

# Reach New Heights!

*The Las Vegas ESOP Conference & Trade Show*



*November 9 -10, 2017*

Boards of Directors'  
and Trustees' Roles in  
ESOP Companies:  
Part 2 (Advanced)



# Preface

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- Please fill out a session evaluation form and drop it off at the table outside of this room
- Your feedback on topics and presenters is important and will be used to develop subsequent TEA programs
- Take a moment to silence your cell phone
- Remember to get your CPE sheet stamped before and after each session for CPE credit

# Corporate and ESOP Structure

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- Board elected by all shareholders, including ESOP
- ESOP Plan Administrator selected by Board 
  - Can be a committee separate from Board
  - Can be Board itself (either intentionally or by default)
- Trustee selected, monitored and removed by Board
- Trustee may be discretionary, or directed by ESOP Plan Administrator or participants. Must be directed by participants with respect to allocated shares on certain major corporate events.

## Attachment C: Interface Tools for Exercising Mutual Oversight

Board Responsibility	Interface Tools	Trustee Responsibility
General Oversight of Trustee	<ul style="list-style-type: none"> <li>Board &amp; Trustee Governance Charters</li> <li>Financial Statements</li> <li>Board Meeting Minutes</li> <li>Annual Financial Audit of Company &amp; Trust</li> <li>Chair/Trustee Meetings</li> <li>Attend Trustee and Board Meetings as invited</li> </ul>	General Oversight of Board
Understand Valuation Process & qualifications of Valuation Consultants	<ul style="list-style-type: none"> <li>Valuation Report</li> <li>Conference of the Trustee, Board, and the Valuation Consultant</li> </ul>	Valuation <ul style="list-style-type: none"> <li>Select &amp; engage Valuation Consultants</li> <li>Determine Company Fair Market Value</li> </ul>
Establish executive compensation practices that are in the best interests of the company and its stakeholders	<ul style="list-style-type: none"> <li>Executive Comp Philosophy &amp; Practices documents</li> <li>Executive Compensation Benchmark Surveys</li> </ul>	Understand Board-approved compensation plans and their alignment with shareholder interests
Evaluate & consider serious offers to purchase the company	<ul style="list-style-type: none"> <li>Board notification to Trustee of serious offers under consideration to purchase the company or a substantial portion thereof</li> <li>Board Policy for Unsolicited Offers</li> </ul>	Understand serious purchase offers as presented by the Board in accordance with its Policy for Unsolicited Offers
Consider & approve acquisitions of other companies or lines of business	<ul style="list-style-type: none"> <li>Opportunity Summary documents</li> </ul>	Understand the purpose & projected value of acquisitions the Board is considering
Assure Plan compliance & financial viability <ul style="list-style-type: none"> <li>Monitor Plan Administrator</li> <li>Repurchase liability and funding Plan</li> <li>ESOP distribution policy compliance</li> </ul>	<ul style="list-style-type: none"> <li>Independent audits of ESOP and company</li> <li>ESOP distribution policy</li> </ul>	Monitor ESOP Plan compliance
CEO succession	<ul style="list-style-type: none"> <li>CEO Succession Plan description documents</li> </ul>	Verify that Board has a plan underway
Succession Plan Guidance & Approval	<ul style="list-style-type: none"> <li>Succession Plan Documents</li> </ul>	Review & Understand Succession Plans
Leadership development	<ul style="list-style-type: none"> <li>Corporate Leadership Development Plan</li> </ul>	Verify that company has a plan underway
Board performance assessment	<ul style="list-style-type: none"> <li>Board 's self-assessment process</li> </ul>	Verify that the board has such a process
Board governance clarity & policy development	<ul style="list-style-type: none"> <li>Board Governance documents</li> <li>Board Governance development agenda</li> </ul>	Understand governance policies and provide input on Board selection & corporate governance matters

# Corporate Fiduciary Standard

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- Board's duties determined under applicable State corporate law
- Business Judgment Rule (Delaware and most other States)
  - Generally, the court will not review the business decisions of directors who performed their duties (1) in good faith; (2) with the care that an ordinarily prudent person\* in a like position would exercise under similar circumstances (“Duty of Care”); and (3) in a manner the directors reasonably believe to be in the best interests of the corporation (“Duty of Loyalty”) □ Burden of proof is on challenger (shareholder) to overcome presumption
- \*the “prudent person” standard

# Corporate Governance

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- Shareholders / Trustee – Trustee acts on behalf of ESOP as a shareholder. In a majority or 100% ESOP company, the ESOP is the controlling shareholder. Primary responsibility is to elect the Board of Directors; and to approve or disapprove certain major corporate events
- Board of Directors – Board acts on behalf of all shareholders, including the ESOP. The company's governing body, the Board is responsible for hiring and evaluating senior management, particularly the CEO, and selecting the Trustee
- Management – Runs the company's day-to-day operations

# Corporate Governance

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- Consideration of interests of stakeholders other than stockholders –
  - Owners of synthetic equity
  - Debt holders
  - Local community
  - Local charities
- Consideration of non-financial interests of employees
  - Working conditions
  - Unionization
  - Perpetuation of employee ownership (sustainability)
- Comparison with “B Corporations”

# Role of Board of Directors

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- Grow shareholder value
- Set corporate goals and strategy
- Appoint, monitor, and remove officers and ESOP Trustee
- Appoint ESOP Plan Administrator
- Advise CEO and management



## Role of Board of Directors (cont'd.)

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- Evaluate and approve significant corporate transactions, including merger of the company or sale of its assets
- Review corporate financial statements
- Evaluate senior officers' performance
- Facilitate succession planning
- Determine senior officer compensation
- Establish corporate standards and conduct

# Key Board of Directors Committees

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- Audit / Finance Committee: Responsible for approving financial statements, audits, and financial projections
- Compensation Committee: Responsible for determining compensation of Board and Executive Management
- Governance / Nominating Committee: Responsible for committee structure, regulatory compliance and delineation of Board and management responsibilities, and director nominations
- Not all committees are applicable or possible in every ESOP company

# Board Selection of ESOP Trustee

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## Appointing ESOP trustee

- Who should serve as trustee?
- Corporate insider(s)?
- Shareholder(s)/seller(s)?
- Board member(s)?
- Outside advisor(s)/individual(s)?
- Institutional trustee?
  - More than one? (if not institutional)
  - Dealing with conflicts of interest
  - Directed vs. discretionary trustees

## Monitoring and Removal of trustee

Because these duties are defined by ERISA, in carrying out these duties, the Board is held to the ERISA fiduciary standard (see next slide)

# ERISA Fiduciary Standards

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- 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 matters\* would use in the conduct of an enterprise of like character and with like aims;
- In conformance with (1) ERISA; and (2) the Plan and Trust documents \*the “prudent expert” standard

# Role of Trustee

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- 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 appraiser
- Act as a shareholder, including voting stock and responding to offers
- Ensure plan is operated according to plan document
- Monitor Board performance?

# Voting of ESOP Shares – Trustee’s Role

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Electing the Directors

Directed vs. Discretionary Trustees

Extraordinary transactions

- merger
- consolidation
- Recapitalization
- Reclassification
- Liquidation
- Dissolution
- sale of substantially all assets of a trade or business
- such similar transaction as the Secretary may prescribe in regulations

The Trustee as election monitor

# Monitoring Board Performance

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Representation on Board?

General Review

- meetings and minutes
- financial statements

Specific Areas of Concern

- related-party transactions
- executive compensation
- stock issuances
- Acquisitions
- repurchase liability

# Valuation of ESOP Shares

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- ESOP must use an independent qualified appraiser
- Appraiser must report solely to the Trustee
- Ultimate conclusion of value is the Trustee's responsibility
- See DOL's Fiduciary Process Agreement
  - <http://www.dol.gov/ebsa/pdf/esopagreement.pdf>
  - <http://www.nceo.org/DOL-Fiduciary-Process-AgreementESOP/pub.php/id/665/>



# Repurchase Obligation

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- Company responsibility
- Trustee should monitor
- Recycling vs. redemption
- Impact on valuation

# Recordkeeping / Trust Account

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- Maintain trust checking account
- Retain custody of ESOP stock certificates for allocated shares
- Submit annual report and accounting to company
- Monitor allocations
- Distributions

# Trustee Role in Plan Administration

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- Trustee is not the Plan Administrator — the Trustee has no direct role in determining who is eligible or vested or who has what allocation under the plan (unless the Trustee has also been appointed to serve as the Plan Administrator).
- The Trustee should vet plan recordkeeping to make sure the calculation of plan assets and liabilities is correct, and that the appropriate compliance tests were performed and corrective action was taken if the test(s) failed.

# Special Issues - Offers

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- Sale of Business
- Voting pass-through?
  - Fairness
  - Price
  - other terms/relative fairness
- Purchase Offer to Trustee
  - Outside offer
  - Redemption offer from plan sponsor
- Recapitalization
- See DOL's Fiduciary Process Agreement

# Special Issues – Acquisition or Sale of ESOP Shares

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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

Whether ESOP trustee is performing its role effectively?

# Special Issues – Acquisition or Sale of ESOP Shares (cont'd)

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An ESOP fiduciary should:

- Engage in a diligent, independent investigation of the entity involved
- Visit the company premises, review documents, and interview management
- Engage its own advisors
- Actively participate in negotiation of price and terms of transaction
- Get what you pay for: control “in fact”?

See DOL’s Fiduciary Process Agreement

## Special Issues – Acquisition or Sale of ESOP Shares (cont'd)

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An ESOP fiduciary should:

- Have experience and knowledge to understand nature of transaction and any investment, or engage advisors who have such experience and knowledge
- Scrutinize the work of their advisors
- Review predecessor fiduciary efforts, if any

See DOL's Fiduciary Process Agreement

# Special Issues – Executive Compensation

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- 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



# Special Issues – Conflicts of Interest

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- Potential Conflict Situations
  - Board of Directors members' compensation
  - Multiple hats: Trustee, Director, Executive, Creditor, Guarantor, Shareholder or Warrant holder
- Conflict situations create heightened standard of review
- Possible Solutions
  - Transparency; identify and disclose conflict
  - Hire independent fiduciary, remove or sequester conflicted person
  - Hire independent advisors
  - Document analysis and decisions

# Best Practices

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- Independent Directors
  - Add skills, experience, knowledge, perspective, resources, contacts
  - Compensation
- Frequency and conduct of meetings
- Productive Board meetings with agenda and information distributed before the meeting
- Compensation and Audit Committee controlled by outside directors
- Informed Directors and Trustee
- Effective use of outside advisors
- Open communications between Trustee, Board, and Officers

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## **BOARD OF DIRECTORS' AND TRUSTEES' ROLES IN ESOP COMPANIES: PART 2**

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# Christopher L. McLean

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Christopher is a part of Kaufman & Canoles' ESOPs & Employee Benefits Group where he advises clients on a broad range of issues relating to qualified and nonqualified plans and corporate succession transactions. Christopher works with corporations and their shareholders in a wide range of M&A as well as exit transactions, including leveraged buyouts, stock sales and corporate redemptions, mergers, reorganizations, asset sales and purchases, and generational transfers.

Christopher's employee benefits practice focuses on the design, implementation, maintenance and compliance of employee stock ownership plans. Christopher works with both ESOP Sponsors and ESOP Trustees in initial stock purchase transactions, second stage transactions and sale transactions of successful ESOP companies. Christopher also advises ESOP Sponsors in the management of mature ESOPs including evaluating repurchase obligation options, resolving administrative issues, counseling on acquisitions and secondary purchase transactions, and coordinating and designing executive compensation plans complimentary to ESOPs.

Christopher's executive compensation practice involves a variety of nonqualified executive compensation plans. Christopher works with corporations in the design, adoption, implementation and compliance of nonqualified plans which have involved phantom stock, stock appreciation rights and other synthetic equity, stock options, restricted stock, deferred compensation and other executive compensation arrangements. Christopher also represents executives in the negotiation of executive compensation arrangements and employment agreements, taking an inclusive approach so to ensure the compensation structure is a part of the executive's broader trust and estate planning.

# Jared Kaplan

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## **Jared Kaplan**

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After 23 years at McDermott Will & Emery, Jerry retired from that firm to form Delaware Place Advisory Services LLC to assist on matters involving employee stock ownership plans, family business and corporate governance. He currently serves on the board of The Family Firm Institute and is its General Counsel. He has served on the boards of directors of a number of both family owned businesses and ESOP companies and has extensive experience in the areas of corporate finance, corporate tax and employee stock ownership plans (ESOPS). Jerry is a former Chair of the ESOP Association Legislative and Regulatory Advisory Committee, and currently serves on the Association's Valuation Advisory Committee. He is a founder of the Private Directors' Association, a member of the Economic Club of Chicago, the Association for Corporate Growth, the ESOP Association and the Lawyer's Club of Chicago.

# Al Harrington

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Al Harrington is the Director of Human Resources for Web Industries, Inc., at its headquarters in Marlborough, Massachusetts. He has served as its internal discretionary ESOP Trustee and Plan Administrator since 1994 and as a Trustee and the Plan Administrator for the 401(k) Plan since 1995. Al has been a presenter and frequent attendee at both National Center for Employee Ownership and ESOP Association conferences. He has completed the Certificate Program for Non-Professional ESOP Fiduciaries offered at the Rady School of Management at the University of California in San Diego. Al serves on the Board of Directors of two local non-profit organizations and is the Moderator for his Church. He serves on the Empower Retirement Plans Advisory Board, a subsidiary of Great-West Financial, and is a member of the ESOP Association's Interdisciplinary Advisory Committee on Fiduciary Issues. Al has a B.S. in Accounting from Northeastern University and an M.B.A. in Finance from Babson College.

# Postscript

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