Internal vs. External ESOP Trustee Matters for Consideration
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Overview

Part 1. Legal Framework for ESOP Trustee Duties and Liability

Part 2. Case Study – Considerations of an Internal Trustee at Mantaline Corporation – on separate Power Point and handout materials

Part 3. Considerations of an External Trustee and Views on Best Practices for All Trustees
Part 1.

Legal Framework for ESOP Trustee Duties and Liability
Legal Framework for Trustees

• The federal pension laws controlling ESOPs include:
  – Internal Revenue (IRC) - the federal tax laws under the general jurisdiction of the Internal Revenue Service (IRS), which issues regulations and rulings interpreting and administering the IRC.
  – Employee Retirement Income Security Act of 1974 (ERISA) – the non-tax pension, including fiduciary, laws under the general jurisdiction of the Department of Labor (DOL), which issues regulations and rulings interpreting and administering ERISA.
  – Federal court cases on IRC and ERISA disputes.
Legal Framework for Trustees

• IRC §401(a) and ERISA §403(a) require every tax-qualified retirement plan, including ESOPs, to have a trust to hold the plan’s assets: Plan assets must be held in “trust”.
• ERISA §403(a) requires a trustee for such trust, and the trustee has exclusive authority over the plan assets except to the extent the trustee is a “directed” trustee, where:
  – The terms of the plan/trust make the trustee subject to the direction of a named plan fiduciary; and
  – The direction of such fiduciary is in accordance with the plan/trust terms and not contrary to ERISA.
Legal Framework for Trustees

• IRC §4975 and ERISA §406 prohibit trustees from entering into related party [so-called self-dealing] transactions (Prohibited Transactions).

• A number of Prohibited Transaction exemptions are available, including exemptions for related party ESOP loans and share acquisitions, assuming all of the conditions for the exemption are met. See IRC §4975(d)(3) and (13) and ERISA §408(b)(3) and (12), and related IRS and DOL regulations.
Legal Framework for Trustees

• Today’s session focuses on –

• ERISA §404, which sets forth the ERISA fiduciary duty requirements for all plan trustees, including ESOP trustees; and

• ERISA §409, which imposes liability on trustees for losses to the plan resulting from a breach of the trustee’s fiduciary duty to the plan.
  – ERISA §405 imposes liability for a co-fiduciary’s breach under certain circumstances.
ERISA §404 Fiduciary Duties

• **Duty of loyalty** – to act solely in the interest of plan participants and beneficiaries
• **Exclusive Purpose Duty** – to act for the exclusive purpose of providing benefits
• **Duty of prudence** - to act as a prudent expert (process v. result)
• **Duty of diversification of plan assets** - ESOP exception applies, but no exception from prudence
• **Duty to follow plan/trust terms** - if not contrary to ERISA
ERISA Fiduciary Liability

- ESOP fiduciaries, including ESOP trustees, are personally liable for plan losses resulting from the fiduciary’s breach of duty.
- ESOP fiduciaries also can be liable for penalties and/or personal liability for entering into a Prohibited Transaction without a fully applicable exemption. See IRC §4975(a) and (b), and ERISA §409 and §502(l).
- Personal liability means just that – the fiduciary’s personal assets (bank accounts, home, etc.) can be attached to satisfy a judgment against a fiduciary for a breach of duty.
ERISA Fiduciary Liability

• Breaches of fiduciary duty claims generally involve claims for breach of:
  – Duty of Loyalty – engaging in acts where conflicts of interest exist - often overlapping with claims of “exclusive purpose” violations
  – Duty of Prudence – where fiduciary did not know what was required of the fiduciary - what process to follow and/or when to follow the process
  – Failure to follow plan/trust document terms
ERISA Fiduciary Liability

Conflicts of Interest Considerations for Internal Trustee

• Officers or directors of ESOP sponsor may serve as trustee, plan administrator, or ESOP committee member – but:
  – Duty as officer/director to company and all shareholders may conflict with ERISA fiduciary duty to act “solely” for benefit of ESOP participants.
  – ESOP’s general interests may conflict with management’s interests (e.g., on levels of compensation).

Note: Part 2 - Case Study – Considerations of an Internal Trustee at Mantaline Corporation – is on a separate Power Point and handout materials.
Part 3.
Considerations of an External Trustee
And Views on Best Practices for All Trustees
External Trustee

• Engaging an external trustee.
  – Initial due diligence before engagement
  – Formal Engagement – a written contract
    • Scope of engagement
    • Discretionary vs. Directed trustee
Trustee Duties

• ESOP stock purchase and/or stock sale transactions
  – Initial ESOP formation and stock purchase
  – “Second stage” stock purchase transactions
• Fiduciary’s Issues in connection with the Day-to-Day Operations of an ESOP:
  – Valuation
  – Voting ESOP stock/Governance Issues
  – Recordkeeping and Day-to-Day Trust Accounting
  – Recycling and Repurchase Issues
  – Duty to monitor fiduciaries and advisors – Conflicts of Interest
## Trustee Duties

Note 1: the "Period" represents the time either Before (-) or After (+) First Day of Plan Year to complete the task
Note 2: specific due dates are for calendar year end. Dates marked with an "*" are date certain

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<tr>
<th>Period</th>
<th>Duty</th>
<th>Description</th>
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<tr>
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<td>1 - 2 mos Distribution Ensure Diversification &amp; RMD Distributions for current &amp; next plan year</td>
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<td>2 - 2 mos Investment Engage Valuation Firm</td>
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<td>3 - 1 mos Distribution Engage Third Party Administrator</td>
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<td>4 31-Jan * Compliance Last day to Prepare and Mail IRS Form 1099-R AND IRS Form 945</td>
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<td>5 + 1 mos Distribution Determine Participant Eligibility</td>
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<td>6 28-Feb * Compliance Last day to Prepare and Mail IRS Form 1096</td>
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<td>7 + 2 mos Distribution Review Share Release Calculation &amp; Allocation</td>
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<td>8 + 2 mos Investment Review Financial Statements of underlying Company</td>
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<td>9 15-Mar Compliance Last day to Receive Company Contribution for prior plan year (unless corporate return is extended)</td>
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<td>10 + 3 mos Distribution Review Allocation Report &amp; Distribute Participant Statements</td>
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<td>11 + 3 mos Compliance Distribute Diversification Notices</td>
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<td>12 1-Apr * Compliance Last day for RMD payments to any participant who turned 70&amp;1/2 in prior year</td>
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<td>13 + 4 mos Distribution Review &amp; Prepare Participant Distributions</td>
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<td>14 + 5 mos Corp Governance Review Proposals &amp; Nominated Directors</td>
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<td>15 + 5 mos Corp Governance Distribute Proxy Information to Participants</td>
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<td>16 + 6 mos Compliance Last day to Execute Diversification Elections</td>
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<td>17 + 6 mos Corp Governance Attend Annual Meeting</td>
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<td>18 + 6 mos Corp Governance Vote Proxy</td>
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<td>19 +7 mos Compliance Last day to file 5500 (can be extended 2&amp;1/2 mos)</td>
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<td>20 30-Sep Compliance Last day to Distribute Summary Annual Report (within 2 mos after filing tax return)</td>
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<td>21 +10 mos Distribution Review Repurchase Obligation Study</td>
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<td>22 +10 mos Corp Governance Review Repurchase Obligation Study</td>
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<td>23 +10 mos Corp Governance Review Corporate Actions, Budgets &amp; Plans</td>
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<td>24 Occasionally Custody Collect, Receive and Invest Asset revenues (divs or S-Corp earnings)</td>
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<td>25 Occasionally Corp Governance Engage Plan &amp; Trust Legal Advisor</td>
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<td>26 Occasionally Custody Accept Employer Contribution(s)</td>
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<td>27 Occasionally Investment Engage in Assets Purchases or Sales</td>
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<td>28 Occasionally Investment Prepare and Process Loan Payments</td>
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<td>29 Recurring Compliance Distribute Summary Plan Description to new participants</td>
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<td>30 Recurring Custody Hold, Control and Maintain assets</td>
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<td>31 Recurring Investment Determine Plan Investment Prudence</td>
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Trustee Best Practices

Valuation – Trustee responsible for setting share value.

• Process for accepting the report from Valuation Firm
  – Review the Report
    • Review the approach
    • How many / what different methods used
      – Market Approach
      – Income Approach
      – Asset-based approach
Trustee Best Practices

Valuation cont’d

– Overall solvency of the company
– Trends exhibited in the report
– Plan Liability versus Fair Market Value
– Necessity of the Trustee to discuss issues with management
– Repurchase Liability

• Setting the share price – best practices
Trustee Best Practices

Payment of the ESOP loan

- Notify the Company of pending loan payments due.
- Collect the loan payments from the company and make the necessary payments to the bank or back to the company.
  - All loan payments need to be run through the trust even if the loan is from the company.
  - Calculate the release of the shares as per the loan documents and make sure that all covenants have not been violated.
Trustee Best Practices

Record Keeping

• Maintain Trust Checking Account
• Retain and Maintain Custody of ESOP Stock Certificates
• Submit Annual Report and Accounting to Company
Trustee Best Practices

Allocations – under the ESOP

• Verify the release of shares
• Spot check the allocations
• Verify the number of shares on the reports to the Trust
• Statements for both the allocated and unallocated shares
• Look at the results of the 409(p) test for Sub S ESOPS. Is there a non-allocation year?
Trustee Best Practices

**Distributions** - of benefits from the ESOP.

- The Trustee makes the distributions to the plan participants as directed by the plan administrator.
- The distributions should be verified to the allocation reports before checks are issued.
- Prepare the check or have stock certificates prepared if shares are to be paid out.
- Compute income tax withholding.
  - Prepare the appropriate tax reporting forms and send withholding timely to the IRS.
Trustee Best Practices

Distributions cont’d

• If the Company purchases distributed ESOP shares, is it a Fiduciary decision?
• If the ESOP purchases distributed ESOP shares, is it a Fiduciary decision?
• What if Company offers to repurchase ESOP shares from the ESOP so that the ESOP can distribute cash in lieu of shares?
  – If stock is sold by the ESOP to the Company, the sale is a party-in-interest transaction and must be done at a fair market value as determined at time of the sale, not as of last annual valuation date.
Trustee Best Practices

Voting

- **Pass-Through:** Distribute “adequate” information to Participants to permit an informed vote.

- **Confidential Tabulation of Participant Directions** on allocated shares and voting in accordance with those directions
  - How does Trustee vote unallocated shares?
  - How does Trustee vote shares not directed?
  - How does Trustee vote voted but disqualified shares?

- **Non-Pass Through Voting:** Trustee votes ESOP shares on shareholder issues which are not subject to Pass-Through requirements (e.g., Election of Directors)
Speaker Contact Information


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