



Protecting Your Company From Legal Problems

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General Overview

- **Protecting your ESOP Company from legal problems can be broken down into two main areas:**
 - **Plan Governance**
 - **Corporate Governance**

Plan Governance Overview

- **IRS Determination Letters**
- **Form 990**
 - **Plan Audit**
- **ERISA Fidelity Bond**



Plan Governance Overview

- **Administrative Committee/Plan Administration**
 - **Plan Amendment**
 - **Plan Termination**
 - **Duty to comply with Plan Document**
 - **Distributions/Diversifications**
 - **Entry/Eligibility/Re-hires**

IRS Determination Letters

- **Distinguish** prior program where qualified plans were submitted to **IRS** for review and determination as to favorable tax qualification on x-year cycles
- **IRS** discontinued cyclical program in 1101C—meaning they will only review and issue determination letters qualified plans for newly adopted plans and terminated plans (birth and death **DLs**)

IRS Determination Letters

- **Why does tax-qualification matter anyway?**
 - Tax-qualified status of a plan is the basis for a company receiving a tax-deduction for contributions and employees being able to defer income until retirement
 - If a plan loses qualified status, it can be catastrophic to the sponsoring company who would have to restate prior years' tax returns and pay back-taxes plus interest
 - Additionally, if **S-Corp ESOP**, company could lose **S-Corp** status
 - Employees could be forced to claim contributions as additional income

IRS Determination Letters

- So, if cyclical determination letter program is discontinued, what are plan sponsors/companies to rely upon for tax-qualification?
 - **IRS** will annually issue a list of mandatory amendments that all plans should adopt—evidence of timely adoption will be necessary upon termination or investigation/audit
 - Correspond frequently with legal counsel to ensure maintenance of plan's qualification
 - Some legal advisors may issue private opinions as to plan's qualification
 - Some plan sponsors may consider amending and restating **ESOP** plan document into a pre-qualified prototype plan document

Form 5500

- “**Annual Report**” for all retirement plans required by **ERISA**—goes to both **DOL** and **IRS**
- **Requires** information regarding the number of participants, financial information about the assets held in the plan, and the service providers involved with the plan
- **Companies** who sponsor plans must file one each year
- **Work** with third-party administrator (**TPA**) to file by extended deadline (mid-**October**)



Form 5500/Plan Audit

- Failure to file a Form 5500 or filing late is punishable by fairly stiff penalties
- Failure to include all the required information and/or the required audit can cause the Form 5500 to be treated as if it had not been filed
- **When is a plan audit required?**
 - If the plan covers 100 or more participants as of the beginning of the plan year, the plan is a “larger” plan and the **Plan Administrator** must attach an audited financial report on the plan assets
 - **Note:** the term participant for purposes of counting the 100 participant threshold includes active employees who are participants, as well as former employees who still have account balances or benefits in the plan

ERISA Fidelity Bond

- **An ERISA fidelity bond is a type of insurance that protects the plan against losses caused by acts of fraud or dishonesty**
- **Fraud or dishonesty includes, but is not limited to, larceny, theft, embezzlement, forgery, misappropriation, wrongful abstraction, wrongful conversion, willful misapplication, and other acts**
- **Deductibles or other similar features are prohibited for coverage of losses within the maximum amount for which the person causing the loss is required to be bonded**
- **In addition, it is important to make sure that the plan is named (or otherwise specifically identified) as an insured party on the bond so that the plan can recover losses covered by the bond**

Administrative Committee

- **ESOP Administrative Committee (or Administration Committee)** is usually appointed by the board of directors and delegated the responsibility to oversee day-to-day operations of the plan
- **Not required**, however, most plan documents specify that there be an **ESOP Administrative Committee** to administer the plan and oversee its operations
- **Often assume responsibility for administrative oversight of the plan** (making sure that statements go out, that participants are paid, that allocations are properly made, etc.), although they rarely do the administration

Administrative Committee

- **O**ften act as the vehicle for communicating the plan to participants and even oversee the company's employee involvement program
- **O**ften make decisions on plan design and amendments
- **U**sually directs the trustee on plan decisions, such as voting shares, but can just have an advisory role
- **T**o the extent the **ESOP Committee** actually makes decisions affecting the plan, including directing a trustee to make such decisions, it is acting as a plan fiduciary, meaning it is legally responsible for the operation of the plan
- **D**istinguish **ESOP Communications Committee** from fiduciary **Administrative Committee**.

Administrative Committee

- **ESOP** fiduciary decisions would include, but not be limited to:
 - making decisions as to the voting of shares in the **ESOP** where the law does not require a pass-through of voting rights to participants,
 - making decisions about investing plan assets both in employer stock and other investments,
 - selling stock,
 - insuring that the **ESOP** pays no more than fair market value,
 - selecting qualified advisors,
 - assuring that the operation and design of the plan comply with **ERISA**, and
 - moving assets from the **ESOP** to another plan

Administrative Committee

- In contrast, **Administrative Committee** actions that are not fiduciary decisions are:
 - establishing or terminating the plan,
 - changing its features within acceptable **ERISA** boundaries,
 - increasing or decreasing funding of the plan in a non-leveraged situation,
 - voting for the board, and
 - doing the day-to-day plan administration, presuming it is done in compliance with the law

Plan Administration

- **Key plan administration oversight duties include the following:**
 - **Keeping minutes of committee meetings**
 - **Making sure the plan administrator gets everyone who is qualified into the plan, and that once they are there, they get their proper allocations, statements, and forfeitures**
 - **Making sure the administrator files the proper reports with the government and provides required forms to plan participants**
 - **Guaranteeing that proper procedures are followed in the case of employee complaints about the plan and that other employee rights, such as voting and the opportunity to inspect plan documents, are provided**

Plan Administration

- **Key plan administration duties (cont'd)**
 - **Hiring a plan administrator and an investment manager for non-stock assets in the plan**
 - **Assuring that contributions to the plan are properly credited**
 - **Overseeing plan distributions to assure they are done properly**
 - **Having a repurchase obligation study done and creating a plan to deal with the issue**

Plan Administration

- **Key plan administration duties (cont'd)**
 - **Interpreting plan provisions**
 - **Adopting any additional rules that may be necessary to operate the plan to make specific what may be general or discretionary plan provisions**
 - **Providing the administrator with the information needed to operate the plan and getting from the administrator the information the company needs to file tax reports**

Corporate Governance Overview

- **Corporate Overview**
- **Meetings (Director and Shareholder)**
- **Insurance (D+O and Fiduciary)**
- **Accounts (Corporate and Trust)**
- **Monitoring Plan**

Corporate Overview

- **State Law**
- **Fiduciary Duties of Shareholders**
 - **Protect all shareholders, including minority shareholders**
- **Fiduciary Duties of Board of Directors**
 - **Duty of Care to act prudently**
 - **Duty of Loyalty to act in good faith and in the interests of the company and its shareholders**
 - **Duty of Obedience to remain faithful to the purpose of the company**
 - **Minutes should reflect conflicts of interest and solution to conflict**
- **Fiduciary Duties of Officers**
 - **Share financial information with shareholders**

Corporate Overview

- **Roles and Responsibilities**
 - **Board of Directors**
 - Establishes the strategic vision and direction of the company
 - Oversees the **CEO** and **Management**
 - Enhance shareholder value – must keep within the company's core values

Corporate Overview

- **Roles and Responsibilities**
 - **ESOP Trustee**
 - **Engage with the Board of Directors to be sure the ESOP's best interests are being met**
 - **Represent the interests of the ESOP as a whole**
 - **Protect the best interest of the ESOP participants**

Corporate Overview

- **Roles and Responsibilities**
 - **Management of Company**
 - **Guided by the CEO**
 - **Implement strategic vision and direction**
 - **Keep within the bounds of the company core values**



Corporate Overview

- **Roles and Responsibilities**

- **The board is responsible for managing the business of the corporation**
- **The Board acts in a fiduciary capacity with respect to all shareholders**



Meetings

- **Required by state law to have—at least—annually**
- **Sometimes handled through unanimous written consent**
- **Annual Shareholder Meeting is when the shareholder elects Board of Directors**

- **Key Points –**
 - **Documentation through Minutes or Consent**
 - **Separate Shareholder Meeting and Board of Directors Meeting (end one before beginning another—NEVER overlap)**

Insurance

- **Company should always have Directors + Officers (D+O) Insurance Coverage**
 - **Liability insurance payable to the directors and officers of a company, or to the company itself, as indemnification (reimbursement) for losses or advancement of defense costs in the event an insured suffers a loss as a result of a legal action brought for alleged wrongful acts in their capacity as directors and officers**
 - **Such coverage can extend to defense costs arising out of criminal and regulatory investigations/trials as well—intentional illegal acts, however, are typically not covered under D+O policies**

Insurance

- **ERISA Fiduciary Insurance**
 - **Protects against legal liability arising out of their role as fiduciaries, including the cost of defending those claims that seek to establish such liability**
 - **Not legally required (unlike an ERISA Fidelity Bond)**
 - **D+O Insurance policies typically exclude this specific coverage**
 - **Employer may purchase**
 - **Fiduciary may purchase**
 - **Plan may purchase if insurer has recourse against fiduciary**

Accounts

- **Should always maintain separate plan (ESOP Trust) bank account from corporate bank accounts**
- **When ESOP makes distributions, they should be made directly from ESOP Trust account**
- **Contribution and ESOP Loan Payments should be properly documented in and out of the ESOP Trust account**



Monitoring the Plan

- **A**mendments
- **P**rohibited **T**ransactions
- **R**epurchase **O**bligation
- **S**ervice **P**roviders
- **F**iduciary **D**uties
- **A**udit **R**equirements
- **I**nvestment **P**olicy **S**tatement

Questions ?

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