



# EMPLOYEE OWNED 2019

**BOARDS OF DIRECTORS' AND TRUSTEES' ROLES IN ESOP COMPANIES: PART 1 (BASIC)**

**THE CONFERENCE & TRADE SHOW**

*for* **ESOPs**

# BOARDS OF DIRECTORS' AND TRUSTEES' ROLES IN ESOP COMPANIES: PART 1 (BASIC)



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# AGENDA

- Introduction: Corporate Governance
- Board of Directors
- Legal/Fiduciary Standards and Duties of **Board of Directors**
- Legal/Fiduciary Standards and Duties of the **ESOP Trustee**
- Speakers

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# CORPORATE GOVERNANCE

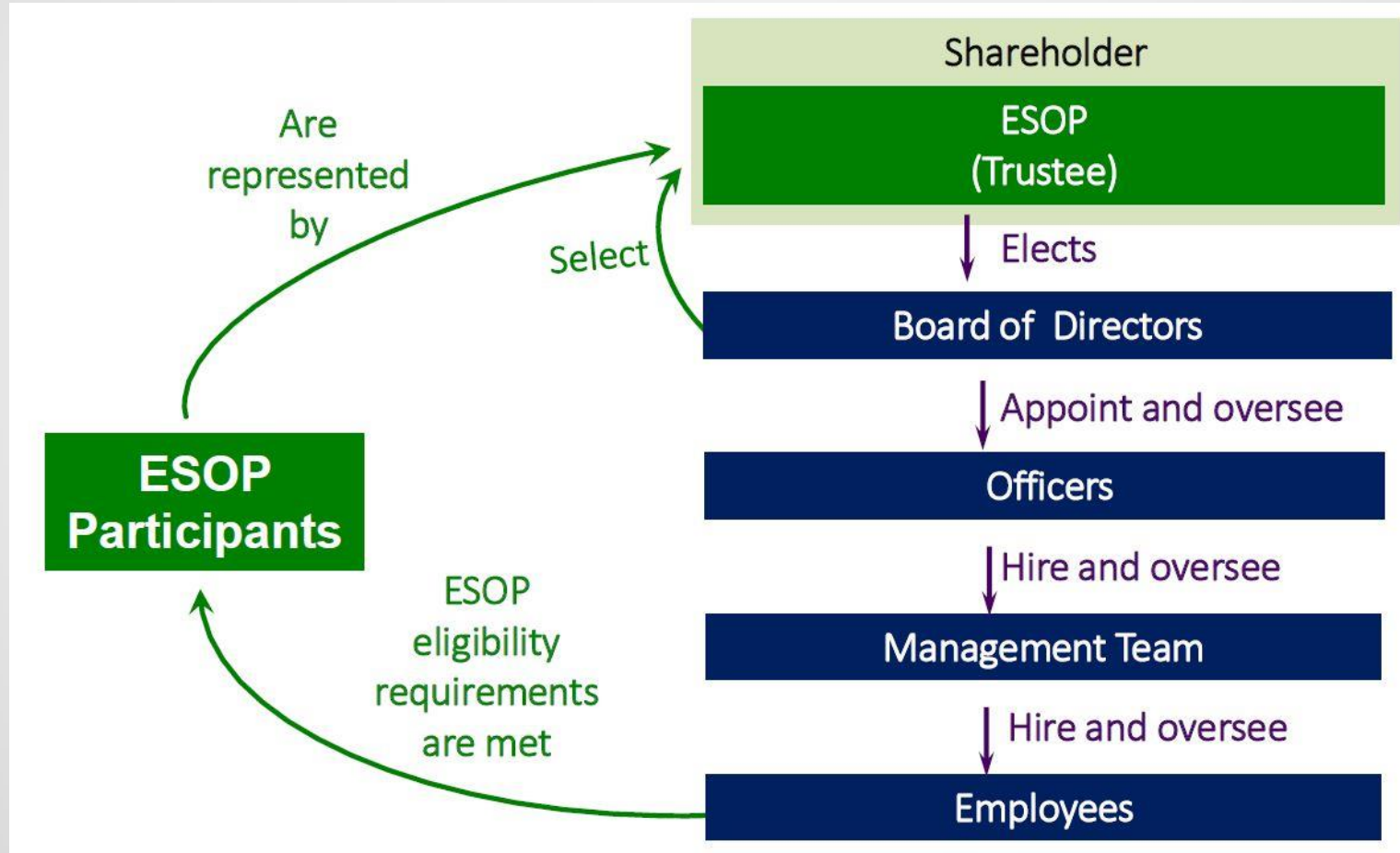
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# INTRODUCTION

- What is “Corporate Governance”?
  - A framework to govern the relationships among shareholders, directors, and officers
  - Method by which directors supervise officers and the business

# 100% ESOP CORPORATE GOVERNANCE



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# THE BOARD OF DIRECTORS

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# BOARD RESPONSIBILITIES

- **General**

- Provide guidance and direction to management on strategy
- Monitor company performance
- Approve certain corporate actions
- Appoint CEO, determine CEO compensation, and evaluate CEO
- Plan for management succession

- **ESOP**

- Appoint ESOP Trustee and Plan Administrative Committee
- Determine plan contributions, distributions, and dividends
- Monitor Trustee
- Understand and plan for Repurchase Liability

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# BOARD COMPOSITION AND OTHER ELEMENTS

- **SIZE** - No mandated requirements; average board has 5 to 6 members.
- **INDEPENDENT MEMBERS**
  - Not an employee or family member or provided material consulting services in past 12 months.
  - DOL wants majority of Board to be independent as part of new ESOP transaction.
- **DIVERSITY** - Of thought and action, gender, ethnicity, and generational.
- **TENURE** - Consideration of staggered terms, term limits, mandatory age limits, and periodic performance evaluations. Boards should experience perpetual development and enhancement.

# INDEPENDENT DIRECTORS

## ADVANTAGES

- Reduce conflicts of interest
- Provide different perspective
- Add credibility, trust, and confidence
- Build networks and resources
- Satisfy lending requirements
- Great for committees
- Viewed favorably by the DOL

## DISADVANTAGES

- Compensation
- May be hard to find
- Lack knowledge of business/industry/ESOP
- Confidentiality concerns
- Have to listen to them

# BOARD COMPENSATION – SURVEYS

## 2017 Lodestone Global Survey (386 YPO int'l private companies)

- Average number of members - 6.4
- Average # of independent directors - 3
- Average # female - approx. 16-17%
- Average annual retainer - \$29,285
- Average per-meeting fee - \$2,187
- Average number of meetings - 4.5
- Equity incentives in addition to cash – 15%
- Higher comp./incent. in *Tech, Real Estate*



## 2016 NCEO ESOP Corp Governance Survey (309 ESOP companies)

- Average number of members 5.6
- At least one independent director - 74%
- Median annual retainer - \$15,000\*
- Median per-meeting fee - \$1,625\*
- Average number of meetings - 4.1
- Equity incentives in addition to cash – 16% \*
- Average annual retainer - \$17,000\*
- Median per committee meeting - \$1,000\*

\* *Compensation for Independent Directors*

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# BOARD SKILLS

- Board
- ESOP
- Finance
- Human Resources
- Industry Specialists
- Information Technology
- Leadership
- Legal
- Marketing and Sales
- Operations
- Strategic Planning

\* SEC expanded proxy rules to require companies to “discuss the specific experience, qualifications, attributes or skills that led to the conclusion that the person should serve as a director...” in 2009. This does not mean each member should represent a particular skill; rather, the Board as a whole should possess a set of skills.

# DIRECTOR EDUCATION

- 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

# BOARD COMMITTEES

- **Typical Committees**
  - Audit
  - Compensation
  - Governance
  - Nominating

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# LEGAL/FIDUCIARY STANDARDS AND DUTIES OF BOARD OF DIRECTORS

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# WHAT DOCUMENTS GOVERN BOARD CONDUCT?

- 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
  - Standing Committee Charters

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# 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 corporate 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
- **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 good faith, with the best interests of the corporation in mind
  - If the business judgment rule applies, courts will look at decision-making process, not the final decision
  - Does not apply in the case of fraud or conflict of interest/self-dealing

# DUTIES OF BOARD OF DIRECTORS WITH RESPECT TO TRUSTEE

- Board has a duty under ERISA to:
  - Select and appoint a qualified Trustee or Trustees
    - Fiduciary in the First Degree
  - Monitor the actions of the ESOP Trustee (and any other Plan fiduciaries it appoints)
    - Fiduciary in the Second Degree
  - Valuation Process
    - 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

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# APPOINTMENT OF THE ESOP TRUSTEE

- **Issues Board Considers**
  - Who should serve?
  - “Inside” vs. “outside” Trustee
  - Experience & awareness
  - 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
      - Voting of shares in special events like sale of company

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# BOARD OF DIRECTORS: STANDARDS OF LIABILITY

- No liability to corporation or shareholders for action or inaction, except for:
  - Conduct not in good faith
  - Conduct involving self-interest, not in the best interest of the corporation
  - Failure to attend to the business of the corporation
  - Unlawful financial benefit
- Burden of Proof: Shareholders bear the burden



# LEGAL/FIDUCIARY STANDARDS AND DUTIES OF THE ESOP TRUSTEE

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# ESOP TRUSTEE & FIDUCIARY DUTY

## Prudent Man Standard of Care

- Duty to act “solely in the interest” of Plan Participants and their beneficiaries (duty of loyalty, and for the exclusive purpose)
- Duty to defray Plan expenses
- Duty to act prudently
- Duty to diversify Plan assets (ESOP exemption)
- Duty to act in accordance with ERISA and the Plan documents

To act “**solely in the interest of the [plan] participants and beneficiaries**...for the exclusive purpose of...providing benefits to participants and their beneficiaries...[and] defraying reasonable expenses of administering the plan...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....”

# WHO IS A FIDUCIARY UNDER ERISA?

- ERISA defines the term “fiduciary” to include any person:
  - who exercises any discretionary authority or discretionary control over the management of a Plan;
  - who exercises any authority or control over the management or disposition of the Plan’s assets;
  - who renders investment advice for a fee; or
  - who has any discretionary authority or responsibility in the administration of the Plan.
- *The determination of fiduciary status is made on a de facto basis.*
  - As a result, a Plan can have more than one fiduciary:
    - the Trustee
    - the Plan Administrator
    - members of a Plan Administrative Committee
    - an investment manager
    - members of the Board/duty to monitor

# LIABILITY FOR BREACH OF DUTY

- ERISA provides that a fiduciary that has breached any of its responsibilities, obligations, or duties:
  - can be personally liable for restoring losses to the Plan;
  - can be personally liable for restoring to the Plan any profits made by the fiduciary through the use of Plan assets;
  - can be subject to other equitable and remedial relief; and
  - can be subject to significant civil penalties.

# DOCUMENTS AND COMPOSITION

- **Documents**
  - ESOP Trust Agreement
  - ESOP Plan Document
  - Corporation's articles/certificate of incorporation
  - Corporation's bylaws
- **Composition**
  - ESOP Trustee Committee – Co-Trustees
  - Internal vs. External
    - Employees, Management?
    - Educational/Training Requirements

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# DUTIES OF THE ESOP TRUSTEE

- Legal owner of shares and all other trust assets
- Appoint and monitor Board of Directors
- Determine annual share value
- Custodian of trust assets
- Manage non-employer stock assets
- Oversee participant distributions
- Comply with ERISA fiduciary duties and avoid prohibited transactions
- Vote stock (e.g., annual director elections)
- Ensure Plan is operated according to Plan Document
- Monitor allocations & release of pledged shares

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# THE ESOP AS SHAREHOLDER

- **Pass-Through Voting to Participants**

- Section 409(e) of the Code requires Participants in an ESOP to have the right to direct the Trustee with respect to the manner in which shares of stock allocated to their ESOP accounts should be voted in certain instances
  - In the case of most private companies, the pass-through voting direction right applies only with respect to certain major corporate matters, including *mergers, consolidations, recapitalizations, reclassifications, dissolutions, liquidations, or sales of substantially all assets*
- If “pass-through voting” is applicable, a Plan’s Trustee/designated fiduciary will generally be responsible for the voting of all unallocated shares and all allocated shares for which no voting direction is provided
- The statutory provisions regarding “pass-through voting” do not extend to the pass-through of certain other rights (i.e., a decision of whether or not to tender ESOP shares in a tender offer), but similar procedures can be employed

# ESOP TRUSTEE DUTIES AS SHAREHOLDER

- **Shareholder Rights**

- May attend meetings of the Board
- Call special meetings
- Vote to elect or remove directors
- Subject to Participant pass-through voting rights, vote ESOP shares with respect to corporate merger or consolidation, recapitalization, reclassification, liquidation, dissolutions, sale of substantially all assets of business
- Vote ESOP shares on other extraordinary changes to the corporation (e.g., amendment of the articles of incorporation)
- Respond to tender offers
- Review annual financial statements, including reports by accountant or finance committee
- Bring derivative shareholder action against third parties



# TODAY'S SPEAKERS

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- Neil co-founded Ventura with Mary Wertz in July of 2016 after providing ESOP trustee services for two institutional trustees from 2005 through April of 2016. He has 28 years of experience in banking, public accounting, management consulting and the IRS.
- The key to Neil's success in providing ESOP trustee services is his dedication to providing outstanding service, his intentional and sincere building of relationships as well as his common-sense approach to problem solving.
- Neil is an active member of the ESOP Association having served on its Board of Governors, Finance Ownership Culture and Valuation Committees, the National Center for Employee Ownership including being a Board member as well as the Minnesota/Dakota and California Western States ESOP Association chapters. He is a recognized national speaker and writer on various ESOP issues.
- Neil lives in Minneapolis with his wife Mary Wertz and Max their adorable chocolate lab.

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- Christopher L. McLean, a member at Kaufman & Canoles, P.C. and a Director of ESOP Strategies, LLC, has an extensive background in corporate law including M&A transactions and Benefit Corporations to complement his broad ESOP background. Christopher has worked with numerous corporations in a wide range of corporate ownership succession transactions, including leveraged buyouts, corporate stock repurchases, and corporate reorganizations in addition to Benefit Corporation elections. His ESOP practice focuses primarily on the design, implementation, maintenance, and compliance of ESOPs, while representing ESOP sponsors or trustees.
- 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.

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