


# **Who Runs an ESOP Company?**

**MANAGING IN AN EMPLOYEE OWNERSHIP COMPANY**


**MONDAY OCTOBER 15, 2007**

**9:45 – 10:45 AM**

**Anthony I. Mathews  
Beyster Institute  
Rady School of Management, UCSD**

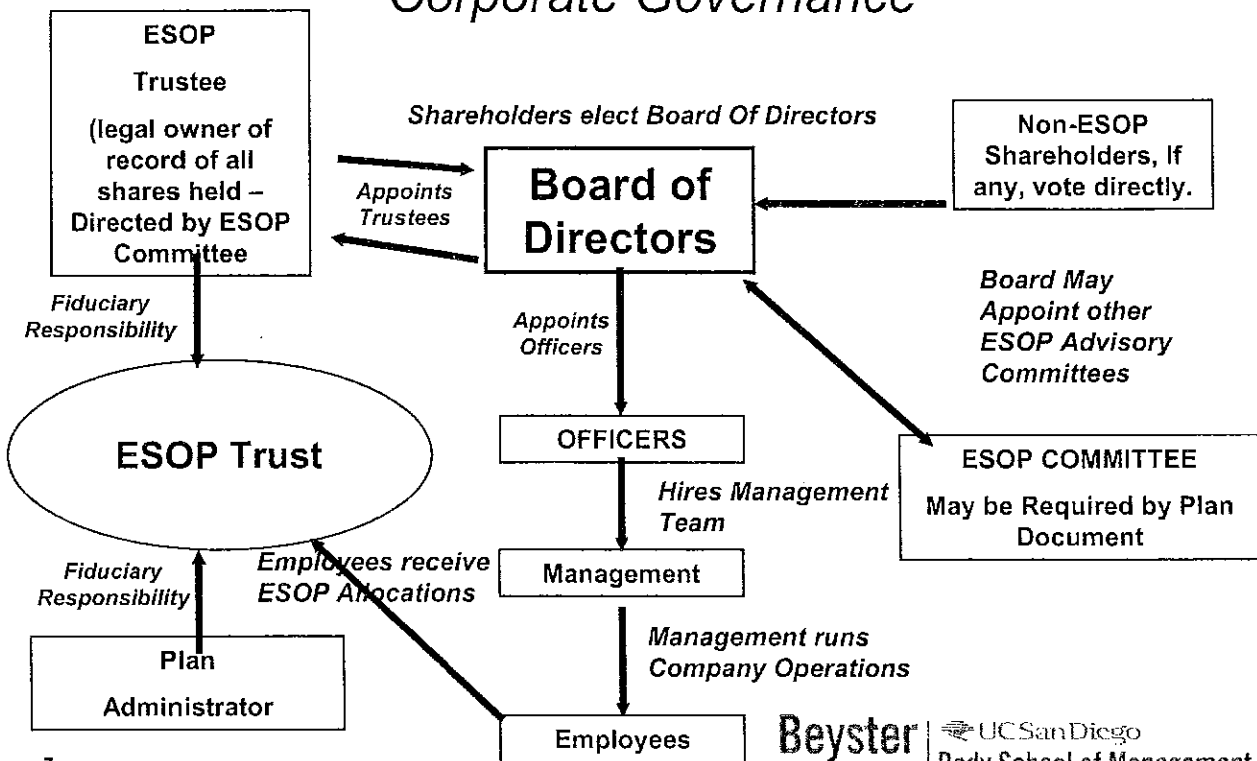
**Beyster** |  UC San Diego  
INSTITUTE | **Rady School of Management**

# Who's Running this Place Anyway?

**Beyster** |  UC San Diego  
INSTITUTE | Rady School of Management

# Who Runs an ESOP Company?

## Corporate Governance



## Safeguards Under ERISA

---

**E**MPLOYEES'  
**R**ETIREMENT  
**I**NCOME  
**S**ECURITY  
**A**CT

1. SPONSORS ARE FIDUCIARIES  
No Self-Dealing  
Minimize Risk of Loss
2. DISCRIMINATION NOT ALLOWED  
Required Coverage  
Consistent Participation
3. VESTED BENEFITS PROTECTED  
Reasonable Schedule  
Vested Means Non-forfeitable
4. EXCLUSIVE BENEFIT RULES

**-BUT-**

THE PERFORMANCE OF THE FUND IS NOT GUARANTEED

**ESOP BENEFITS ARE NOT GUARANTEED**

## Who are ERISA Fiduciaries?

---

- You are an ERISA fiduciary if you exercise any discretionary authority or control over the assets of an employee benefit plan.

Title	Are they an ERISA Fiduciary?
Trustee	Yes
Plan Administrator	Yes
ESOP Committee	May Be
In-house Administrator	Generally not
ESOP Attorney	No
Board of Directors	Sometimes
Management	Generally not
Participants	Can be a Named Fiduciary
Third Party Administrator	Generally Not

## Trustee:

---

- **Is Appointed by the Board of Directors**
- **Primary Responsibilities**
  - Fiduciary for the care and investment of the Trust assets
    - sometimes with direction from ESOP Committee or Board
  - Votes stock as fiduciary
    - also often, with direction of Committee or Board
  - Determines the Value of Trust Assets
    - With advice from independent advisor
  - Required to solicit voting instructions from participants where “pass through” is required
    - Nevertheless must vote as it determines prudent

## Selecting a Trustee

---

- **Sources:**
  - Institutional Trustee
  - Individual-Independent Trustee
  - In-House Trustee/Board of Trustees
  - "Self" Trustee
- **Qualifications:**
  - **Not a felon and not prohibited from serving because of some previous fiduciary breach**
  - Sufficient Knowledge of the Business and ERISA to be able to act Effectively.
- **Terms of Service:**
  - Directed Trustee
  - Independent or Discretionary Trustee
  - Situational Fiduciary

## The Plan Administrator

---

- Named Fiduciary
  - Required under ERISA
- May be the Sponsoring Company Itself
- Has fiduciary responsibility for the administration of the Trust and Communicating Benefits to Employees.
- Duties include:
  - Interpreting plan provisions
  - Authorizing Trustee to make plan distributions



## Management (Settlor) vs. Fiduciary Functions

---

- **Board of Directors:**
  - Is a Settlor when:
    - Installing or designing the plan
    - Amending or terminating the plan
  - Is a Fiduciary when:
    - Directing others in the Interpretation of the plan or the Investment of Assets – must approve sales of stock
    - Participating in transactions on behalf of the plan
    - Reviewing and approving the appraisal
    - Selecting the Trustees and Committee Members
- **ESOP Committee Members**
  - Most Committees are Not Fiduciary
  - Generally are Fiduciaries by delegation of Board Powers
    - Sometimes as a result of communication (the ENRON Trap)
- **Management and Others**
  - Unintentional Fiduciaries

## Fiduciary/Management Conflicts

---

- Who controls the company and who makes decisions?
- If ESOP Trustee votes to elect the Board of Directors and Board of Directors appoints ESOP Trustee, how are conflicts resolved?
- If management or the Board is not doing well, does Trustee have obligation to act? When and How?
- Board of Directors establishes officers compensation, what if a Board member is also an officer, is this a conflict of interest and how is it resolved?

## Key Issue: Independent Stock Valuation

---

- The ESOP Value is determined by Trustee based on independent valuation advice
- Trustee Owns the Valuation
- The Board of Directors generally approves the information submitted to the Appraiser
- Management is responsible to provide accurate and timely information
- ESOP can pay no more than fair market value
  - Doing it is a prohibited transaction
  - Causing it is a breach of Fiduciary Duty

## Key Issue: Shareholder Vote

---

- Trustee is the legal owner of the stock, not the participants – Trustee always votes all the stock whenever a shareholder vote is required
- Participants Have the Right to Give Voting Instructions with respect to allocated shares on shareholder votes that involve:
  - Sale of all assets, recapitalization, merger, reclassification, liquidation, restructure, etc.
- Trustee votes as it determines on most operational issues
  - Election of Directors
  - Ratification of acts of officers

## Key Issue: Executive Compensation

---

- Generally, determining executive compensation is a settlor function of the Board
  - What is Board's process for setting compensation?
  - Conflicts of interest?
  - Independent Compensation Committee?
  - Due Diligence and Benchmarking
- Reasonable Compensation Standard
- Waste of Corporate Assets

## Key Issue: Offers to Buy Company

---

- Board of Directors generally receives offer
  - What is Board's standard of review?
  - What is requirement to pass to ESOP Trustee?
- Who makes decision?
- What is Trustee's obligation?
  - Must a value greater than appraised value be accepted?
  - What can be considered in evaluating offer?

## Managing in a Fiduciary Environment

---

- Keep Track of Which Hat You Are Wearing
- Be Conscious of the Situations in Which Your Roles (and Interests) Might Collide
- Always Take Great Care and Perform Due Diligence when making Fiduciary Decisions
- Have Formalized Procedures for Review and Decision Making and Follow Them
- Make Use of Expert Professionals
- Keep Careful Records of Deliberation and Decisions Made

## The Many Roles of Committees

---

- **All Committees are not created Equal:**
  - ESOP Administrative Committee (Board Appointment)
    - Plan Administrator - Fiduciary
    - Recordkeeping Function – Settlor
  - Other Types of Committees (Management Appointment)
    - Communication
    - Culture Building
    - Operational
    - Ad Hoc



## Step 1: Define Purpose

---

- **What is the Committee's purpose?**
  - Fiduciary (Trustee)
  - Communication
  - Input on decision making
  - Liaison between board and employees
  - Ad Hoc (specific need)
- **Define Authority**
  - Scope
  - Limits
  - Reporting

## Step 2: Set Format

---

- Ideal Size?
  - Odd numbers eliminate deadlock
  - Smaller is more efficient
  - Larger is more inclusive
- Term
  - Uniform
  - Rotating

## Step 3: Populating the Committee

---

- **Selecting Members**
  - Appointment
  - Selection by Function
  - Election by peers
  - Combination
- **Term**
  - Uniform
  - Rotating

## Step 4: Training

---

- **Peer to Peer/Informal**
  - Mentor
  - Specific training in plan terms
  - Understanding of function
  - Verification procedure/Certificate
- **Formal**
  - Signed out, numbered materials
  - Participation in conferences and seminars

## Step 5: Conducting Business

---

- **Regular and Special Meetings**
  - Frequency
  - Length
- **Setting the Agenda**
  - Regular Features
  - Out of the Box
- **Documenting Progress**
  - Minutes of Meetings (not too much detail)
  - Specific Reports
- **Communicating Results**
  - Reports to management/ the Board
  - Reports to employees

## Accountability

---

- Is the Committee achieving it's purpose?
- If not, can it be made more effective?
- If not, has it outlived its usefulness?
- If not, can it be re-energized?

## Committee Rules of Engagement

---

- Meet Regularly.
- Remember your mandate.
- Have an agenda and stick to it.
- Be Conscious of situations in which conflicts may exist.
- Have Your Fiduciary Radar on at all times!
- Always take great care and perform due diligence when making fiduciary decisions.
- Have formalized procedures for review and decision making and follow them.
- Make use of expert professionals.
- Keep careful records of deliberation and decisions made.

## Special Issues and Questions

---

- Questions? Questions? Questions?