

# 20 Misconceptions about ESOP Fiduciary Responsibility and Liability

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One of the most misunderstood ESOP concepts is that of fiduciary responsibility. While not intending to identify every misconception or to be a comprehensive encyclopedia about fiduciary responsibility and liability, this article highlights and clarifies, in summary fashion, 20 common misconceptions.

Fiduciary responsibility is an increasingly important and serious issue. Fiduciaries—and all employee-owners and ESOP participants—should have no misconceptions about what it means to have fiduciary responsibility and to have fiduciary liability. They should have confidence that they are complying fully with the requirements accompanying their position. This article will help.



their beneficiaries. ESOP fiduciaries have NO duty to act for the benefit of employees. In rare instances, this distinction is significant. For example, if a company receives an offer to purchase the ESOP stock for 10 times the current appraised value but the purchaser plans to lay off all employees, the trustee cannot consider what will happen to the employees in considering whether or not to accept the offer, as the trustee can consider only the benefit to the Plan participants.

## **Misconception #5 - Management hires the ESOP stock appraiser.**

No. The ESOP stock appraiser works for the ESOP and therefore should be hired by the ESOP trustee.

## **Misconception #1 - A person who is not named as a fiduciary is not a fiduciary.**

It doesn't matter whether or not a person is named as a fiduciary. Formal title is irrelevant. If a person is performing the functions of a fiduciary, then that person is a fiduciary. The "if-it-walks-like-a-duck and talks-like-a-duck, then-it's-a-duck" analogy applies. A fiduciary is anyone with discretionary authority or control over management of the Plan or Plan assets or anyone who provides investment advice for a fee.

## **Misconception #2 - The Board of Directors of an ESOP company does not have fiduciary responsibility for the ESOP.**

The Board of Directors generally selects and appoints the ESOP fiduciaries; i.e., the administrative committee and the trustee(s). This is itself a fiduciary decision and therefore must be done prudently.

## **Misconception #3 - Management selects/hires the ESOP trustee.**

Generally, no. Management may assist in the process—for example by soliciting and reviewing proposals and making recommendations to the Board. But the responsibility usually falls on the Board of Directors unless the plan document provides otherwise.

## **Misconception #4 - For an ESOP company, a person with fiduciary responsibility is responsible for acting solely for the benefit of the company's employees.**

No. ESOP fiduciaries discharge their duties for the exclusive purpose of providing benefits to ESOP PARTICIPANTS and

## **Misconception #6 - The appraiser sets the price for ESOP shares of company stock.**

No. The appraiser's role is an advisor's role. It is usually NOT a fiduciary role. The ESOP trustee has the responsibility to determine the price of shares of company stock. The valuation report is merely a recommendation. The Trustee can either accept or reject that value.

## **Misconception #7 - The outside company that administers the ESOP (third party administrator or TPA) has fiduciary responsibility to the ESOP.**

Generally, no. The TPA is merely assisting the "plan administrator" named in the ESOP document in administering the Plan and generally does NOT have discretionary authority or control over the Plan or Plan assets. Therefore, the TPA is NOT a fiduciary.

## **Misconception #8 - The Administrative Committee has fiduciary responsibility for the ESOP only if the ESOP trustee is a directed trustee.**

The ESOP Administrative Committee has responsibility for interpreting the Plan and establishing policies and procedures to implement the Plan and, as such, is a fiduciary, whether the trustee is directed or non-directed.

## **Misconception #9 - A company's Board of Directors passed a resolution saying "the company is not for sale;" therefore, they do not have to consider any offers to purchase the company.**

At least with respect to the ESOP, this resolution is worthless. In fact, it is likely worse than worthless. If the ESOP fiduci-

aries blindly follow this resolution, it may be a violation of fiduciary responsibility since ESOP fiduciaries must discharge their duties for the exclusive purpose of providing benefits to ESOP participants and their beneficiaries. Ignoring an offer that may be many times greater than the appraised value could possibly be a violation of that fiduciary responsibility.

**Misconception #10** - An ESOP trustee must accept any offer to purchase ESOP shares that is greater than the current appraised ESOP stock price.

No. There are several reasons for this NOT being true. For example, circumstances may have changed since the last appraisal, and the offer might not be greater than an updated ESOP stock price. The ESOP stock appraised value is on the basis of Fair Market Value assuming continued operation of the company as a stand-alone company. The appraised value for a strategic buyer, for example, may be a different valuation and may be substantially larger than the Fair Market Value of the ESOP stock. In a joint statement, the DOL and IRS have said that fiduciaries must evaluate the merits of the offer being made. For example, is the purchase price to be paid in cash or in stock of the buyer? Are there "earn out" provisions and what is the likelihood that they will be paid? The offer should then be compared to the "underlying intrinsic value" of the shares based on a long term view.

**Misconception #11** - ESOP trustees must require pass-through voting to ESOP participants on any merger or acquisition.

Unless the ESOP documents provide otherwise, participants are required to vote their own shares (pass-through voting) on a merger but NOT on an acquisition unless it also involves a merger.

**Misconception #12** - ESOP trustees must require pass-through voting to ESOP participants on a sale of ESOP stock.

Participants are required to vote their own shares (pass-through voting) on a sale of substantially all of the company's assets; however, the sale of ESOP shares does NOT require pass-through voting.

**Misconception #13** - It is illegal for a person with a conflict of interest in a transaction to serve as ESOP trustee for that transaction.

It's not illegal. It may not be smart, and it may be inviting lawsuits; however, it is not illegal.

**Misconception #14** - Trustees fulfill their fiduciary responsibility for determining the stock price by hiring an appraisal firm to conduct the stock valuation.

Hiring a qualified, competent, experienced appraisal firm is a good start in carrying out the fiduciary responsibility of determining stock value; however, trustees must also understand and agree with the reasonableness of the appraiser's assumptions and methodologies, and must review the appraisal to identify any mistakes made by the appraiser.

**Misconception #15** - Only MBAs and/or CPAs are qualified to be trustees...and, certainly, non-management employees do not qualify to be ESOP trustees.

A committee of people can be the trustee. While someone on

the trustee committee must be able to read and understand financial statements, there is no requirement that everyone serving as an ESOP trustee be financial experts. Having said that, it is definitely advantageous for anyone serving as a trustee to receive training on the responsibilities of being a trustee and on the skills needed to fulfill those responsibilities. Having "a good heart and an empty head" is not sufficient.

**Misconception #16** - The doctrine of "business judgment" will protect fiduciaries; therefore, it's best NOT to document the process followed to arrive at a decision so no one will be able to attack the basis for the decision.

Process is the key towards discharging fiduciary responsibility. If fiduciaries followed the appropriate process and made a bad decision, they've successfully fulfilled their fiduciary responsibility; however, if they followed a bad process but made the right decision, they have not fulfilled their fiduciary responsibility and could be held liable. SOLUTION: Follow a process of due diligence. Ask questions and document everything.

**Misconception #17** - If a fiduciary is judged to have failed to fulfill his/her fiduciary responsibilities, any fiduciary liability will be paid by the company, and the fiduciaries will not have any personal liability.

Fiduciary liability is a personal liability. Fiduciaries may have to pay any judgment against them out of their own pocket, with their own money. Yes, you could lose your house.

**Misconception #18** - A company's indemnification clause protects fiduciaries from having to pay personally any fiduciary liability.

Exceptions listed in the company's indemnification clause may mean that the company would NOT indemnify the fiduciaries if they failed to fulfill their fiduciary responsibility and were held to be personally liable. Also, if the company is no longer in business, the indemnification may not be worth much.

**Misconception #19** - Either the ESOP fidelity bond, directors and officers (D&O) insurance, or the ERISA rider to the D&O policy will protect fiduciaries from having to pay personally any fiduciary liability judgment against them.

Possibly not. The fidelity bond protects the Plan, not the individual. D&O insurance usually excludes fiduciary insurance under ERISA, and ERISA riders frequently exclude ESOPs. SOLUTION: Make sure your insurance specifically covers ESOPs. The ESOP Association can refer you to brokers who handle D&O insurance specifically designed for ESOP companies. See [www.esopassociation.org](http://www.esopassociation.org).

**Misconception #20** - Fiduciaries can fulfill their fiduciary responsibility by following the terms of the ESOP Plan Document.

Not always. Fiduciaries are usually required to follow the plan document, but ERISA overrules the Plan. If following the Plan would violate ERISA, the fiduciary must ignore the Plan and comply with ERISA.

*This article was reviewed by Ben Wells, ESOP attorney in the Cincinnati, OH, office of the law firm of Dinsmore & Shohl. However, nothing in this article should be construed to be legal advice or opinion. For answers to specific questions, consult your ESOP professional. OAW*

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