



Is an ESOP Right for You? An In-Depth Look at Employee Stock Ownership Plans

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ESOP FIDUCIARY ISSUES

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ESOP FIDUCIARY OBLIGATION--DEFINITION



An ERISA fiduciary must act:

- Solely in the interest of plan participants
- With the care, skill and prudence that a prudent person familiar with such matters would use under the same circumstances (the prudent expert rule)
- In accordance with the terms of the plan documents insofar as they are consistent with ERISA

TYPICAL TRUSTEE DECISIONS

- Deciding whether to buy (or sell) Company Stock
- Decide on how to vote company stock
- Establishing the annual Company Stock valuation



TRUSTEE ROLE IN ESOP TRANSACTIONS



- Must be tangible property (essentially hard assets of the company)

- Participant must have the right to sell, foreclose upon, or otherwise dispose of the collateral in the event of default

- Value and liquidity of collateral must be such that loss of principal or interest will not result from the loan

- Company stock is not adequate security

TYPICAL TRANSACTION TERMS NEGOTIATED BY TRUSTEE

- Price and terms of purchase
- Financing terms, including warrants and inside ESOP loan terms
- Anticipated governance and board composition
- Management compensation, including any deferred compensation or synthetic equity

TYPICAL ONGOING FIDUCIARY ISSUES

- Corporate governance
- Offers to purchase the ESOP-owned company and/or the ESOP shares
- Acquisitions
- Valuation
- Benefit levels/repurchase obligations
- Synthetic Equity

CORPORATE GOVERNANCE

- Many ESOPs own all or a significant majority of corporate shares
- ESOP Trustee as majority shareholder must participate in corporate governance with fiduciary duty to participants
- Even minority interest ESOPs may have corporate governance role

CORPORATE GOVERNANCE: THE TRADITIONAL VIEW



Corporations are generally regulated under state law

State corporate laws uniformly empower a board of directors to manage the affairs of the corporation

The board of directors is elected by the shareholders of the corporation

CORPORATE GOVERNANCE: THE TRADITIONAL VIEW (Cont.)

Boards of Directors elect officers and hire and authorize senior management to act on behalf of the corporation—the scope of delegated authority varies but generally includes all day-to-day management functions

Corporate organization documents (Articles & bylaws) may contain special provisions regarding the relative power of shareholders, officers and directors and the process of election or appointment



ESOP AS SHAREHOLDER

- Shares owned by an ESOP are held in trust of behalf of ESOP participants and beneficiaries
- The trustee(s) of the ESOP have legal possession of ESOP shares and the ability to exercise all of the rights and privileges of a shareholder
- ESOP participants and beneficiaries have no direct shareholder rights—a participant has no legal right to attend a shareholder meeting or to demand information to which shareholders are entitled

ESOP AS SHAREHOLDER (Cont.)

- ERISA requires that participants be permitted to instruct the trustee as to voting of individual allocated shares with respect to recapitalization, reclassification, merger, consolidation, dissolution, liquidation, or sale of substantially all corporate assets
- ESOP plan may permit but does not require “pass-through” voting on other corporate matters or instruction as to tender or exchange of shares held by the ESOP

ROLE AND ELECTION OF BOARD OF DIRECTORS

- ▲ The Board of Directors is the locus of corporate authority and power
- ▲ Directors must be elected by shareholders
- ▲ Corporation does not have authority to agree to elect specific directors

ROLE AND ELECTION OF BOARD OF DIRECTORS (Cont.)

■ Corporate organization documents may provide:

- Staggered terms
- Restrictive nominating provisions

ROLE AND ELECTION OF DIRECTORS (Cont.)

- Trustee in 100% ESOP-owned company often has theoretical power to elect and/or remove entire board
- Trustee will (as most institutional shareholders in public companies) defer to management nominees unless there are apparent issues with business or director performance
- Some ESOPs have pass-through vote for or against management slate

MERGERS, SALES, EXCHANGES AND SHAREHOLDER APPROVAL

- State law generally requires shareholder approval of merger and ERISA mandates pass-through vote
- No shareholder vote on similar transactions involving tender of ESOP shares or exchange of ESOP shares for shares of another corporation—therefore no pass-through vote required
- Plan provision requiring pass-through vote may be wise anyway for tender or exchange

OTHER TYPICAL SHAREHOLDER ISSUES

- Review of Board actions with respect to:
 - Synthetic equity/Executive Compensation
 - Acquisitions
 - Replace CEO
 - Significant issuance of new equity
 - Other key decisions not requiring shareholder vote
- Lack of shareholder vote does not mean lack of fiduciary duty
 - Some fiduciary questions are about shareholder scrutiny/review of board decisions

ESOP ACQUISITIONS

- ESOP-owned companies often seek acquisitions to deploy tax-advantaged financing/tax savings
- Acquisitions are generally board decision—may involve shareholder vote if statutory merger or change in capital structure
- Trustee as shareholder should be “in the loop”, particularly for larger, riskier acquisitions or other capital structure changes

Questions ?

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