Occasionally	Compliance	Distribute Summary Plan Description to new participants
25	Occasionally	Corp Governance	Review Corporate Actions, Budgets & Plans
26	Occasionally	Corp Governance	Engage Plan & Trust Legal Advisor
27	Occasionally	Custody	Collect, Receive and Invest Asset revenues (divs or S-Corp earnings)
28	Occasionally	Custody	Accept Employer Contribution(s)
29	Occasionally	Investment	Engage in Assets Purchases or Sales
30	Occasionally	Investment	Prepare and Process Loan Payments
31	Recurring	Compliance	Monitor Plan & Trust compliance with applicable laws & regulations
32	Recurring	Custody	Hold, Control and Maintain assets
33	Recurring	Investment	Determine Plan Investment Prudence

Questions ?

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