

## Boards of Directors' in ESOP Companies (Track 1G)

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**SAVING THE WORLD  
ONE COMPANY AT A TIME**

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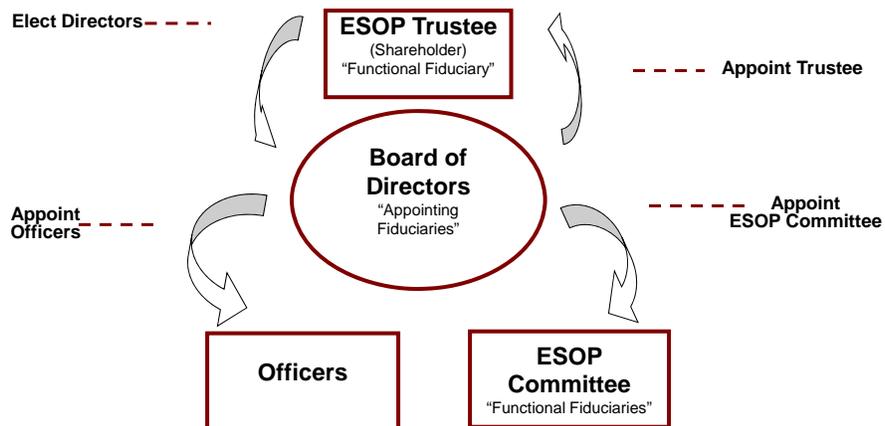
## Agenda

1. ESOP Company Governance
2. Specific Duties of the Board & Trustees
3. Legal/Fiduciary Standards
4. Best Practices
5. Special Issues

# 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
- Who are the Main Participants in Corporate Governance?
  - Board of Directors and its advisors
  - Officers
  - Shareholders (ESOP trustee and its advisors)
  - In cases of “pass-through” voting, ESOP participants

## Corporate Governance Structure and Participants



## Typical Board Structure

### 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

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## Typical Board Structure

### Board Responsibilities

- Provide guidance and direction to management on strategy
- Monitor company performance vs. operating, financial and long-range plans and objectives and approve changes
- Approve certain corporate actions
- Appoint company officers
- Appoint ESOP trustee and benefits committee
- Appoint and establish goals for CEO; establish and evaluate CEO compensation; plan for CEO succession.

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## Board Committees

- Audit Committee– responsible for certified financials, audits, and financial projections
- Compensation Committee– responsible for setting and reviewing compensation of Board and Sr. Executives
- Governance Committee– responsible for committee structure, regulatory compliance and delineation of board and management responsibilities and director nominations
- Nominating Committee
- Executive Committee
- Other



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## Skill Sets for Directors

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

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## Understanding your Company's Needs

- Too Many or Too Few Board members?
  - Productive
  - Quorum size
  - Handle work load
  - Mix of skills and experience
- Conflicts of Interest
- Diversity
- Skills and Experience

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## Evaluations of Board Members

- Position descriptions
- Performance objectives
- CEO evaluations
- Self-evaluations
- Board and committee evaluations
- Individual director evaluations
- Peer evaluations
- Governance committee review
- Independent review
- ESOP Trustee's review

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## Independent Directors

- Advantages
  - Reduces conflicts of interest (actual and in appearance)
  - Provides different perspective
  - Adds credibility, trust, and confidence
  - Builds networks and resources
  - Satisfies lending requirements
  - Great for committees (compensation, audit, and nominating/corporate governance)
  - Viewed favorably by the DOL

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## Independent Directors

- Disadvantages
  - Can be hard to find (liability and time commitment concerns)
  - Compensation
  - Lack of knowledge of business/industry/ESOP
  - Confidentiality concerns

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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 corporation law

Focus upon closely-held company with ESOP as majority shareholder

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## State Law Fiduciary Duties

- Duty of Care (i.e. being well informed)
- Duty of Loyalty
- Business Judgement Rule

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## Duties of Board of Directors With Respect to Trustee

- Board has a duty under ERISA to:
  - Select and appoint a qualified trustee or trustees
  - Monitor the actions of the ESOP trustee (and any other plan fiduciaries it appoints)
    - 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
  - Conflicts of interest for “inside” trustee
    - Board member role vs. officer role vs. trustee role
    - If inside trustee, know when to seek counsel
  - Should trustee be “directed” or “discretionary”?
    - Usually directed except:
      - annual valuation
      - special events like sale of company

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## Monitoring Performance

### Trustee Monitors:

- Board Performance; general review
  - Representation on the Board?
  - meetings and minutes
  - financial statements
- Specific Areas of Concern
  - related-party transactions
  - executive compensation
  - synthetic equity issuance
  - stock issuances & stock redemptions
  - acquisitions
  - repurchase liability

Board Monitors: Trustee Performance.

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## Best Practices

- Independent Directors
- Independent or other highly informed and engaged fiduciaries
- Compensation Committee of outside directors
- Informed Directors and Trustee
- Effective use of outside advisors
- Productive Board meeting with agenda and information distributed before the meeting
- Open communications between Trustee, Board, and Officers

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## Corporate Governance

Duties and authority among a company's shareholders, Board and officers:

- Shareholders/Trustee – The trustee acts on behalf of ESOP as a shareholder; protects the participants
- Board of Directors – The company's governing body, responsible for hiring and evaluating senior management and selecting the Trustee
- Management – Runs the day to day operations

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## Governance Conclusions

- Successful governance in an ESOP company requires clearly defined roles and responsibilities, avoidance of conflict situations, and direct, open communication between the Directors, the Trustee, the Officers, and other plan fiduciaries.
- The best form of governance for any given company is dynamic and changes over time.
- Every company must decide for itself what form of governance will most likely achieve its goals.

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## Communication

- Continuous, effective communication between the trustees and the board is essential to building an effective governance style.
- Some legitimate duties of the board are affected by legitimate duties of the trustees and need to be reconciled.
- Valuation may affect both repurchase liability and the amount paid to participants
- Repurchase liability planning may affect the cash available for growth

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## Questions?