

# Boards of Directors' and Trustees' Roles in ESOP Companies

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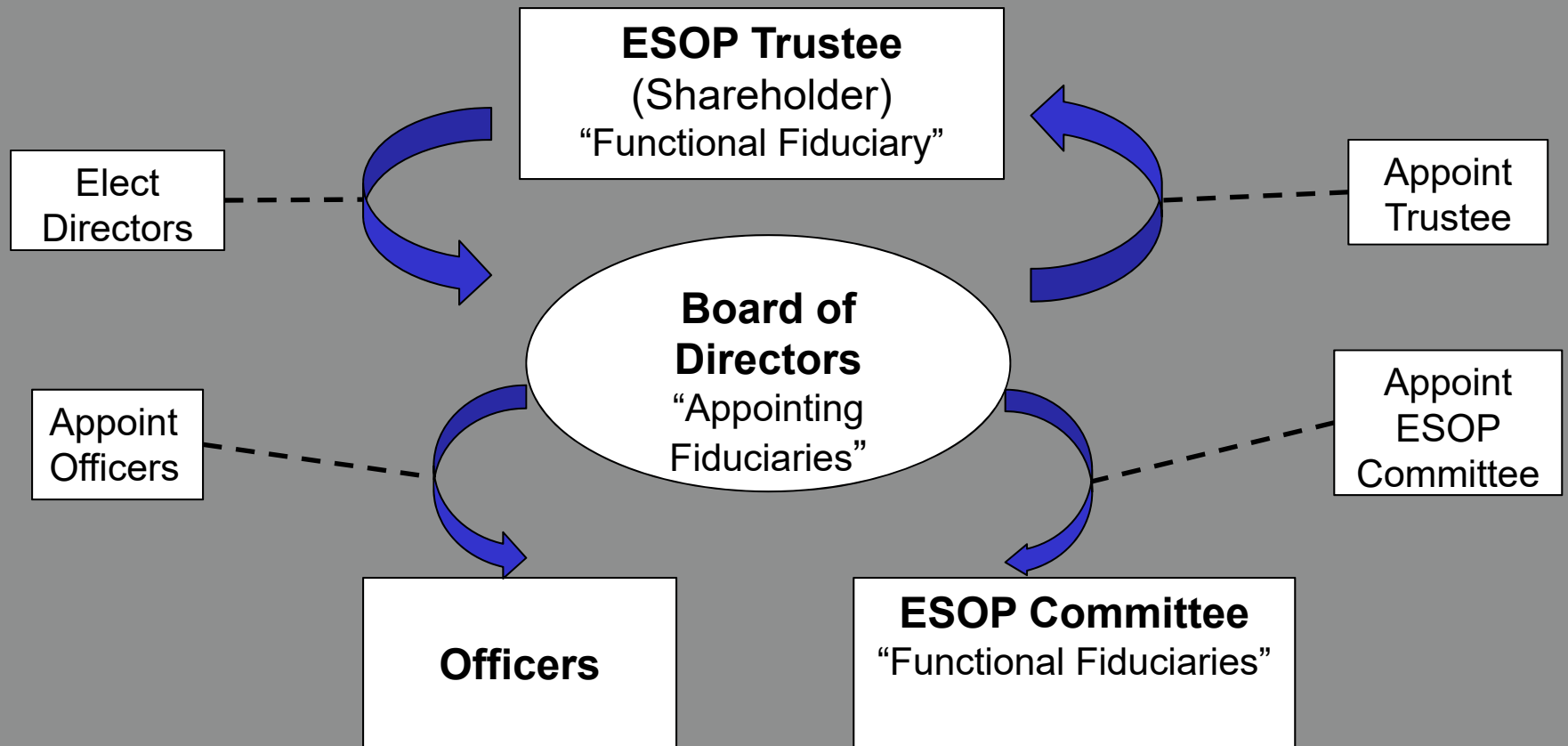
# Agenda

1. Introduction: Corporate Governance
2. Legal/Fiduciary Standards of Board of Directors
3. Duties of the Board of Directors
4. Fiduciary Standards and Duties of the ESOP Trustee
5. Board and Trustee Duties in a few common activities
6. Special Issue – Executive Compensation

# Introduction

- What is “Corporate Governance”?
  - A framework to govern the relationships among shareholders, directors and officers
  - Method by which directors supervise officers and the business
- Who are the Main Participants in Corporate Governance?
  - Board of Directors and its advisors
  - Officers
  - Shareholders (ESOP trustee and its advisors)
  - In cases of “pass-through” voting, ESOP participants

# Corporate Governance Structure and Participants



# Typical Board Structure

- Board Responsibilities
  - Provide guidance and direction to management on strategy
  - Monitor company performance vs. operating, financial and long-range plans and objectives and approve changes
  - Approve certain corporate actions
  - Appoint company officers
  - Appoint ESOP trustee and benefits committee
  - Appoint and establish goals for CEO; establish and evaluate CEO compensation; plan for CEO succession.

# Typical Board Structure

Corporate documents provide framework

- Articles of Incorporation
  - Indemnification provisions
  - Rights of shareholders
- Bylaws
  - Size and election of the Board
  - Meetings of the Board and Shareholders
  - Appointment of officers
  - Powers and structure of Board committees
  - Indemnification provisions

# Typical Board Structure

- Prior to an ESOP transaction, it is common for companies to only have “insiders,” shareholders or family members of shareholders on the Board.
- After an ESOP transaction, it is increasingly common for a trustee to request or require that at least one external/independent director be a member of the Board.

# Skill Sets for Directors

Directors should have a general understanding of the following:

- Factors which drive profitability (earnings)
- Factors which drive stock value
- Financial goals and strategies
- Financial and competitive risks
- Performance vs. competitors
- Business objectives/strategic plans
- Business and industry risk and contingent liabilities



# Evaluations of Board Members

- Position descriptions
- Performance objectives
- CEO evaluations
- Self-evaluations
- Board and committee evaluations
- Individual director evaluations
- Peer evaluations
- Governance committee review
- Independent review
- ESOP Trustee's review

# Independent (Outside) Directors

- Advantages
  - Reduces conflicts of interest (actual and in appearance)
  - Provides different perspective
  - Adds credibility, trust, and confidence
  - Builds networks and resources
  - Satisfies lending requirements
  - Great for committees (compensation, audit, and nominating/corporate governance)
  - Viewed favorably by the DOL

# Independent (Outside) Directors

- Disadvantages
  - Can be hard to find (liability and time commitment concerns)
  - Compensation
  - Lack of knowledge of business/industry/ESOP
  - Confidentiality concerns

# Board Committees

- Audit Committee– responsible for certified financials, audits, and financial projections
- Compensation Committee– responsible for setting and reviewing compensation of Board and Sr. Executives
- Governance Committee– responsible for committee structure, regulatory compliance and delineation of board and management responsibilities and director nominations
- Nominating Committee
- Executive/Succession Committee

# Legal & Fiduciary

## Standards of Board of Directors

# Overview of Fiduciary Standards

Standards for corporate governance arise from corporate fiduciary duties

- Based primarily upon state corporation law and related case law
- Affected by federal statute and case law

Standards for ESOP governance arise from ERISA fiduciary duties

- Based primarily upon ERISA and related case law
- Affected by Internal Revenue Code and state corporation law

Focus upon closely-held company with ESOP as majority shareholder

# State Law Fiduciary Duties

## Duty of Care (i.e., being well informed)

- Commitment of time and attendance
- Well prepared for meetings
- Right to rely, in good faith, on information provided by management and board committees, legal counsel, accountants and other advisors
- Make inquiries when appropriate (where circumstances warrant)
- Disclosure to other directors and management
- Understand valuation process
- Impact of Board decisions on stock value

# State Law Fiduciary Duties

- Duty of Loyalty
  - Acting in good faith and in corporation's best interest
  - Avoid conflicts of interest – approval of transaction by disinterested directors or shareholder(s)
  - Example of disloyalty: Personal financial interests conflict with corporation's interests



# State Law Fiduciary Duties

## Business Judgment Rule

- Applied by courts in analyzing directors' actions
- In a breach of duty of care claim, a director is insulated from liability for the consequences of a business judgment if they acted in accordance with their duties of care and loyalty
- If the business judgment rule applies, courts will look at decision making process, not the final decision
- If the business judgment rule does not apply, the decision is subject to the “entire fairness” standard

# Duties of the Board of Directors

# Duties of Board of Directors With Respect to Trustee

Board has a duty under ERISA to:

- Select and appoint a qualified trustee or trustees
- Monitor the actions of the ESOP trustee (and any other plan fiduciaries it appoints)
- Understand how company stock is valued
- Confirm process is adequate
- Summary of annual valuation
- Reasoning for valuation
- Make sure repurchase obligation is taken into account
- If necessary, take corrective action

# Appointment of the ESOP Trustee

## Issues Board Considers

- Who should serve?
- “Inside” vs. “outside” trustee
- Conflicts of interest for “inside” trustee
  - Board member role vs. officer role vs. trustee role
  - If inside trustee, know when to seek counsel and/or resign
- Should trustee be “directed” or “discretionary”?
  - Can be directed, except often exclude from direction:
    - annual valuation
    - special events like sale of company

# Fiduciary Standards and Duties of the ESOP Trustee

# ERISA Fiduciary Responsibilities

1. Duty to act “solely in the interest” of plan participants and their beneficiaries;
2. Duty to act prudently;
3. Duty to act in accordance with the plan documents;
4. Duty to diversify plan assets.

*\*Note that Board actions that affect the Company's operations and assets (even in a 100% ESOP-owned Company) are generally not subject to ERISA\**

# Duties of the ESOP Trustee

- Theoretically has the highest level of authority
- Legal Owner of Shares
  - directed trustee/discretionary trustee
  - institutional trustee
- Acts as representative for Participants
- Appoints Board of Directors
- Responsible for governance and maintenance of the Plan and Trust to ensure compliance with legal / fiduciary requirements

# Duties of the ESOP Trustee (cont.)

- Comply with ERISA fiduciary duties and avoid prohibited transactions
- Determine share value and monitor performance of ESOP's shares
- Hire independent qualified advisors, including appraiser
- Act as a shareholder, including voting stock and responding to offers
- Ensure plan is operated according to plan document
- Monitor Board and Officers' compensation



# Duties of the ESOP Trustee (cont.)

- Monitor and establish investment policy for non-Company Stock plan assets.
- Recordkeeping and Trust Accounting:
  - Maintain trust checking account
  - Retain custody of ESOP stock certificates
  - Submit annual report and accounting to company
  - Monitor allocations & release of pledged shares
  - Distributions as directed by plan administrator

# Board of Directors and Trustee Duties in some common activities

# Voting

- Trustee Duties\*;
  - Electing the Directors
  - Extraordinary transactions (i.e. merger, sale of assets, etc...)
  - The Trustee as election monitor
    - \*Consider whether Directed vs. discretionary Trustees
- Board Duties:
  - Provide accurate and complete disclosure to shareholder(s)

# Monitoring Performance

## Trustee Monitors:

- Board Performance; general review
- Representation on the Board?
- meetings and minutes
- financial statements
- Specific Areas of Concern
  - related-party transactions
  - executive compensation
  - synthetic equity issuance
  - stock issuances & stock redemptions
  - acquisitions
  - repurchase liability

## Board Monitors: Trustee Performance.

# Stock Valuations

## Trustee Role;

- ESOP must use an independent qualified appraiser
- Appraiser must report solely to the Trustee – no conflict of interest
- Focus on process and documentation of the process
- Ultimate conclusion of value is the Trustee's responsibility (*Note the tension with the Board's responsibility to provide for repurchase liability*)

## Board Role;

- Disclosure of complete and accurate information.

# Repurchase Obligation

## **Board Role;**

- Company responsibility
- Recycling vs. redemption

## **Trustee Role:**

- Trustee should monitor
- Monitor potential Impact on valuation
- Future outlook

# Special Issue: Benefit Corporation

- Benefit Corporation is for-profit business with additional purpose to create a public benefit (either general or specific), such as:
  - preserving the environment, improving human health or providing economic opportunity beyond just jobs (e.g., retirement plan or sense of ownership)
- Both C-Corp and S-Corp ESOPs can elect Benefit Corporation status
- Requires changing duties of company's fiduciaries by supermajority vote of shareholders to add provisions to company's Articles of Incorporation and Bylaws
- Helps maximize shareholder value by ensuring company's ongoing commitment to core values, sustainability and public benefit

# Special Issue: 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
- Board should have a compensation committee comprised of outside directors to approve compensation



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