



ON TRACK TO SUCCESS  
WITH YOUR ESOP

MULTI-STATE CONFERENCE 2014



Navigating Internal Trustee Waters –

Best Practices from the Perspective of an External  
Trustee and Counsel

September 18, 2014



**STEVENS & LEE**  
LAWYERS & CONSULTANTS

A STEVENS & LEE/GRIFFIN COMPANY 



# Agenda

- Internal Conflict?
- Interaction with and Selection of Board
- Interaction with Company Financials
- Selection of Appraiser
- Governmental Interactions
- Indemnification and Insurance
- Communications with Employees

# Internal Conflict?

- When the internal trustee is also employee and, in that role, is subordinate to management
- Differences among internal trustees?
- What if an actual issue requires trustee to assert authority?
  - Example: trustee suspects internal controls do not adequately ensure accuracy of financials. Is this really a trustee issue?
  - Example: trustee disagrees with management decision on new hire. Is this really a trustee issue?
  - Example: trustee is unsure whether senior management compensation is appropriate. Is this really a trustee issue?
- Ways to handle conflict
  - Discussion
  - Recusal
  - Removal of Board
  - Board removal of trustee – Notice periods
- Litigation – last resort

# Interaction with and Selection of Board

- Circle of selection
  - Board selects trustee
  - Trustee selects Board
- How internal trustees select Board candidates
- How an external trustee selects Board candidates
- Pass-through Board vote to participants?
- Recommendations from Board for replacements?
- Staggered Boards?
- Independent Boards (outside directors and advisory boards)?

# Interaction with Company Financials

- Information an external trustee expects
  - What information is required
  - Why is the information required
  - Frequency of review (monthly, quarterly, semi-annually, annually)
  - What if company refuses to divulge requested financials
- How an internal trustee interacts with financial information
  - What can/should trustee divulge to participants
  - Effects of very bad or very good news
  - Frequency of review (monthly, quarterly, semi-annually, annually)
  - What if company refuses to divulge requested financials
- Internal controls – reliability of information
  - Reliance on management for financials
  - What to do if there are concerns about the accuracy of financials

# Interaction with and Selection of Appraiser

- Importance of appraiser's independence
  - Can the appraiser provide other professional services to the company while serving as the trustee's appraiser
- Board or management influence in selection of the appraiser
  - What if a trustee is ordered to use a certain appraiser
- Handed down from trustee to trustee?
  - Advantages: Historical knowledge, consistency of appraisal methodologies
  - Disadvantages: Is appraiser "beholden" to company or management
- Real-life example of internal trustee selection
- How an external trustee selects an appraiser
- Trustee review of appraiser report
- Trustee determination of value

# Governmental Interactions

- Examination by IRS or DOL
  - DOL primarily focused on fiduciary issues (esp. trustee diligence)
  - IRS primarily focused on plan form and operation in accordance document
- Self-discovered problems
- Record keeping
- Should trustee care or be involved? YES!!!!

# Indemnification and Insurance

- Indemnification by Company
  - Is it advisable?
  - Is it customary?
  - Should an internal trustee serve without indemnification?
  - When does indemnification kick-in
  - What to do if the trustee's interests and company's interests conflict
- Fiduciary Liability Coverage
  - Make sure the policy does not exclude ERISA related claims
  - When is an internal trustee acting as a trustee as opposed to acting in an employment function
- Other coverage advisable
  - D&O, E&O, etc.



# Communications with Employees

- Example of what information an internal trustee shares with employees
- External trustee's communications with employees
  - Does the company pre-approve communications?
  - What if the company and trustee disagree on what should be communicated
- Legal roles and responsibilities
- The trustee's role in enhancing the culture of employee ownership

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# APPENDIX

# Internal Conflict?

- Fiduciary duty requires trustee to discharge his or her duties ***solely in the interest of the participants and beneficiaries***:
  - For the exclusive purpose of providing benefits and defraying reasonable expenses of administering the plan
  - With the care, skill, prudence (ESOP exception), and diligence under the circumstances that a prudent person acting in like capacity and familiar with such matters would use
  - By diversifying the investments of the plan so as to minimize the risk of large losses unless it is clearly not prudent to do so (ESOP exception)
  - In accordance with the documents and instruments governing the plan
- It is permissible for trustee to wear more than one hat
  - Can be trustee and employee
  - Can be trustee and management
  - Can be trustee and shareholder
  - Can be trustee and director

# Internal Conflict? cont'd

- Problem only arises when there is a conflict
  - Between duty as employee/officer/shareholder and trustee
  - Between personal interests of trustee and interests of Trust
- If non-fiduciary hat is more important – recuse yourself
- Cannot walk away from fiduciary duty – must make sure there is a competent successor trustee
- If you become aware that a co-fiduciary has breached their duty, must take steps to remedy the breach
- Legal Counsel
  - Make sure you know who the lawyer represents
  - Many legal engagements are with the Company as ESOP counsel
  - If so, the lawyer's client is the Company, not the trustee
  - In the event of a conflict, it may be necessary for trustee to engage own legal counsel

# Interaction with and Selection of Board

- If there is a conflict between two – trustee typically has upper hand
  - Notice for board meetings is typically longer than time required for trustee to act but not always
  - Especially if trustee has insider on Board
- Trustee is shareholder and shareholder under corporate law has obligation to select board and design board structure
- Design decisions:
  - Staggered or not
  - Independence
  - Length of term

# Interaction with and Selection of Board cont'd

- Pass-through Board vote to participants?
  - Required for registration-type securities (NASDAQ or NYSE)
  - Not required for non-registration type securities
  - But some companies decide to pass-through board selection to participants and beneficiaries
- How are Board members selected?
  - Recommendations from Board?
  - Trustee seeks Board members
  - Recommendations from participants?

# Interaction with Company Financials

- Best practices
  - Frequency - quarterly review of financial performance
  - Should understand basic performance metrics – if not, educate yourself or engage a competent advisor to assist in the review
  - Should be procedure for management to certify that the financials are materially accurate
- Internal controls
  - Internal controls are essential for reliability of reported information
  - Trustee will rely on management for accuracy of financials, but...
  - Management must have internal controls in place
  - Are you familiar with your company's internal control procedures?
- What to do if there are concerns about the accuracy of financials
  - Ask questions – probe
  - Do not ignore comments or concerns
  - Third-party review or investigation
  - Still concerned? See conflict section!



# Interaction with and Selection of Appraiser

- Independence is key
  - Appraiser should not be providing services to Company
  - Appraiser should not be related to any employees
  - Company can recommend that trustee use specific appraiser
  - But trustee must complete their own due diligence and make their own determination that appraiser is appropriate
  - Appraiser should not have been engaged prior to trustee's involvement
- Trustee should not assume that appraiser is qualified
  - Review recommendations
  - Review work product
  - Review past experience with ESOPs
- Trustee determines value
  - Appraiser does not
  - Appraisal report does help trustee determine Company's worth
  - But trustee cannot blindly rely on appraisal report
  - Trustee must push, prod, look for issues
  - Be sure to keep a written record of discussion – procedural due diligence

# Governmental Interactions

- Trustee examination
  - Although an examination of the ESOP is directed toward the Company
  - The trustee, and the trustee's procedural due diligence, are often intimately tied up in the examination
- How to protect yourself as trustee
  - MAINTAIN RECORDS - cannot be overstated
  - Records showing due diligence are the best defense to a claim that the trustee breached his or her fiduciary duties
  - These records should show that the trustee
    - Considered the issue
    - Weighed the pros and cons
    - Understood the issue
    - Made a determination based on the facts and circumstances
    - That decision was in the best interests of the participants and beneficiaries

# Indemnification and Insurance

- What is indemnification?
  - Protects the trustee, and other fiduciaries, from claims against the trustee
  - Should also cover trustee costs to defend
  - Exception: cannot cover breaches of the trustee's fiduciary duty, esp. if it involves self-dealing
- Internal trustee should always be indemnified by Company
  - Internal trustee should never serve without indemnification
  - Corporate trustee indemnification depends upon facts and circumstances

# Indemnification and Insurance cont'd.

- How?
  - Typically in plan document and/or trust agreement
  - Can be in separate agreement
  - Ideally, should be in both, but need to make sure there are no conflicts between the two
  - Unfortunate scenario: two separate indemnification provisions conflict with each other and both say they take precedence in the event of conflict
  - In that scenario, trustee could be left with weaker indemnification protection
- Fiduciary Liability Coverage
  - Essential for ESOP companies
  - Will cover costs involved in defending trustee – technically pays company
  - Trustee should require since that guarantees source of funds to pay for indemnity obligation
  - Make sure the policy does not exclude ERISA related claims

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