

What to Do and Not Do as an ESOP Fiduciary

**This Is a Sample of One Part of the
Presentation Only**

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The Basic Obligations

1. Follow the terms of the plan document. That means you need to actually read it!
2. Follow what the law requires. No matter what your plan says, if it is contrary to the law, the law rules and you are responsible for that.
3. But that in turn is trumped by your obligation to do what will best achieve your ultimate objective of assuring maximum retirement benefits to participants.



The Interests of Employees or Participants?

The law is very clear. You must protect the interests of plan participants as participants not as employees. Something might be good for employees as employees, such as saying no to a good offer.



The Basic Duties

1. Make sure the ESOP pays no more than fair market value when buying shares from outsiders and no less than FMV when buying back shares from employees.
2. Make sure allocation, diversification, eligibility, vesting, voting rights, and distribution rules are followed. Practically speaking, this means making sure you have a good administrator and that you look into any complaints.
3. Make sure all required filings are filed.
4. Make sure the advisors are well-qualified.
5. Manage non-stock investments prudently (which means more than just putting them in CD's).
6. Review any changes in plan rules to make sure they comply with the law.
7. Act as a responsible shareholder (see next slide).



Valuation: The Big Issue

- ESOPs must be appraised by an independent, outside appraiser at least annually.
- ESOPs must buy shares from outside owners at no more than fair market value and from participants at no less than FMV.
- Value must be current. In practice this means there should be clear plan rules for what valuation is used for distributions and diversification. Generally, you can write the rules to use the most recent valuation, but in some cases where a substantial amount of time has passed between the distribution or diversification event, and there is reason to think there may have been substantial changes, a “drop-down” letter from the appraiser affirming the most recent value or a new appraisal may be needed.
- Diversification rules are especially tricky on the timing of valuations. This is too complex an issue for a slide, but should be reviewed with plan administrator and counsel.



Valuation Basics

- Appraisers create an enterprise value based on what a willing financial (not strategic) buyer would pay.
- The most important factor is some multiple of future free cash flow or, similarly, discounted future cash flow over an appropriate number of years. Basically, this tells the investor how quickly an investment can be paid back. The investor will want a faster payback (and hence annual rate of return) on riskier investments).
- Comparable company sales data and, if applicable, public company comparison data will be factored in.
- Asset value is usually the least important factor, but valuable non-performing assets may add to value.



Adjustments to Value

- An enterprise value is the value of the entire company assuming fully liquid shares.
- ESOPs have a put option, but the shares are not as liquid as public company stock. A discount is usually applied, often 5% to 15%, to reflect this. This will be lower, or even zero, if the company has substantial cash on hand to handle repurchase.
- ESOPs pay less per share if they do have control (often 20% or more).
- Best practice is to reflect the emerging repurchase obligation in value by adjusting future cash flows for the excess cost of funding the ESOP relative to other benefit plans in comparable companies.



Trustees as Shareholders

- Trustees are the shareholder of record.
- As shareholders, trustees can and should act to protect their interests.
- Corporate law provides that boards are subject to the “business judgment rule,” a rule that allows them very wide leeway in making management decisions.
- As a shareholder, however, trustees should monitor a few key issues, including the amount and structure of executive compensation; decisions on corporate strategy; and any other decisions made that would constitute an egregious waste of assets.
- Because the business judgment rule is so broad, it is difficult to sustain a lawsuit against a board for wasting corporate assets, but trustees can work in a more cooperative way with the board on these issues.

