Shareholder Obligations of the ESOP Trustee

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Under the Employee Retirement Income Security Act of 1974 (ERISA), the ESOP trustee is considered the owner of record for shares held by the plan. The responsibilities of the ESOP shareholder are at least as great as those of other shareholders in the same corporation. Generally, the corporation's charter will outline shareholders' privileges, such as voting rights, dividend receipt rights, rights to inspect corporate books and records, and the right to sue the corporation for wrongful acts (see the chapter "ESOP Participants and Shareholder Rights" for details). These rights vary by state. They are very important in protecting shareholders against poor management. Thus ESOP trustees must understand what rights they have as holders of corporate shares.

Shares of the ESOP must be held in trust. As a shareholder, the ESOP trustee must act in a fair and reasonable manner with respect to other shareholders while also performing the fiduciary duties for the trust and its beneficiaries. A trustee is a fiduciary under the rules of ERISA because it has discretionary authority over the investment of trust assets. All of the ESOP trustee decisions are subject to the fiduciary requirements of ERISA, including the duty to act prudently and carefully, the duty to act only in the interest of the ESOP participants, and the duty of strict loyalty to the ESOP participants.

Roles and Issues for Trustees in Electing the Board

ESOP trustees must play active roles in the election of a corporation's board of directors. The board is responsible for directing the corporation and its senior managers, who conduct the company's day-to-day affairs. Their decisions will largely determine the value of the corporation and ultimately the value of the shareholders' investment.

Ideally, a group from the board, often a nominating committee, will present a slate of directors. The committee should examine each potential nominee's qualifications, including experience, relationship to the corporation, age, and investment in the corporation, whether as a shareholder or through some other arrangement. The ESOP may provide for voting on directors to be passed through to plan participants. If so, the ESOP trustee has a duty to send relevant information to and obtain instructions from the participants. After receipt, the ESOP trustee should summarize the direction results to draw a consensus from the plan participants. The ESOP plan document will generally state how the trustee is to vote. Some plans provide for participant direction; most provide that the trustee either make an independent decision or follow the directions of a third party (often the board itself). In this case, the third party becomes a co-fiduciary to the decision. Ultimately, though, the ESOP trustee must evaluate the slate of potential directors, determine whether their qualifications are acceptable, and vote the trust's shares as he or she believes is in the best interests of the plan participants. While it would be very rare for a trustee whose actions are directed by employees or another entity to override these directions, ERISA does provide that if the trustee believes that not doing so would violate the law or the plan, or is clearly not in the best interests of plan participants, then the trustee should act to protect those interests.

Several issues can develop and must be addressed by the ESOP trustee:

- *Board member qualifications:* In order to vote for a candidate, the trustee must believe that candidate possesses the qualities necessary to effectively direct the corporation and its management. If the candidate was nominated by the board, the trustee must also have faith in the board's effectiveness before agreeing with its choice.
- *Participant direction contrary to board nomination:* When participants are given the opportunity to direct their shares, they may not agree with board nominations. Personality issues may arise, particularly if the board nominee is also an employee supervisor. For example certain decisions made by a supervisor may be unpopular among the ESOP participants but be necessary for the business. Or a number of participants may write in an alternative candidate. Personality issues can influence a participant's vote. The ESOP trustee needs to understand these issues but must also determine the best candidate for the corporation's board. Again, this situation is extremely rare—participants tend to be conservative voters—but requires trustee attention.
- *Exertion of undue influence over participants as to how they should vote:* Participants must be able to direct their votes without undue influence from members of the board, management, or other employees. Participants should be encouraged to express their views by voting but cannot be coerced into particular yes or no votes.
- *Voting direction confidentiality:* Participants must have confidence that their votes are recorded discreetly. A participant who votes against the recommendations of management or the board should not have to worry about who will discover their particular voting selection. Without confidence in the voting process, participants may be reluctant to participate.
- *Multiple sets of board nominations:* While this is unlikely to be an issue in privately held companies, interested parties can present additional slates of directors. The other party may be a dissenting shareholder who believes the current board is not meeting appropriate performance standards or has made poor decisions. If participant direction is sought, the ESOP trustee must give equal consideration to both slates of directors. The ESOP trustee now must decide among the alternatives available with the aid of the participants' direction. Obviously, the trustee will consider issues of qualification and the implications of voting contrary to the board's recommendation before voting in the best interests of the plan participants.
- *Appropriate board composition and structure:* The Department of Labor has stated that trustees have an affirmative duty to exercise their shareholder rights to try to assure that the governance of the company is appropriate and effective. This could mean, for instance, voting for directors who favor establishing independent review of executive compensation.

Roles/Issues for Trustees in Responding to Acquisition Proposals

Like any other asset, tangible or otherwise, a corporation has value. Like beauty, the value can be in the eye of the beholder. For example, businesses developing Internet-based products in the 1980s probably had little value in this new frontier. Then, in the mid-1990s, their business values began to increase, and soon people were paying speculatively high amounts. By 2001, many companies had become insolvent, and those remaining had limited value. In a very short span, the industry went through a complete lifecycle.

As companies were merged, acquired, or closed, boards of directors entertained and reviewed many proposals, some with merit, others without. The board has a duty to the shareholders to investigate the merits of each proposal. It cannot simply decide the corporation is not for sale. If the board fails to respond to an offer, it is not fulfilling its duties and could be sued for wrongful acts.

Once the board has determined that an offer to buy the company is legitimate, it must notify its shareholders, including the ESOP trustee. The trustee then must provide sufficient information and request voting instructions from each plan participant, if the transaction is structured so that there is a vote (it could be done as a sale of stock). The information provided to participants to solicit their votes would include the name of the acquiring company, the offer price, and prospective financial statements. If the sale is structured so that a vote is not required, the trustee or ESOP committee could make the decision as to the ESOP shares, unless the plan provides that the participants have the right to direct the trustee as to the tendering of the shares.

The idea of selling the corporation can be emotional for plan participants, especially if layoffs seem likely. Participants directing their votes may not look favorably upon such an offer. The ESOP trustee should seek the advice of legal and financial experts to review the offer. If it is determined to be in the best interests of all plan participants, then the ESOP trustee must consider accepting it.

Several considerations affect how the ESOP trustee acts on unsolicited offers. First, as described in the chapter by James Steiker in this book, the Department of Labor and the courts have generally concurred that when employees direct the trustee as to how to vote their shares in an acquisition proposal, the trustee should go along with those directions absent a compelling reason to believe that the employees are acting contrary to their best interests as plan participants (as opposed to as employees). On unallocated shares, trustees generally must follow their own judgment unless the plan designates employees as named fiduciaries for those shares. Even in this case, however, the trustee has an affirmative obligation to exercise independent judgment in voting these shares, even if contrary to employee directions.

This same theory applies to acquisitions structured as tender offers. Employees do not have an automatic right to direct the tendering of shares in an ESOP (whether in a public or private company). Some plans pass through this right to plan participants, but it is subject to the same fiduciary constraints as voting on an acquisition.

In many cases, an ESOP company will not want to be acquired, even in the face of an attractive offer. The dilemma is that trustees must act to maximize the value of plan assets, which seems to suggest the only answer to a good offer is “yes.” Trustees, however, can respond “no,” even if the offer is for more than the fair market value, for a number of reasons:

- The courts and the Department of Labor have said that trustees must look to the long-term value of the plan assets; it may be the offer provides a short-term bump, but that the corporation’s long-term prospects are better. This may especially be the case if the offer involves exchanging the ESOP stock into stock of the acquirer.
- The trustee must look at the future retirement benefits to participants as a whole. It may be that the ESOP, for instance, still has shares to be allocated, or that future contributions are planned at a high percentage of pay. There may also be other retirement plans operating alongside the ESOP. The acquiring company may offer smaller retirement contributions. So even though the stock price is attractive, employees would receive fewer benefits long term.
- Some plans state that the ESOP’s principal purpose is to maintain long-term employee ownership. This may be the weakest legal justification for saying no, but it is still arguably an employee benefit to be considered.

In practice, companies that make it clear that the trustee will consider these issues make themselves relatively unattractive acquisition targets. As a result, unwanted acquisitions are rare. However, in the face of an exceptional offer, an ESOP trustee may still have to say “yes.”

More common are solicited offers. Here, the trustees must act aggressively to protect employee interests, seeking to maximize the acquisition’s effects on both the share price and the future retirement benefits of the employees. The trustee should be an active negotiator in the transaction, represented by its own independent counsel.

Oversight of Board/Executive Compensation

The rights and privileges of ownership allow the shareholder to review the records of the corporation. If, by election, shareholders determine who is on the board, then one could surmise that they have the right to review the compensation of those individuals. After all, the board members serve at the pleasure of the shareholders. Additionally, the board hires management. The shareholders should be privy to the board’s decisions about hiring those individuals and determining their compensation.

Our capitalist system of rewarding good performance with good pay has worked for decades. The ESOP trustee needs to understand how the corporation’s performance relates to the compensation paid to the individuals responsible for decision-making. Excessive compensation begins when the performance is less than expected, and when alternative individuals who could improve performance and be paid less are available but not used. It is not unreasonable for the ESOP trustee to request the corporation complete studies on board/executive compensation. Such analysis can benchmark the corporation with its peers.

Every shareholder understands it takes people to make the organization work. Finding the right people with the right qualifications can be a daunting task. Every corporation faces compensation issues. Underpay, and the right people will move on to greener pastures, which will tarnish the corporation's performance; overpay, and the corporation's financial performance will suffer.

In summary, the roles and responsibilities of directors and shareholders are far-reaching and can provide great rewards. The roles and responsibilities of the ESOP trustee are vast and need special attention and care. The duties of shareholder, director, and trustee can coexist. However, the opinions of each group can diverge. Anyone serving as the ESOP trustee must be ready to put the fiduciary duties required by ERISA before his or her duties as shareholder or director.

Additional Shareholder Obligations of ESOP Trustees

In addition to these most common shareholder obligations, ESOP trustees may need to exercise their shareholder rights in a variety of additional circumstances:

- *Perceived wasting of corporate assets:* This broad term can cover any use of corporate funds that can be inimical to the interests of plan participants. Excessive executive pay, discussed above, is a primary example, but other instances could include such things as keeping relatives of managers on the payroll who do not perform useful functions, excessive board pay, improper reimbursements for substantial expenses, fraud, misappropriation of funds, and other egregious activities. It is more difficult to challenge business decisions that do not work out as a waste of corporate assets, but in extreme circumstances, it may be necessary.
- *Corporate acquisitions by the ESOP company:* If the company makes an acquisition with its own funds, the trustee should be satisfied that this is not a waste of corporate assets. It should be actively involved in reviewing the transaction and providing appropriate input, but ultimately this is a board decision.
- *Monitoring the board's duty to monitor executive leadership:* If the trustee believes that the current executive leadership is not performing adequately, the trustee should engage with the board to take corrective steps. Similarly, the trustee should make sure there are appropriate plans for leadership succession.
- *Protecting minority rights of the ESOP as a shareholder:* If the ESOP has a noncontrolling interest, state corporate laws provide a variety of rules to prevent controlling shareholders from harming their interests. State laws generally require majority shareholders to deal fairly with minority shareholders, particularly with respect to the terms and prices of the acquisition of shares. Minority owners may need to be given "tag-along" rights, for instance, in a change of control transaction.