

# Process & Decision Making of the ESOP Administration Committee

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# Introduction

## – Presentation Goal

- Understand the role of the Plan Administrative Committee so that proper processes can be implemented to ensure a proper and defensible process

## – Fiduciary Overview

- What are the standards of duty?
- Interaction of Corporate Governance and Plan Fiduciary Duties

## – Plan Governance

- Development of processes and procedures to comply with fiduciary obligations

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# Fiduciary Overview

- Differences between:
  - 403(a) – Trustee
  - 3(16) – Plan Administrator
  - 3(21) – Named Fiduciary
- Regulate internal controls to minimize IRS Code or ERISA violations, offer limited scope opinion for audit purposes, handle administrative details

# Interaction of Corporate Governance and Plan Fiduciary Duties

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# Who are the Corporate Fiduciaries?

- Directors
- Officers
- Directors owe fiduciary duties to corporation and shareholder(s)
- Officers owe fiduciary duties to corporation and shareholders
- Officers also have a duty of candor to Directors
- Law less developed on Officer duties than Director duties

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# ERISA Fiduciary Duties

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# Fiduciary Duty Overview

- ERISA Section 404(a)(1)(B) requires that in discharging his fiduciary duties, the fiduciary must act....

“With the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.”

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# Fiduciary Duty Overview (cont.)

- Fiduciary duties under ERISA....
  - “are the highest known to law.” *Donovan v. Bierworth*, 680 F.2d 263, 271 (2d Cir.), cert. denied, 459 U.S. 1069 (1982)
- When enforcing these duties...
  - “the court focuses not only on the merits of the transaction, but also on the thoroughness of the investigation into the merits of the transaction.” *Donovan v. Cunningham*, 716 F.2d 1455, 1467 (5th Cir.) (1983)

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# What are the ERISA Fiduciary Duties?

- To act solely in the best interest of participants and beneficiaries
- To use plan assets for the exclusive purpose of paying plan benefits or reasonable expenses of plan administration
- To act with the care, skill, prudence and diligence of a prudent person
- To allow participants to diversify investments in order to minimize the risk of loss
- To act in accordance with governing documents (assuming such documents comply with all legal requirements)
- To avoid prohibited transactions with disqualified parties

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# To What Standard Are They Held?

- The “Prudent Expert Rule” requires fiduciaries to act with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims
  - Permits employment of professionals, requires fiduciary to monitor them and their work product
  - Requires documenting the process by which decisions are made
  - Holds fiduciaries to the standard of a prudent expert in the enterprise being undertaken
    - Plan administration
    - Investment selection and monitoring

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# Settlor Functions – Corporate Duties

- Company/Plan Sponsor and/or business related decisions which are not subject to an ERISA fiduciary standard of care
  - Establishment of the plan
  - Determining the group of covered employees
  - Level of benefits to be provided
  - Plan amendment and termination

# Are They ERISA Fiduciaries?

- Board of Directors
- ESOP (Administrative) Committee Members
- Officers who perform fiduciary functions
- Employees who perform fiduciary functions
- Trustee
  - Internal
  - External
- Accidental Fiduciary

# Trustee – ERISA Section 403(a)

- “...all assets of an employee benefit plan shall be held in trust by one or more trustees.”
  - Directed Trustee – Legal Owner of Plan’s Assets; limited ERISA Section 3(21) Fiduciary
    - Duty not to violate the plan document;
    - Duty not to violate ERISA; and
    - Duty to follow directions which do not violate either (1) or (2) above
  - Discretionary Trustee – unlimited ERISA Section 3(21) Fiduciary

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# Trustee – ERISA Section 403(a) (cont.)

- Required of the Trustee (may be directed by the Committee)
  - Voting stock
  - Oversee trust activity
  - Buying/selling Trust holdings
    - Selection of Investments may be required depending upon terms of Trust Agreement – Directed vs. Discretionary Trustee

# What Are the Specific Duties of the Board?

- Select, appoint and monitor all Board Committees
- Select, appoint and monitor Trustee
- Select, appoint and monitor Administrative Committee



# What are the Specific Duties of the ESOP Administrative Committee?

- What does the plan and trust documents say?
  - Who is the Plan Administrator?
- If Company is the “Plan Administrator”
  - Have individuals been properly appointed?
  - Have they accepted their fiduciary role?
  - Are they qualified?
  - Does the role default to the Board?
- Administrative versus Communications Committee

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# What are the Specific Duties of the ESOP Administrative Committee? (cont.)

- Is there a Committee Charter in place?
  - Is the appointment/removal process consistent with the Plan Document?
- Internal/external trustee?
  - Directed or discretionary?
- If directed, all or partial?
  - Voting
  - Valuation
  - Management and investment of trust assets
  - Distributions

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# What are Common Duties of the ESOP Administrative Committee?

- Monitor the Trustee
- Instruct Trustee regarding election of the Board of Directors (if directed)
- Construe and interpret the terms and provisions of the plan and trust
- Hire, retain, remove all service providers & set performance expectations
- Establish rules to facilitate the regulation and operation of the plan
- Establish claims procedures consistent with regulations for presentation of claims by participants and beneficiaries for plan benefits
- Review and decide all appeals (to the extent not done by plan's service provider) for eligibility and benefits
- Prosecute, settle or assign any claims, litigation, or threatened litigation and respond to and comply with court proceedings and orders on the plan's behalf

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# What are Common Duties of the ESOP Administrative Committee? (cont'd)

- Developing policies and standards with respect to the use of plan assets for payment of expenses and monitoring compliance with these standards
- Arrange for and review the plan's annual audit (to the extent required by applicable law)
- Arrange for repurchase liability study
- Delegate fiduciary responsibility
- Reports to appointed fiduciaries
- Prepare government reports
- Provide plan documents and required notices and disclosures to participants

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# Administrative Committee Duties – A Closer Look

- Stay familiar with plan operations
  - Employee eligibility and enrollment
  - Recordkeeping including allocations and investment instructions
  - Evaluation of plan's service providers
  - Vesting of employer contributions
  - Withdrawals and distributions
  - Participants loans/hardship withdrawals (if applicable)

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# Administrative Committee Duties – A Closer Look (cont'd)

- Participant Disclosure and Communication of Plan Changes
  - Periodic benefit statement
  - Summary Plan Description (and updates – SMMs)
  - Explanation of distribution options and notice of tax treatment and rollover distributions
  - Right to defer distribution notice
  - Written explanation of denial of benefit claim
  - Notice of right to diversify out of employer securities
  - Notice of black-out periods (if applicable)
  - Copies of Form 5500, plan documents, etc. (when requested) 22

# What Are the Specific Duties of the Trustee?

- If the Trustee is a directed Trustee, the Committee may also be responsible to direct the Trustee to:
  - Elect Board of Directors
  - Employ financial advisor for ESOP
  - Determine fair market value of employer securities
  - Pay only reasonable expenses
  - Vote employer securities
  - Diversify plan assets for qualifying participants
  - Manage investments (if any in assets other than employer securities)
  - Make distributions to participants as directed by ESOP Committee

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# Committee Structure/Membership

- Avoid overlap of fiduciary and settlor activities
  - Committee shouldn't necessarily be the entity to address "plan changes"
- "Down arrows" should determine membership and structure
  - What sort of committees will be established and maintained (administrative, investment, settlor, etc.)?



# Committee Structure/Membership (cont.)

- Who should be on the committee?
  - Investment experts, human resources experts, benefits experts, representatives from business units?
  - Consider who should be responsible for appointing fiduciary committee members and monitoring their activities
    - Being a fiduciary should not be viewed as a training or development opportunity
  - Board of Directors, CEO or other officers; designate committee members in the plan document by name or title?

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# Committee Operation

- Documents governing committee actions:
  - Committee charter/operating rules; clarify how committee functions
  - As important as it is to have good governance documents, it is critical to follow them; not following them is almost worse than not having them at all, since failure to follow will be prima facie evidence of imprudence

# Conduct of Meetings

- Agenda and list of topics to address
  - “Perennials” – reports from fund providers and investment managers, key vendors, consultants; review of fund and manager performance, including fees and expenses;
  - Review of legal/compliance issues; review of participant issues (usage/trends, complaints, claims/appeals)
  - Record minutes to document activities and confirm exercise of procedural prudence

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# Delegating Fiduciary Duties

- Review Trust Agreement
  - May have hidden or different duties
  - Trustee is not permitted to delegate trust duties (create co-trustee relationship); e.g. review of trust activities or ownership of assets
- Commonly delegated duties
  - Investment management
  - Tax form preparation
  - Administrative (ministerial) in nature

# Delegating Fiduciary Duties

- Ministerial functions
  - Establish detailed processes and procedures for individuals carrying out ministerial functions
  - Provide ongoing training to those serving in a ministerial capacity
  - Perform routine monitoring of those performing ministerial functions to ensure all duties are being performed in accordance with ERISA and IRC
  - Ensure that individuals performing ministerial tasks don't become an "accidental fiduciary"

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# Service Providers and Their Roles

- Third Party Administrator
  - Participant statements
  - Plan testing
  - May prepare Form 5500
  - May prepare 1099-Rs
  - Not a plan fiduciary
- Corporate Attorney
  - Engaged by the company
  - Corporate legal docs
    - By-laws
    - Articles of Incorporation, etc.
    - May update plan documents

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# Service Providers and Their Roles (cont.)

- Accountant
  - Perform plan audit if necessary
  - May prepare Form 5500
- Trustee
  - If external, typical functions
    - Manage Trust

# Protection Against Liability

- Protecting ERISA Fiduciaries
- “Hold Harmless” provisions are void under ERISA
- Indemnification Agreements\*
  - Review structure (Plan vs. Separate Agreement)
  - Review parties (Plan may not indemnify; Company ???)
  - Review legal fee advancement provisions
  - Review limitations (Gross Negligence/Intentional Misconduct)
  - Review Board authorization



# Protection Against Liability (cont.)

- Fiduciary Liability Insurance
  - Plan may purchase such insurance (permitted under ERISA), provided that insurer has recourse against Fiduciary for breach of fiduciary obligations
  - Fiduciary may purchase such insurance with Fiduciary's own money, to cover Fiduciary's own liability
  - Employer or an employee organization may purchase such insurance, to cover liabilities of fiduciaries of employee benefit plans

# Protection Against Liability (cont.)

- Fiduciary Liability Insurance
  - Transaction Insurance vs. Ongoing Insurance
  - Does your insurer understand ESOPs?
  - Coverage
    - Who are the named insureds?
    - Are claims for benefits covered?
    - What is the premium?
    - What is the deductible?
  - Limits

# Protection Against Liability (cont.)

- The Fidelity Bond
  - Every plan must have a Fidelity Bond
  - DOL will always request on audit
  - Protects against theft of assets

# Questions?



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# Todd L. Denison

Todd is a partner in Phelps Dunbar, LLP's Mobile, Alabama office where he practices with the firm's business group. With an L.L.M. in taxation from New York University, Todd focuses on corporate representation and business, tax and estate planning. A major part of his practice consists of advising clients with respect to business succession strategies, including Employee Stock Ownership Plans. Todd has worked with companies and selling shareholders in conducting ESOP feasibility studies, adopting an ESOP, structuring and overseeing ESOP transactions and counseling ESOP companies and their board/committees post-transaction. Additionally, he has represented ESOP trustees in transactions and has counseled lending institutions with respect to ESOP issues. In addition to ESOPs, Todd's corporate and business practice includes business formation, financing, mergers, acquisitions and dispositions. He counsels corporations on diverse subjects such as captive insurance and aircraft ownership. In the estate planning area, Todd's practice includes planning techniques such as leveraged giving, sophisticated trusts and charitable plans. Todd currently serves as a member of the ESOP Association's Legal and Regulatory Advisory Committee.

# Christopher L. McLean

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.

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