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Should a Publicly-Traded Company Sponsor an ESOP: Pros and Cons

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Kelly practices in the tax group with a concentration in the area of executive compensation and employee benefits.

She has worked with both public and private companies on an array of employee benefit matters, focusing on qualified retirement plans, health and welfare plans and executive compensation arrangements. Her experience includes helping clients navigate and comply with the complex and numerous legal requirements associated with the administration of equity compensation and employee benefit plans and advising companies on fiduciary duties with respect to qualified retirement plans.

She works with entities on all stages of benefit plan matters, including advising companies on the design and implementation of new plans, drafting documents, counseling companies on the maintenance and correction of plans and finally, assisting in merging or termination of plans. She is experienced in design and implementation of employee stock ownership plans (ESOPs) as well as ESOP transactions.

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Tony's multi-disciplinary legal practice focuses on executive compensation, ESOPs and employee benefit arrangements (including their related tax, accounting, securities and corporate governance issues) in the United States and abroad. He leads the Firm's Compensation Practice Group.

Before entering private practice, Tony:

- Served as a judicial clerk to the Hon. Richard F. Suhrheinrich of the United States Court of Appeals (6th Circuit)
- Obtained his LL.M. (Taxation) from New York University
- Obtained his J.D. (Tax Concentration) from Michigan State University College of Law
- Editor-in-Chief, Journal of Medicine and Law
- President, Tax and Estate Planning Society

Introduction

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- The purpose of this presentation is to discuss the pros and cons associated with a publicly-traded company ("***PubCo***") sponsoring an employee stock ownership plan (an "***ESOP***")
- To that end, this presentation will focus on the related administrative and transactional design issues, including:
  - Introduction to ESOPs
  - The advantages and disadvantages associated with PubCo sponsoring an ESOP,
  - Typical fiduciary structures that can help to limit or contain fiduciary liability,
  - Incorporating ESOPs into PubCo's "poison pill" analysis,
  - Diversification requirements,
  - Whether a Form S-8 (and related Form 11-K) is required or advisable, and
  - Pass-through voting issues

What is an ESOP

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- An ESOP is a tax-qualified retirement plan, similar to a profit sharing plan except that an ESOP is required to invest primarily in employer stock

- An ESOP is subject to most of the rules applicable to qualified retirement plans, including:
  - Nondiscrimination and coverage testing,
  - Fiduciary obligations, and
  - Reporting and disclosure requirements

ESOPs as an Employee Benefit

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- Employees become part owners of the company and should become more motivated to improve corporate performance and shareholder values since they benefit directly:
  - If the company grows and is successful, ESOP benefits are often superior to those of other employee retirement plans.
  - Studies indicate that employee productivity in fact improves when ESOPs are put in place. Studies also indicate that the greater the level of employee ownership, the greater the gain in productivity
  - Applies to management as well as rank and file.
- After an employee has been with the company for a pre-determined length of time, he becomes "vested" and has the right to receive the company stock allocated to his account at termination of employment.

How the ESOP is invested

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- ESOP must be primarily invested in employer securities.
  - May be exclusively invested in employer securities.
  - Exempt from ERISA's diversification requirement.
  - Exempt from prudence requirement to extent it would require diversification.
- Other assets (cash contributions, dividends and S Corp distributions not invested in company stock) must be invested according to ERISA's prudent investment rules.
  - Trustee or another fiduciary may invest.
  - Participants may direct the investment of assets.
  - Key Inquiry: how quickly will these assets be invested in company stock.

Sources of Shares for ESOP

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- Contributions of stock by the employer.
- Purchases of stock from the employer.
- Purchases of stock from shareholders.
  - Buy out shares of deceased shareholders.
  - Buy out dissident shareholders.
- Conditions on purchases
  - Prudent and in the best interests of participants.
  - Price does not exceed FMV.
  - No commissions are charged to the plan.
  - If debt is incurred, a separate prohibited transaction exemption must be satisfied.

Funding the ESOP

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- Employer contributions.
  - Employer discretionary contributions of cash or stock
  - Deductible up to (at least) 25% of participant compensation.
- Securities acquisition loans.
  - Use of borrowed funds to purchase employer securities.
    - Third party loan to the plan, typically guaranteed by the employer and/or others.
    - Third party Loan to the employer with a corresponding (back-to-back) loan by the employer to the ESOP.
    - Credit sale to the ESOP.
  - Shares held in suspense, released to participant accounts as loan is paid.
  - Allows the acquisition of a block of shares at a single time for the current price.
  - Can be combined with a one-time offering to employees.
- One–time 401(k) participant elections.

Distributions from ESOP

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Determined by plan.

- Lump sum.
- Installments:
  - Installments may be required for distributions exceeding a given threshold.

Must be completed within 5 years unless:

- Participant elects a longer term (if permitted by the plan).
- For benefits exceeding $1,165,000, one additional year permitted for each $230,000 up to a maximum of 10 years.

Uses of an ESOP

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- ESOP thoughts for PubCo to consider include:
  - It can facilitate a tax-advantaged means for PubCo to finance the expansion of a business unit (*i.e.*, contributions are tax deductible, and payment of dividends to an ESOP are tax deductible),
  - It provides equity to rank-and-file employees without having to seek prior shareholder approval for the grant of shares (*i.e.*, an ESOP falls within an exception to the shareholder approval requirements under NYSE and NASDAQ listing rules),
  - An ESOP is a less risky alternative than having employer stock within PubCo's employer-sponsored 401(k) plan

Advantages of an ESOP (Not Exhaustive)

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- If properly communicated, an ESOP creates an ownership culture that should increase employee morale and increase profitability
- Help PubCo defend against a hostile takeover
  - Studies show that employees vote favorably with management when a possible hostile takeover exists because employees fear a takeover would result in loss of jobs
  - Voting rights of allocated shares would be passed through to ESOP participants in tender offer situations
  - A mirror provision could be implemented whereby the ESOP trustee would vote unallocated ESOP shares in the same manner/percentage as allocated shares were voted by ESOP participants (though the ESOP trustee would not be required to follow the mirror provision if fiduciary duties dictate otherwise)

Advantages of an ESOP (con't)

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- Shareholder approval is not required to implement an ESOP
  - NYSE and NASDAQ listing rules generally provide that plans intended to satisfy the requirements of Section 401(a) of the Internal Revenue Code (the "*Code*") are exempt from the shareholder approval requirements
  - ISS voting policies favor ESOPs
  - This means that if PubCo otherwise provides equity grants deep into the employee pool, and such PubCo has difficulty obtaining shareholder approval to increase the share reserve of its equity incentive plan, then PubCo could change its strategy to:
    - Eliminate grants from the equity incentive plan to rank-and-file employees, and
    - Replace such grants with an ESOP

Disadvantages of an ESOP (not exhaustive)

- Existing shareholders are diluted to the extent contributions of newly issued stock is granted by PubCo to an ESOP
  - Though for such companies dilution can be avoided to the extent PubCo contributes cash to the ESOP for the latter to fund purchases of employer stock in the open market

- As a retirement plan subject to ERISA, certain fiduciary duties apply at the time of implementing an ESOP and throughout its operation

- Initial and ongoing costs of setting up and maintaining an ESOP
  - Legal and consulting fees,
  - Employee communications,
  - Participant recordkeeping, and
  - Annual valuations

Issues Unique to Public Companies: Voting Rights

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- As to shares allocated to a participant's account, participants would have full voting rights on all issues subject to shareholder vote
  - Noteworthy is that receipt of an unsolicited tender offer would not require a shareholder meeting
- Addressing unallocated shares, voting rights would generally be exercised by the trustee
  - However, the ESOP document could provide that unallocated shares would be voted by the trustee in the same proportion as participants direct the voting of allocated shares (a "mirror provision"), subject to fiduciary duties
- To implement a defense against hostile takeovers, the ESOP could be designed to pass through voting rights of allocated shares to participants in tender offer situations
  - A mirror provision would address the trustee's decision to vote the unallocated shares

Issues Unique to Public Companies: Diversification

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- For ESOPs sponsored by PubCos, the diversification requirements are different depending upon whether the stock represents employee contributions, matching contributions or only PubCo contributions

- Generally, if the ESOP has no employee contributions and no matching contributions, participants who first attain 55 years of age with 10 years of service must be allowed to diversify up to 25% of their account for the next 6 years (and the percentage is up to 50% for the 6th year) :
  - Alternatives for divesting out of PubCo stock include:
    - Transfer to a 401(k) plan
    - Distribute to the participant
    - Offer at least 3 investment options within the ESOP

- Generally, if the ESOP has employee contributions invested in PubCo stock, then the participant must be able to diversify out of PubCo stock and reinvest in other investment alternatives at least quarterly

- Generally, if the ESOP has PubCo matching contributions in PubCo stock, then once the participant has 3 years of service with PubCo such participant must be able to diversify out of PubCo stock and reinvest in other investment alternatives at least quarterly

Limiting Fiduciary Liability: Who is a Fiduciary

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- Under ERISA, a person is generally a fiduciary to the extent:
  - Such person is named in the ERISA plan document and is provided discretionary authority or responsibility over the administration of the ERISA plan (the "*Named Fiduciary*"),
    - Typically, the Retirement Plan Committee or Benefits Committee will be the Named Fiduciary for the ESOP
  - Such person exercises any discretionary authority or control respecting administration of the ERISA plan, or
  - Such person exercises any authority or control respecting management or disposition of the assets of the ERISA plan

Limiting Fiduciary Liability: Who Is a Fiduciary (cont.)

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- Qualified retirement plans such as an ESOP generally have more than one fiduciary (e.g., officers, human resources, etc.)

- An important point for a plan sponsor to keep in mind is that, with proper planning, fiduciary liability for a particular individual or group can be localized to certain acts
  - A person is a fiduciary ". . . only as to the activities which bring the person within the definition." *See Coleman v. National Life Ins. Co.,* 969 F.2d 54, 61 (4th Cir. 1992)
  - However, for example, if one or more persons have responsibility to approve recommendations made by others with respect to investment alternatives, then such persons will likely be considered fiduciaries with respect to investment decisions. *See Yeseta v. Baima,* 837 F.3d 380 (9th Cir. 1988)

Fiduciary Duties

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- Fiduciary obligations are among the highest known to law
- Fiduciaries are generally subject to the following standards (not an exhaustive list):
  - They must act for the exclusive benefit of providing benefits and defraying reasonable expenses of administering the ERISA plan (*i.e.*, the duty of loyalty)
    - Important note with respect to fiduciaries wearing multiple hats (*i.e.*, having multiple positions within the employer) is that satisfying the duty owed as an ERISA fiduciary is primary and comes before any duty owed to the employer as an institution
  - They must act with the care, skill, prudence and diligence under the circumstances that a prudent person with similar capacity would use (*i.e.*, the duty of prudence), applied using an expert standard (*i.e.*, if the fiduciary lacks the requisite expertise, then the fiduciary is required to hire such expertise);
  - They must act in accordance with the plan documents;
  - They must act to diversify the ERISA plan's assets, unless doing so would be imprudent; and
  - They must not knowingly participate in or conceal the breach of a co-fiduciary
- A fiduciary has a duty not to mislead or misinform participants
  - This means that fiduciaries have an affirmative duty to disclose information to plan participants when the fiduciary knows that his or her silence could be harmful to participants

Fiduciary Duties (con't)

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- Important to note: functions that are "settlor" in nature are typically not subject to fiduciary restraint
  - This allows an employer, as the settlor, to make fundamental business decisions without being restricted by fiduciary duties
  - Settlor functions pertain to decisions with respect to establishing and maintaining a plan. Fiduciary functions pertain to implementing the settlor decisions and administering and managing the plan
  - Examples of settlor functions include establishing, designing, amending or terminating an ERISA plan and employing agents
  - Examples of fiduciary functions include adopt and enforce procedural rules for the plan, review claims for benefits, maintain records required by ERISA, interpret plan provisions

- If an individual's powers are limited to appointing, retaining and removing a fiduciary, then such individual's fiduciary liability could be limited to only a failure-to-monitor claim

- As applied to members of the Board of Directors, and to help limit their liability, such Board would delegate its authority with respect to the ESOP to an individual (*e.g.*, the Director of HR), and then have that individual further delegate its authority to a benefits committee
  - Such should limit the board's liability to a "failure to monitor" claim, if any; and
  - Should insulate the Board of Directors from the determination of "who" should be on the benefits committee

Consequences for Breach of Fiduciary Duty

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- Personal liability
  - Restore losses to the plan resulting from the breach,
  - Restore to the plan any profits made by the fiduciary through use of plan assets, and
  - Other equitable and remedial relief

- Other liability includes:
  - Criminal liability for "willful" violations (*i.e.*, a general intent standard, knowingly and intentionally committing the act is all that is required, and intention to violate the law is not required), and
  - DOL penalty of 20% of the applicable recovery amount

- Protecting the purse?
  - Fiduciary liability insurance
  - D&O indemnity and/or a company reimbursement policy

Fiduciary Exception to the Attorney Client Privilege

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- The general rule is that discussions between a lawyer and his or her client are privileged. This is known as the attorney-client privilege

- One exception to the general rule applies to communications between a lawyer and an ERISA fiduciary
  - In the ERISA context the identity of the client is questionable
  - Fiduciaries do not act on behalf of themselves, they act on behalf of participants
  - Courts have generally held that the true "client" is the participants
  - Therefore, the attorney-client privilege could not be used against the participants

- This means ERISA fiduciaries cannot assert the privilege against plan participants and beneficiaries. And, ERISA fiduciaries are prohibited from asserting the privilege with respect to communications on plan administration matters

- However, the privilege should continue to apply to settlor functions or any other non-fiduciary function

A Typical Fiduciary Structure

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- The Board of Directors established the ESOP and in conjunction with the same (or later) delegates its duties to the [Benefits Committee]
  - As a result, the Board of Directors should only have a duty to monitor the [Benefits Committee]
  - The [Benefits Committee] would be specifically designated within the ESOP as the "plan administrator" and the "named fiduciary" within the ESOP documents, and would have the duty to monitor operational fiduciaries of the ESOP (operational fiduciaries generally include those who have authority to make investment decisions for the ESOP)

- And too, but slightly different, PubCo could create two committees for the purpose of:
  - Having any Section 16 insiders residing on the operational committee, and
  - Having a separate committee with no Section 16 insiders reside on the committee empowered with the investment decisions under the ESOP

Upcoming 2020 Webinars

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- **2021 webinars**:
  - **June 24**: Key Issues for HSAs, HRAs and FSAs
  - **July 22**: Employment and Benefits Issues in M&A Transactions
  - **August 26**: Basics and Update on IRS and DOL Correction Programs
  - **September 23**: Self-Directed IRAs and investments relating to the same
  - **October 28**: Navigating controlled group and affiliated service group rules
  - **November 18**: Year-End Benefit Plan Requirements/End of Year Benefits "To Do" List
  - **December 16**: Benefits Year in Review and a Look Ahead to the Upcoming Year
- Sign up here: Employee Benefits Academy Webinar Series - Subscribe

Next Month's Webinars

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Executive Compensation Academy

- Title: Training Course on Designing an Equity Incentive Plan (Part 1 of 3)
- When: June 10, 2021
- Time: 10:00 am – 11:00 am CT
  11:00 am – 12:00 pm ET

Employee Benefits Academy

- Title: Key Issues for HSAs, HRAs and FSAs
- When: June 24, 2021
- Time: 10:00 am – 11:00 am CT
  11:00 am – 12:00 pm ET

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