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Evolving Case Law and Recent Legal Actions Influence Compilation of Boards of Directors of ESOP-Owned Companies

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The unique ownership structure of a company owned by an employee stock ownership plan and trust (ESOP) expands the fiduciary duties of the board of directors of the ESOP company.

Since the trustee of the ESOP acts on behalf of the ESOP (which is a shareholder) and the ESOP is subject to the rules under the Employee Retirement Income Security Act of 1974, the directors are subject to (1) the traditional state law duties of care and loyalty and (2) the duty to monitor the activities of the ESOP trustee and the plan administrator or ESOP committee (the ESOP committee is composed of management employees of the company that give the ESOP trustee directions to act on certain items).

The Department of Labor and employees participating in the ESOP are the parties that commence legal actions against the directors for fiduciary duty breaches. Generally, director scrutiny focuses on the valuation of the stock of the ESOP company owned by the ESOP. Because of the expanded fiduciary duties imposed on directors and the increased fiduciary risk associated with serving as director, it is best practice to have the directors composed of the proper number and type of individuals, with certain committees established by the directors responsible for specific functions that assist the directors in carrying out its fiduciary duties.

Board Compilation

Because of the expanded fiduciary responsibilities and the importance to minimize "conflict of interest" and "self-interest" situations (which are prevalent in ESOP companies), the compilation of the individuals serving as directors is an important part in minimizing director scrutiny. Normally, it is best practice for an ESOP company to have five directors, with at least two of the directors considered independent. To the extent there are more directors, the number of independent directors should also be proportionately increased.

Generally, a director is considered independent if the individual: (1) is not (and has not been for the three years prior to such director's appointment) a member of the management or employee of the ESOP company; (2) does not have any close family (or similar) relationship with the former shareholders that sold to the ESOP, another shareholder (i.e., if the ESOP is a less than 100 percent owner), another director or the management of the ESOP company, (3) has no material financial relationship with or in the ESOP company, a former shareholder, current shareholders, management or other directors, and (4) does not otherwise have any direct or indirect material relationship with the ESOP company, a former shareholder, current shareholders or management that may impair such director's ability to make independent decisions on behalf of the ESOP company.

Fiduciary Duties

Directors have two types of fiduciary duties with different standards of care:

- The traditional state law corporate duties of care and loyalty, which are afforded the protections of the business judgment doctrine, and
- The ERISA federal law duty to monitor (oversee) the ESOP trustee and ESOP plan committee.

The duty to monitor is a higher standard than the state law duties of care and loyalty. It subjects the directors to a "prudent man standard" (and not a reasonable person standard) and does not afford directors protections under the "business judgement rule."

Under ERISA, the "prudent man standard" requires ERISA fiduciaries to act with the care, skill, prudence and diligence that a prudent person in such capacity and in such circumstances would act.

The types of director actions that generally fall within the purview of the higher standard of the duty to monitor, based on case law and complaints filed in federal courts against directors, are as follows:

- The oversight of the activities of the ESOP trustee;
- The oversight of the activities of the ESOP committee directing the ESOP trustee to take certain actions under the ESOP;
- The oversight of the reasonableness of the

financial projections and interim financial statements that are used by the ESOP trustee's valuation firm to value the stock held by the ESOP (including the ones used by ESOP investment banker in the initial transaction hired by the ESOP company);

- The oversight of transactions with the former and current shareholders such as terms, components and conditions of (1) debt arrangements (including size of leverage), (2) governance rights and (3) future equity participation;

- The establishment and reasonableness of management equity and other compensation arrangements that impact the ESOP;

- Board procedures that address conflicts of interest and self-interested situations (such as the ESOP company leasing a building from a former shareholder at above market rate); and

- The execution of engagement letters and agreements with the ESOP trustee and its valuation firm with contractual indemnifications that do not have appropriate limitations as to amounts and periods (i.e., an indefinite survival indemnification period) that could potentially cost the ESOP company millions of dollars in future indemnification obligations. Directors are becoming subject to director scrutiny because these types of contractual indemnifications are viewed as egregiously one sided, insular and incompatible with the ESOP trustee's exclusive duty owed to the ESOP and do not benefit the ESOP company or the ESOP.

As a practical matter, directors should affirmatively demonstrate their exercise of the "prudent man standard" by (1) documenting their actions, (2) engaging and communicating with the ESOP trustee as may be necessary and (3) establishing committees to oversee the various activities of the ESOP company, ESOP and ESOP trustee.

Committees

As a general matter, the directors should establish certain committees and designate a chairman for each established committee. The chairman will chair all meetings of a committee and set the agenda for each such meeting. If any member of a committee is conflicted on a certain matter, such member should abstain from voting on the matter.

It is best practice for the Directors to establish the following committees:

Audit and corporate governance committee.

This committee should consist of at least three members comprising of two independent directors and one director that is not the chief financial officer. The committee's responsibilities should generally be as follows:

- To review and recommend to the directors the internal accounting, financial controls, accounting principles and auditing practices and procedures to be employed in the preparation of the financial statements and the financial projections used as part of the valuation of the ESOP stock, and the tax status of the ESOP company and related ESOP-specific tax status compliance testing (i.e., S corporation compliance);

- To make recommendations to the directors concerning the engagement of independent public accountants (which accountants will report directly to the audit and corporate governance committee) and the scope of the audit or review of the financial statements;

- To make recommendations to the directors relating to the performance of the ESOP trustee, the ESOP trustee's procedures in qualifying and engaging valuation firms and the ESOP trustee's transaction and valuation processes;

- To resolve any disputes between any engaged independent public accountant and management;

- To address and discuss questions of possible conflicts of interest of former shareholders, current shareholders, directors, members of other committees, senior executives and related party matters; and

- To discuss, monitor and advise on the directors and omissions ERISA fiduciary policy (D&O insuance), the ESOP trustee's fiduciary errors and omission policy, any litigation involving the ESOP Trustee and its valuation firm, and the ESOP company's other policies purchased to minimize risk exposure.

Compensation committee

This committee should consist of three directors with at least one independent director serving on the committee. The committee's responsibilities should generally be as follows:

- To review, monitor and recommend to the board policies, practices and procedures relating to the compensation of managerial and executive level employees and related bonus plans;

- To evaluate the performance of key executives and their compensation and obtain compensation studies supporting the related compensation amounts;

- To oversee and monitor the ESOP company's equity incentive arrangements, such as phantom equity arrangements, stock appreciation rights arrangements, restricted stock arrangements and other employee incentive plans; and

- To communicate with the ESOP trustee with respect to the ESOP company's equity incentive arrangements and review specific ESOP compliance testing relating to such arrangements.

Nomination committee

This committee should consist of three members with at least two independent directors. Since ESOP trustees tend to be inactive and not involved in the operations of the ESOP company, the committee's responsibilities should generally be as follows:

- To establish criteria for director membership (including experience, skill set and diversity); and
- To evaluate qualifications, conduct background examinations, interview possible candidates and recommend the nominations of individuals to be considered for election as directors to the ESOP trustee and other shareholders.

Conclusion

The unique ownership structure of an ESOP company expands the responsibilities of the directors. Because of the higher standard of duties, the directors (1) should not simply rely on the work performed by the ESOP trustee to satisfy their fiduciary obligations and (2) should recognize that the directors' interests and fiduciary duties are not always aligned with the ESOP trustee.

The directors (1) should be composed of some independent directors, (2) meet at least four times a year, (3) establish committees to function in a proper manner and (4) be aware of the information used by the ESOP trustee in the valuation of the ESOP stock and situations in which "conflicts of interest" and "self-interest" may arise.

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