
Legal Risks of ESOPs:

Strategies To Avoid ERISA Violations and Liability

November 1, 2007

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Overview

- **Similarities to other tax-qualified retirement plans**
 - Employees meeting certain age and service requirements generally participate
 - Employer makes yearly contributions, which are allocated to the accounts of participants based on a specified formula (usually keyed to compensation)

Overview (cont'd)

- **Similarities to other tax-qualified retirement plans (cont'd)**
 - Value of participant accounts is distributed on retirement, death or other separation from service
 - ESOPs are subject to most of the requirements of ERISA and the Internal Revenue Code ordinarily applicable to tax-qualified plans
 - One of the primary purposes of an ESOP is to provide retirement benefits to employees

Overview (cont'd)

- **Differences from other tax-qualified retirement plans**
 - ESOP is designed to have its assets invested primarily in employer securities. ESOP trustee typically obtains the stock directly from the employer as a contribution to the ESOP
 - Although participants do not actually own the shares allocated to their accounts, their account balances grow with the success of the company

Overview (cont'd)

- **Differences from other tax-qualified retirement plans (cont'd)**
 - ESOP participants may receive company stock (or the equivalent cash value) when their employment terminates

Benefits of an ESOP

- **Corporate Financing Tool**
 - Provides a market for large blocks of stock
 - Can be used to take a public company private
 - Allows employees to share in the expected stock growth when a closely held company is planning to go public, or to transfer ownership and control of a company to its employees
 - Can provide a market for the principal shareholders' shares if the estate needs cash at death

Benefits of an ESOP (Cont'd)

- **Employee Performance Incentive**
 - ESOPs can be used to develop a sense of Company ownership by employees, and in many cases this capitalistic spirit improves productivity
- **Takeover Defense**
 - For a public company, once installed for proper retirement planning purposes, an ESOP can assist in hindering a tender offer or acquisition by putting the employer stock in “friendly hands”

Benefits of an ESOP (Cont'd)

- **Financing Vehicle (Leveraging the ESOP)**
 - ESOP borrows money from a bank or other lender to purchase the stock, and the company will guarantee the loan.
 - Produces tax benefits for the sponsoring employer, because the employer receives tax deductions for the repayment of principal

Benefits of an ESOP (Cont'd)

- **Financing Vehicle (Cont'd)**
 - In some cases, the company borrows the funds, and either re-lends the proceeds to the ESOP to be used in acquiring company stock, or issues stock equal in value to the amount of the loan.
 - The stock purchased with the loan proceeds serves as collateral for the loan

Benefits of an ESOP (Cont'd)

- **Financing Vehicle (Cont'd)**
 - The stock purchased with the loan proceeds must be held in a suspense account, and then released and allocated annually to the participants as the loan is repaid
 - The ESOP cannot provide any collateral other than the shares that are purchased with the loan (but the company can provide other collateral to support a guarantee of the loan)

Benefits of an ESOP (Cont'd)

- **Tax Incentives**
 - Increased deductions for contributions used to make principal payments on a loan
 - Participants' annual contribution limits increased because allocations attributable to repayment of interest on exempt loans are generally not subject to such limits
 - Dividends may be deducted, which significantly increases the ability to finance transactions through an ESOP

Benefits of an ESOP (Cont'd)

- **Non-recognition of Seller's Gain (Section 1042)**
 - A person selling shares to an ESOP may avoid current taxation on the gain by reinvesting the proceeds of the sale in another corporation
 - In order to qualify for this non-recognition, at least 30% of the company maintaining the ESOP must be owned by the ESOP immediately after the sale
 - The seller's new investments must meet certain technical requirements and must be in operating companies

Benefits of an ESOP (Cont'd)

- **Non-recognition of Seller's Gain (Cont'd)**
 - If non-recognition treatment is elected, neither the seller nor his or her family members can generally receive any allocation of the stock sold to the ESOP on which the gain was deferred
 - Also, any 25% owner and his or her family members (even though unrelated to the seller) will be barred from receiving any allocation of shares on which the gain was deferred

Benefits of an ESOP (Cont'd)

- **Non-recognition of Seller's Gain (Cont'd)**
 - Further, the ESOP cannot dispose of the stock acquired in a non-recognition transaction until at least three years after it is acquired, although distributions can be made to retiring, disabled or deceased participants, those over age 59 1/2, and those who have had a break-in-service
 - Non-recognition treatment is only available for stock held for at least 6 months, and is subject to many technical restrictions

Drawbacks of an ESOP

- **Complex and expensive to establish plan and trust, prepare loan documents, value securities, hire and monitor independent trustees, and administer the ESOP**
- **Transfer of share ownership and voting rights may limit the ability of existing owners and managers to direct corporate affairs**
- **ERISA Fiduciary duties with respect to ESOP stock may further inhibit management**

Drawbacks of an ESOP (Cont'd)

- **ESOPs impose cash flow requirements that may be burdensome**
 - Put options on non-publicly traded stock require cash flow analysis and planning
 - Diversification may impose additional cash flow requirements
- **ESOPs dilute shareholder equity**
 - Share acquisitions are funded through employer contributions and dividends

Operational Rules

- **Eligibility and Participation**
 - An ESOP has the same eligibility requirements as any other qualified pension or profit sharing plan
 - An ESOP generally must cover each employee who has attained 21 years of age (may be lower) and who has completed 1,000 hours of service with the company
 - Employees who meet these standards must become participants in the ESOP on a semi-annual basis

Operational Rules (Cont'd)

- **Contributions and Allocations**
 - The amount of employer contributions to the ESOP are within the discretion with the Board of Directors
 - To the extent the ESOP is leveraged, the annual contribution must cover the principal and interest payments on the loan to the ESOP
 - The annual contributions can be in the form of employer stock or in the form of cash

Operational Rules (Cont'd)

- **Contributions and Allocations (Cont'd)**
 - If the contributions are in cash, the trustee usually will use the cash to purchase employer stock
 - In a leveraged ESOP, the employer will contribute cash, which the trustee will use to pay off the loan
 - If the trustee must buy the stock rather than having it contributed to the ESOP, the ESOP cannot pay more than “fair market value”

Operational Rules (Cont'd)

- **Contributions and Allocations (Cont'd)**
 - Contributions to an ESOP are deductible up to 25% of the compensation of all the employees participating the ESOP
 - If contributions are used to pay off a loan made to a leveraged ESOP, the deduction is 25% of compensation, plus the amount of interest paid on the loan so long as at least two-thirds of the contributions each year are allocated to non-highly compensated employees

Operational Rules (Cont'd)

- **Vesting**
 - Graded: a participant must be at least 20% vested in his or her account after three years, with annual increases so that the participant is 100% vested after seven years of service
 - Cliff: a participant may be 0% vested, so long as the participant is 100% vested upon the completion of no more than five years of service
 - A participant who terminates employment before becoming fully vested will forfeit the non-vested portion of his or her account

Operational Rules (Cont'd)

- **Voting and Other Rights**
 - Once shares have been allocated to an employee's account in an ESOP sponsored by a public company, the employee has the right to vote the shares on all shareholder matters
 - The ESOP of a privately held company generally will pass through voting only on selected issues which generally involve a corporate reorganization of some kind

Operational Rules (Cont'd)

- **Voting and Other Rights (Cont'd)**
 - Voting and tender offer response rights not passed through to participants are usually exercised by the trustee or another fiduciary
 - Regardless of whether a bank or management committee makes the original decision to invest in employer stock, many companies want an inside committee (or an outside trustee where conflict of interest exists) to decide how shares will be voted

Operational Rules (Cont'd)

- **Dividends**
 - If the sponsor of an ESOP pays a dividend on its stock, the ESOP may pass the dividend through to the participants (rather than allocating them to the participants' accounts)
 - Most leveraged ESOPs, however, retain the dividend paid on the suspense shares and use them to repay the loan
 - Dividends passed through or used to repay an ESOP loan are tax deductible by the Company

Operational Rules (Cont'd)

- **Investments and Earnings**
 - Although an ESOP must invest primarily in employer securities, this does not mean that there can never be other investments
 - However, the extended holding of a significant percentage of plan assets in other investments would violate the rules governing ESOPs

Operational Rules (Cont'd)

- **Distribution Requirements**
 - Benefits are usually paid to a participant or his or her beneficiary in the event of retirement, disability, death or other severance of employment
 - An ESOP is required to make distributions to terminated employees in shares of company stock (unless the company's charter or by-laws restrict ownership of shares to employees), although fractional shares may be distributed in cash

Operational Rules (Cont'd)

- **Distribution Requirements (Cont'd)**
 - The ESOP can make all distributions in stock, or allow the participants to elect stock or cash
 - An ESOP is required to commence distributions to a participant within one year after the year of the participant's retirement, disability or death
 - Distributions to a terminated employee who has not died, become disabled or reached retirement age must generally commence within six years after the year in which employment terminates

Operational Rules (Cont'd)

- **Distribution Requirements (Cont'd)**
 - Distributions are not required to be in a lump-sum and may generally be made over a five-year period
 - Distributions of accounts in excess of \$800,000 may be paid over a somewhat longer period in some cases, and stock acquired with a loan need not be distributed until the loan is repaid
 - When stock without a public market is distributed, the participant has the right to force the company to buy it based on the most recent appraised value

Operational Rules (Cont'd)

- **Diversification Requirements**
 - A participant who has reached the age of 55 and completed 10 years of participation in an ESOP must be offered the opportunity to diversify 25% of the ESOP account balance
 - These diversification requirements can be met by distributing the applicable percentage of a qualified participant's account to him or her, in stock or cash, or by allowing such participant to invest in at least three other investment options

Operational Rules (Cont'd)

- **Securities Laws**
 - Most ESOPs do not have to be registered under the securities laws if employees are not allowed to designate their account investments
 - Applicable securities law requirements in connection with the ESOP's acquisition and disposition of stock have to be observed
 - Some regulated industries have requirements that restrict the adoption of an ESOP or limit participation of managers

Operational Rules (Cont'd)

- **Legislation Risks**

- Anytime there is a tax benefit, someone in Congress or in the Treasury could be interested in eliminating it or at least reducing the benefit
- Thus, there is no way of assuring that any of the particular tax advantages of ESOPs will not be changed at some point in the future
- Most likely any changes will be prospective, however, they could apply to transactions in progress

Fiduciary Duties

- **Plan Assets**

- Contributions made by an employer to an ESOP are held in trust for employees and the investment of trust assets must comply with ERISA's fiduciary standards governing plan assets

- **Prudence**

- ERISA requires investment decisions with respect to plan assets be prudent, generally meaning made with a high degree of skill and care

Fiduciary Duties (Cont'd)

- **Fiduciaries**
 - A person who makes investment decisions for the ESOP is a fiduciary. Investment fiduciaries are accountable for the prudence of investment decisions
 - Fiduciaries also include anyone who administers the plan. Administrative fiduciaries are responsible for fairly administering the plan for the benefit of the employees

Fiduciary Duties (Cont'd)

- **Independent Fiduciaries (Cont'd)**
 - Sponsors of ESOPs generally seek to have investment decisions made by an independent bank trustee so as to avoid conflicts of interest that might develop between the interests of the plan and those of the company
 - However, the problem with having an independent trustee is that the trustee's sole fiduciary duty is to the participants, and the trustee must base its decisions on the best interests of the participants

Fiduciary Duties (Cont'd)

- **Independent Fiduciaries (Cont'd)**
 - Bank trustees sometimes insist on making decisions it considers “safe,” even if management believes that the decision is not in the long-term best interests of the employees
 - For example, if a tender offer is made for the ESOP’s stock at a very high price, the bank may believe that it will have liability if the offer is not accepted, even if management believes that the offer is not in the best interests of stockholders

Fiduciary Duties (Cont'd)

- **Independent Fiduciaries (Cont'd)**
 - Thus, management cannot rely on a trustee to be “friendly” in all cases
 - However, individual trustees are also required to make fiduciary decisions solely for the benefit of the participants
 - Thus, management personnel serving in this role must be prepared, when necessary, to set aside the interests of the company when making decisions that affect the ESOP

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The Development of the ESOP Law

- Public Companies
 - Stock Drop
- Private Companies
 - Voting
 - Information
 - Valuation/redemption

ERISA Fiduciary Duties

- Act solely in the interest of the plan participants and beneficiaries;
- Care, prudence, and diligence;
- Diversify plan investments to prevent loss;
- Act in accordance with plan provisions;
- Act in accordance with ERISA.

ERISA Fiduciary Duties

- An ERISA fiduciary if person or group:
 - Has discretionary authority or control regarding management of assets,
 - Renders investment advice for fee, or
 - Has discretionary authority or control in plan administration.

ESOP Fiduciaries

- The following are examples of ESOP fiduciaries:
 - The company employer,
 - Individuals or committees acting as plan administrators, who may also be on the employer's board of directors or employees themselves,
 - Third party banks and trust companies acting as asset trustees, investment managers, or directed trustees.

ESOP Fiduciary Duties

- ESOP fiduciaries are subject to the same standards as other ERISA fiduciaries, except to the extent that the standards require diversification.
 - Duty of Loyalty, or Exclusive Benefit Rule
 - Duty of Prudence or Care
 - *Duty to Diversify*
 - Comply with Plan Documents and Instruments
 - Prohibited Transactions and Exemptions
 - Paying or Receiving Adequate Consideration for Employer Stock

ERISA Stock Drop Cases

- Employee investment in employer stock.
- May be optional or through employer matching plan.
- Suits stem from significant decline in the value of employer stock.
- Plan participants allege breach of fiduciary duties.

ERISA Stock Drop Cases

- **ERISA Stock Drop Lawsuits**

- Recent years have seen a trend in fiduciary litigation by employees under ERISA in connection with drops in stock price.
- The ERISA breach of fiduciary claims are often accompanied by 10b-5 securities claims.
- These stock drop lawsuits are the result of the increased role of pension money in ownership of companies.
- Different and broader legal standard than fiduciary duties elsewhere.
- Pension / 401k money is significant to corporate finance structure.

Litigation Issues for ESOP Fiduciaries of Public Companies

The *Moench* Presumption

- Former employees sued ESOP fiduciary for remaining invested in employer stock when financial condition of employer was rapidly deteriorating
- Court addressed the tension between Congressional intent to keep retirement plans safe and to encourage employee ownership through ESOPs
- The presumption is that an EIAP fiduciary's investment in employer stock is reasonable
- But a plaintiff may overcome the presumption notwithstanding the diversification exemption under ERISA
- *Moench* identified a “precipitous decline” in employer stock value as well as the fiduciary’s “knowledge of [the employer’s] impending collapse” as possible rebuttals to the presumption

Litigation Issues for ESOP Fiduciaries of Public Companies

- No definite set of circumstances has emerged for rebutting the *Moench* presumption
- Courts are unclear on whether the *Moench* presumption applies to EIAPs or only ESOPs, or even on what the presumption means
- The terms of the plan, and whether they absolutely require that the plan invest in employer securities, may also affect how the courts apply the presumption, since the fiduciary is also subject to claims of breach of fiduciary duty for failing to maintain investment in employer stock if the plan requires such investment

Litigation Issues for ESOP Fiduciaries of Public Companies

- *In re Schering-Plough Corp.*, 420 F.3d 231 (3d Cir. 2005)
 - Former employees brought class action against fiduciaries of retirement plan for breach of fiduciary duty
 - *Moench* presumption was only available to plans that formally qualify as ESOPs, not to all EIAPs
- *Wright v. Oregon Metallurgical Corp.*, 360 F.3d 1090 (9th Cir. 2004)
 - Participants in a stock bonus plan – not an ESOP – brought suit for breach of fiduciary duty
 - A significant downward trend in stock price is insufficient to rebut the *Moench* presumption when the employer is not facing impending collapse
- *DiFelice v. U.S. Airways, Inc.*, 436 F. Supp. 2d 788 (E.D. Va. 2006)
 - “Unlike ESOP cases, the prudence of continuing to offer company stock as an investment option in a 401(k) plan will depend largely on the other investment options offered to participants and the participants’ ability to diversify their account assets among those investment options.”

Litigation Issues for ESOP Fiduciaries of Public Companies

- Inside Information
- Tension between fiduciary duty to company and ERISA fiduciary duty to plan participants.
- *Harzewski v. Guidant Corp.* (7th Cir. 2007)
 - Noting that it may be illegal for insiders to sell company stock based on inside knowledge of company' problems.
 - If so, no breach of fiduciary duty because ERISA fiduciary duty does not extend to violating the law.

Litigation Issues for ESOP Fiduciaries of Private Companies

- **Voting**
 - In control contests, the control or management of ESOP voting may give rise to fiduciary duties
 - Corporate governance of closely held ESOPs is often insular
- **Information**
 - Though participants may have access to less information about a closely held company, disclosure requirements are the same, as specified in ERISA provisions
 - An affirmative duty to disclose may arise if the fiduciary actively misleads participants or knows that changes to the plan are under serious consideration
- **Valuation/Redemption**
 - Unlike an ESOP of a publicly traded company, an ESOP of a closely held company does not have a market gauge of the value of the employer stock

Voting Issues for ESOP Fiduciary

- ***Grindstaff v. Green*, 133 F.3d 416 (6th Cir. 1998)**
 - Participants in ESOP alleged violation of ERISA fiduciary duties through “corporate retrenchment” and rejection of “pass through voting”
 - Court held that “corporate retrenchment” via elections in regular annual meetings, without contests for control, does not constitute a fiduciary breach
 - Stock voting rights do not by themselves constitute an ERISA plan asset
- ***Newton v. Van Otterloo*, 756 F. Supp. 1121 (N.D. Ind. 1991)**
 - Stock voting rights constitute an ERISA plan asset, the management of which produces an ERISA-based obligation to act solely in the interest of the plan’s participants
 - In a proxy fight to determine the voting of the ESOP, the plan committee was required to scrupulously investigate of whether it should abstain at the shareholders’ meeting

Information Disclosure Issues for ESOP Fiduciary

- ***Faircloth v. Lundy Packing Co.*, 91 F.3d 648 (4th Cir. 1996)**
 - Participants sued plan administrators and trustees for refusing to furnish requested documents
 - ERISA imposes a specific set of disclosure obligations, so courts will not create an additional general duty to disclose
 - ESOP fiduciaries did not have to disclose appraisal or valuation reports, which did not constitute documents “under which the plan [was] established or operated.” 29 U.S.C. § 1024(b)(4)
- ***Sweeney v. Kroger Co.*, 773 F. Supp. 1266 (E.D. Mo. 1991)**
 - Participant alleged that fiduciary failed to disclose company’s possible corporate restructuring and prospects of acquisition of company
 - ESOP fiduciary is not required to inform all Plan participants and beneficiaries of every corporate event, especially contingent events, that might impact the value of the company's common stock

Valuating Employer Securities in an ESOP

- Litigation arises in all stages of the valuation process:
 - Creation of the ESOP
 - Repurchase or Redemption of Employer Stock from Participants
 - Merger of Companies and ESOPs
 - Termination of ESOPs
- ERISA prohibits the acquisition or sale by a plan fiduciary of employer securities, unless the acquisition or sale is for “adequate consideration.” 29 U.S.C. §§ 1106(a), 1108(e)
- Courts closely consider the process that leads to good faith determination of fair market value
- To meet the good faith requirement, the fiduciary of a closely held company must employ independent experts in the valuation process

Valuating Employer Securities in an ESOP

- *Keach v. U.S. Trust Co.*, 419 F.3d 626 (7th Cir. 2005)
 - Participants alleged that trustee breached its fiduciary duty by making a leveraged purchase of employer stock without fully assessing the legal risks
 - Though a written record of communications between the trustee and its law firm was absent, this was not determinative of the valuation issue
 - Instead, the court held that there was a sufficient investigation of the legal risks based on the totality of the evidence of the investigation conducted by the trustee and its valuation firm

Valuating Employer Securities in an ESOP

- *Henry v. Champlain Enterprises*, 445 F.3d 610 (2d Cir. 2006)

Participants sued the ESOP fiduciary for failing to make a good faith investigation into the valuation of employer shares when the ESOP was established

- Court held that the lack of good faith could not be determined solely on the basis of a lack of documentation of the investigation
- All evidence of a good faith investigation must be considered, as well as what the fiduciary was ill-informed about in the valuation process

Redeeming Employer Securities in an ESOP

- *Armstrong v. LaSalle Bank Nat'l Assn.*, 446 F.3d 728 (7th Cir. 2006)
 - Participants sued the ESOP trustee for making an imprudent valuation of employer's stock after the company's profitable acquisition resulted in a surge of departing employees redeeming their shares
 - Court applied deferential standard of review to fiduciary's balancing of interests of the various participants when valuating the shares
 - Court remanded for determination of whether it was unreasonable under the circumstances for fiduciary to apply a marketability discount to the redemption price of the employer stock

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Lessons from Recent Case Law

Lesson One: Executives who also serve as plan fiduciaries have dual loyalties and do not have a lesser fiduciary standard.

- When communicating with participants, dual-hat executives are presumed to act as fiduciaries.
- Corporate position and inside information is a two-edged sword: enhanced expertise is a plus, but inside information is a burden.

Lessons from Recent Case Law (cont'd)

- Critical to make it clear when executive is acting in each capacity – greater risk occurs when it is unclear which “hat” executive is wearing.

Lessons from Recent Case Law (cont'd)

Lesson Two: Appointing a fiduciary carries with it the duty to monitor closely the fiduciary's performance.

- Duty to monitor becomes duty to act when appointing fiduciary knows of possible breach.
- This could include duty to assure that appointed fiduciary has accurate information on employer's financial condition.

Lessons from Recent Case Law (cont'd)

- Not a responsibility to carry out appointed fiduciary's duty, but to oversee and perhaps replace appointed fiduciary.

Lesson Three: Plan fiduciaries must carefully monitor the activities of board and management which impact long-term value.

- Merger and acquisitions policy
- Recruitment and retention of employees
- Senior executive compensation
- Financial performance
- Covenant compliance

Lessons from Recent Case Law (cont'd)

Lesson Four: Good corporate governance and good plan governance are good for business and reduce litigation risk.

- **Independent board members control Audit, Compensation and Governance Committees**
- **Outside trustee that selects its own financial and legal advisors**
- **Trustee regularly receives copies of board packages, minutes, interim financials and audited financials**

Lessons from Recent Case Law (cont'd)

Lesson Five: Prudent behavior reflects a process of thorough, diligent steps that are all carefully documented

- Good decisions usually result from a solid process
- Courts normally unwilling to second guess decisions that reflect careful, thorough process

Typical Plan Governance Intersection with Corporate Governance Guidelines

- Board of Directors appoints/removes ESOP Administrative Committee members and Trustee
- Board of Directors nominates its own members, with ESOP Administrative Committee directing Trustee on Board election
- ESOP Administrative Committee may make exceptions on interlocking directorships limitations
- ESOP Administrative Committee reviews Compensation Committee recommendation for Board compensation

Typical Plan Governance Intersection with Corporate Governance Guidelines (cont'd)

- Governance Committee reviews annually the performance of the ESOP Administrative Committee and reports its findings to Board
- Board meets annually with ESOP Administrative Committee
- Audit Committee, Governance Committee and Compensation Committee consist only of independent directors

Allocation of Plan Governance

	<u>Fiduciary?</u>
• Company (through its Board)	
— Makes contributions to ESOP	No
— Appoints and removes ESOP Administrative Committee members and Trustee	Yes
— Appoints Governance Committee	Yes
— Adopts and Amends Plan and Trust	No

Allocation of Plan Governance (cont'd)

ESOP Administrative Committee	<u>Fiduciary?</u>
— Directs Trustee on plan investments	Yes
— Directs Trustee on borrowing acquisition loan proceeds	Yes
— Directs Trustee on voting of Company stock	Yes
— Delegate to Trustee responsibility for managing ESOP assets other than Company stock	Yes

Allocation of Plan Governance (cont'd)

	<u>Fiduciary?</u>
● ESOP Administrative Committee (cont'd)	
— Interprets ESOP document	Yes
— Decides questions on eligibility and on amount, timing and manner of payments	Yes
— Approves certain plan amendments	No
— Prescribes procedures for applying for benefits	Yes
— Adopts investment guidelines and funding policy for investments other than Company stock	Yes

Allocation of Plan Governance (cont'd)

ESOP Administrative Committee (cont'd)	<u>Fiduciary?</u>
— Decides appeals of denied benefit claims	Yes
— Decides whether domestic relations orders are QDROs	Yes
— Prepares and distributes information explaining ESOP	No
— Receives information needed to administer ESOP	No
— Appoints/hires service providers (appraiser, <i>e.g.</i>)	Yes



Allocation of Plan Governance (cont'd)

-
- | ESOP Administrative Committee (cont'd) | <u>Fiduciary?</u> |
|--|-------------------|
| — Review compliance issues and approve corrections of errors in plan administration or legal compliance | Yes |
| — Approves/ratifies grants of stock appreciation rights to independent directors by Compensation Committee | Yes |
| — Discharge all other duties described in plan | Perhaps |

Allocation of Plan Governance (cont'd)

ESOP Trustee	<u>Fiduciary?</u>
— Administer ESOP Trust Fund in accordance with ESOP Administrative Committee directions (with proxy)	No
— Approves trust agreement amendments	No
— Manages ESOP assets other than Company stock pursuant to Administrative Committee delegation	Yes

Allocation of Plan Governance (cont'd)

• Governance Committee	<u>Fiduciary?</u>
— Report to Board on assessment of Board's performance	No
— Review qualifications, composite and performance of ESOP Administrative Committee and report to Board	No



How Can Fiduciary Liability be Controlled?

- Specific allocation of responsibility among named fiduciaries
- Fiduciary liability insurance (review carefully for coverage gaps and restrictions, dollar limitations, and other traps)
- Indemnification by employer, using reasonable conduct standard
- Defalcation/honesty bond (the ERISA-required bond that protects against theft of plan assets)

How Can Fiduciary Liability be Controlled? (cont'd)

- Formalized appointment procedures and documents:
 - Formal appointment of specific individuals or entities as fiduciaries
 - Acceptance documents
 - Limit on responsibility to “time served”
 - Clear appointment terms

How Can Fiduciary Liability be Controlled? (cont'd)

- Service contracts with clear terms and commercially reasonable liability-allocation provisions
- Plan provisions that give broad and final interpretive discretion and authority to a named fiduciary (*e.g.*, Administrative Committee)

Tightening Fiduciary Insurance Market

- Fiduciary risk covered in several ways: corporate and plan indemnification, fiduciary bond, and fiduciary liability insurance
- Insurance is becoming scarcer, more expensive and narrower in scope
- Be clear when officer acts as fiduciary, to avoid risk that D&O and fiduciary policies will each point to other policy

Tightening Fiduciary Insurance Market (cont'd)

- Carefully review renewal terms for changes in scope of coverage
- Consider proactive step of describing for insurer all procedures designed to reduce risk of fiduciary liability

“Best Practices” to Reduce Liability Risks

- (1) Clear allocation of responsibility among fiduciaries
- (2) Fiduciary liability insurance with reasonable coverage limits and exclusions
- (3) Employer indemnification with reasonable conduct standard
- (4) Anticipate possible “prohibited transactions” arising in conflict of interest situations involving plan assets

“Best Practices” to Reduce Liability Risks (cont’d)

- (5) Formal fiduciary appointment procedures and documents
- (6) Clearly establish responsibility and liability of service-providers in contracts
- (7) Grant broad and final interpretive discretion and authority to fiduciaries in plan

“Best Practices” to Reduce Liability Risks (cont’d)

- (8) Regular Committee meetings
 - Comprehensive meeting minutes showing issues raised, questions asked, and overall diligence
 - May act between meetings; keep record of such actions
 - Majority vote in all cases is sufficient
- (9) Apply administrative procedures strictly and consistently

“Best Practices” to Reduce Liability Risks (cont’d)

- (10) Supply each Committee member with complete set of all key documents
- (11) Adopt investment policy statement for investments other than Company stock with longer-term performance targets that result, when not met, in range of potential actions
- (12) Be familiar with DOL guidelines on paying plan-related expenses out of plan assets, and adopt policy

“Best Practices” to Reduce Liability Risks (cont’d)

(13) Address issues with following standards:

- Do not participate if own benefit or account is involved
- Be consistent as to similarly situated participants
- Provide no exceptions or “favors,” especially for highly compensated employees

“Best Practices” to Reduce Liability Risks (cont’d)

- Make no “deals” with anyone in special relationship to Company
- Never act in arbitrary or capricious manner

“Best Practices” to Reduce Liability Risks (cont’d)

(14) Trustee Valuation Determination

- Review Valuation Report
- Ask questions until Report understood
 - Assumptions
 - Methodology

“Best Practices” to Reduce Liability Risks (cont’d)

(15) Related Information for Trustee to Review

- Solvency
- Trends
- Repurchase liability
- Management projections
- Changes from prior Report

“Best Practices” to Reduce Liability Risks (cont’d)

(16) For Leveraged ESOPs:

- Trustee notifies Company of pending loan payments due
- Trustee collects and processes loan payments
- Committee reviews calculation of share releases
- Trustee compares allocations of share distributions with allocation reports before issuing checks

“Best Practices” to Reduce Liability Risks (cont’d)

(17) When Considering Transactions:

- Trustee should always lead deal negotiations
- Trustee must conduct significant due diligence and seek advise of qualified financial advisors and legal counsel
- Trustee should obtain fair market value/fairness opinions on any party-in-interest transactions

“Best Practices” to Reduce Liability Risks (cont’d)

(18) In Voting and Tendering Shares:

- Vote or tender ESOP shares in own discretion unless plan provisions provide otherwise
- Trustee must ensure that participants receive timely and adequate information and are free from coercion
- Keep individual instructions confidential

Further Suggestions

- Ensure that Governance Committee has written procedures for monitoring the performance of ESOP Administrative Committee and reporting to full Board
- Consider retaining separate ERISA counsel for the ESOP Administrative Committee to preserve attorney-client privilege between Company and its counsel on certain issues

Further Suggestions (cont'd)

- Have ESOP Administrative Committee develop and use the following documents:
 - Statement of fiduciary duties and procedures
 - Individual fiduciary appointment/acceptance
 - Committee Bylaws
 - Conflict of interest policy
 - Document retention policy
 - Written procedures for the payment of Plan expenses with ESOP assets

The purpose here is to provide written guidelines for fiduciary functions and evidence of fiduciary compliance under ERISA to protect Company and the plan fiduciaries