

## CURRENT ESOP AND ESOP TRUSTEE CORPORATE GOVERNANCE ISSUES

David Burdette

*Recent corporate scandals and conflict of interest issues related to merger and acquisition transactions have focused investors' attention on the topic of corporate governance "best practices." A review of corporate governance "best practices" related to employee stock ownership plan (ESOP) acquisition transactions can shed light on the broader topic of general corporate governance practices and procedures.*

---

### INTRODUCTION

The topic of corporate governance has been at the forefront of the media's and the regulator's attention following the collapse of companies such as Adelphia, Enron, and Worldcom. The subsequent period of corporate governance practice reform has also been reflected in the employee stock ownership plan (ESOP) community.

Financial advisory firms and all related parties to ESOP formation/stock acquisition transactions have intensified their focus on increased corporate governance responsibilities. These increased corporate governance responsibilities include those of:

1. the sponsor company's management,
2. the employer corporation's board of directors, and
3. the ESOP trustee for the employee-owned company.

There are substantial differences between publicly traded corporations and private companies that sponsor ESOPs. However, the potential for conflicts of interest in both types of companies is still present.

The typical public corporation has numerous owners who often have little or no role in the operations of the subject company. Decisions are delegated and entrusted to professional managers. These managers decide how to utilize corporate assets, operate the company, expand the business, and maximize value for the shareholders. This separation between business owners and company management creates the potential for conflicts, which occurs when company management puts its own interests ahead of the interests of shareholders.

One of the principal purposes of an ESOP is to align the interests of a company's employees with the interests of

the company's shareholders. However, the ESOP ownership structure does not guarantee that all conflicts of interests are reduced or eliminated.

The ultimate goals of corporate governance are:

1. to eliminate, or at least significantly reduce, conflicts of interest;
2. to ensure that management employs the company assets in a manner consistent with the best interests of the company's owners; and
3. to aid in the maximization of the value of the company.

This discussion will outline the importance—and the attributes—of an effective corporate governance system. In addition, this discussion will explore (1) situations in which different conflicts of interest could arise and (2) potential solutions that company management can pursue.

Finally, this discussion summarizes corporate governance "best practices" that can provide guidance to all parties.

### IMPORTANCE OF CORPORATE GOVERNANCE

It is reasonable to expect that the investing public will avoid markets, corporations, and management teams in which they do not have faith or trust. This observation applies equally to publicly traded companies, privately held companies, and employee-owned sponsor companies.

Corporate stockholders place their trust in the corporation's management to properly manage the assets of the company. Corporate stockholders also place their trust in

the company board of directors to oversee the management team.

An open, honest, and transparent corporate governance system helps investors gauge the company's commitment to protecting their interests. Therefore, proper corporate governance systems help assure the effective administration of the capital markets.

Regardless of whether a company is publicly traded, privately held, or employee-owned, the strength and effectiveness of a corporate governance system will have a direct impact on the value of a company. As described below, companies with an effective corporate governance system are shown to have higher measures of profitability and to generate higher returns for their shareholders:

1. In a joint study conducted by Institutional Shareholder Services and Georgia State University, the best governed companies generated a return on equity that was 23.8 percent higher than companies with poor corporate governance.<sup>1</sup>
2. Portfolios of companies with strong shareholder-rights protections were found to outperform portfolios of companies with weaker shareholder-rights protections by 8.5 percent annually.<sup>2</sup>

*"... an effective corporate governance system add[s] value to shareholders."*

Clearly, an effective corporate governance system has the prospect to add value to shareholders; and, the added value translates into higher equity prices. The opposite situation also holds true: companies that lack an effective corporate governance system increase the investment risk to the shareholders. This added investment risk reduces the value of the subject company.

## EFFECTIVE CORPORATE GOVERNANCE PRACTICES

Corporate governance systems will differ across industries, legal environments, cultures, and other factors. These differences will also relate (1) to the ownership structure of the company and (2) to whether or not the company is public or privately held. Despite these differences, there are four core attributes that all effective corporate governance systems share.

In general, an effective corporate governance system will:

1. define the rights and privileges of the shareholders;
2. provide for fair and equitable treatment in all dealings between managers, directors, and owners;

3. define and communicate to all stakeholders the responsibilities of the managers and directors; and
4. have complete transparency and accuracy in disclosures regarding the operations, performance, risk, and financial position of the company.

Corporate shareholders, independent financial advisors, and valuation analysts should first turn their attention to the subject company Shareholder's Agreement and the Articles of Incorporation in order to determine the company's commitment to corporate governance. These documents outline how the company should be operated and describe the shareholder's rights and obligations.

The Shareholder's Agreement includes information on the regulation of the shareholders' relationship, the management of the subject company, the ownership of shares, and the various rights, privileges, and protection of shareholders. Companies that do not possess the aforementioned core attributes of corporate governance are more likely to:

1. jeopardize the rights of shareholders and
2. decrease the value of the subject company.

## CONFLICTS OF INTERESTS BETWEEN SPONSOR COMPANY MANAGEMENT AND THE TRUSTEE

In an ideal world, the interests between the sponsor company management, the employer board of directors, and the ESOP trustee would be perfectly aligned. The primary reason why this is not the case is the necessary separation between stock ownership and operational control.

An ESOP trustee represents the buyer of the sponsor company equity. The ESOP trust is a shareholder that owns all or part of the sponsor company stock. By law, the ESOP trustee is prohibited from paying more than fair market value for the purchase of the sponsor company stock.

The sponsor company management is primarily responsible for:

1. managing the sponsor company's operations,
2. creating value for the shareholders, and
3. preparing financial projections (these projections become an integral part of the sponsor company stock valuation when they are used in the discounted cash flow valuation method).

In an ESOP ownership situation (as with a public corporation), operational control falls to a centralized man-

agement team. As a result, the sponsor company management expects to share in the profits earned by the sponsor company. The ESOP trustee typically will encourage such management perquisites as an incentive for management to manage the sponsor company for the benefit of all stockholders, including the ESOP.

Accordingly, the interests of the sponsor company management should be consistent with the interests of the ESOP trustee. This is because both parties want (1) the sponsor company to succeed and (2) the value of the employer corporation stock to increase. However, in the subject company ownership/control dynamic, the interests of the ESOP trustee and the interests of sponsor company management sometimes will diverge.

Sponsor company management may have a desire to:

1. use funds to expand the size of the company—a larger company may increase management's job security, power, and compensation without benefiting the shareholders via increased wealth;
2. receive more equity and compensation than may be appropriate under an ESOP ownership structure;
3. grant excessive compensation—company managers may grant themselves higher salaries and corporate perquisites that are expensed as normal business operations, thus depriving the ESOP shareholders of wealth accumulation;
4. invest in risky ventures—the incentive for company management to undertake risky projects may decrease the value of the sponsor company. This is the case when managers holding large amounts of options reap huge benefits if the risky projects succeed. If managers do not share in the losses if the risky projects fail, all of the losses are born by the shareholders; and
5. engage in related-party transactions, such as owning real estate and equipment that is leased to the sponsor company (in order to increase management's personal income).

Further, employer corporation management may be more interested in increasing cash flow available for compensation and bonuses than in increasing the equity value of the sponsor company stock. As a result, sponsor company management is often averse to having a corporate institutional trustee serve as the ESOP fiduciary, in favor of a company insider or director.

Due to these conflicts of interests, many employer corporation boards of directors, as well as many ESOP advisors, believe that a best practice for an effective sponsor company corporate governance system is to contract with an independent, qualified corporate ESOP trustee to serve the interests of the ESOP.

## CONFLICTS OF INTERESTS BETWEEN THE BOARD OF DIRECTORS AND THE TRUSTEE

ESOP trustees have a fiduciary duty to the participants of the plan. General fiduciary standards, as outlined by ERISA, are the core fiduciary duties that apply to all trustee actions.

As provided under ERISA, the law governing fiduciaries requires a fiduciary to manage and administer the trust:

1. solely in the interests of ESOP plan participants and beneficiaries;
2. for the exclusive purpose of providing benefits to ESOP plan participants and their beneficiaries and defraying reasonable expenses of administering the plan;
3. with the care, skill, prudence, and diligence, which, under the circumstances then prevailing, a prudent man acting in like capacity and familiar with such matters would use in the conduct of an enterprise of a like charter and with like aims;
4. in accordance with ESOP plan and trust agreement; and
5. in accordance with applicable requirements of the law.

ESOP trustees have been held liable for failing to discharge these duties, and for failing to:

1. properly perform due diligence,
2. properly monitor the activities of company management (i.e., in conflict of interest situations in which a company director is also the trustee),
3. properly assess the value of the company stock purchased by the ESOP, and
4. properly assess the valuation impact of the company's ESOP repurchase liability.

Fortunately, the employer corporation board of directors share similar fiduciary responsibilities. These fiduciary responsibilities include duties owed to the company and to the company's shareholders. This fact more closely aligns the interests of the employer corporation board with the interests of the ESOP trustee.

However, conflicts may arise if the board fails to perform its fiduciary duties. It is the board of directors' fiduciary duty to see that sponsor company assets are managed for the benefit of the corporate stockholders. The general standard is that a director must fulfill his or her duties:

1. in good faith,
2. with the care an ordinary prudent person in a like position would exercise under similar circumstances, and

3. in a manner that he or she reasonably believes to be in the best interest of the corporation.

In general, a corporate director can demonstrate fulfillment of the duty of care by:

1. instituting corporate values and corporate governance systems that will ensure the business is conducted in an ethical and fair manner,
2. creating long-term strategic goals and objectives that are consistent with the shareholders' best interests,
3. regularly attending corporate meetings,
4. carefully reviewing information provided by company management,
5. evaluating the performance of management, and taking the actions necessary to either reward or discipline executives based on their performance,
6. planning for the repurchase obligation, and
7. performing other duties that are specific to the company.

Conflicts of interest may arise between the employer corporation board of directors and the ESOP trustee. When an ESOP trustee believes that a member or members of the board are either not fulfilling their fiduciary duties or are otherwise ineffective, the trustee may have leverage that can potentially rectify the situation.

In an ESOP-owned company, the percentage of the sponsor company that the ESOP owns has an effect on how much influence the ESOP trustee has (1) over the board of directors and (2) over corporate governance in general. If the ESOP trustee is in a majority ownership control position and can vote to replace one or more board members, then the ESOP trustee can be a significant catalyst for corporate change.

Removing a corporate director who is not performing his/her required duties can be challenging. To effect any governance changes at the sponsor company, the ESOP trustee must work within the role of a company stockholder. As stated previously, the strength of the ESOP trustee's position will be dictated by the percentage of the sponsor company owned by the trust.

An ESOP trustee that controls the majority of the sponsor company stock enjoys significant influence over

the board of directors. The ESOP trustee can employ the annual stockholder vote to effect a change on the board. However, it is the employer corporation board, not the ESOP trustee, that should make decisions about changes to the sponsor company management team. If the board member subject to removal is also an employee of the sponsor company, then terminating the employee relationship is exclusively a board decision.

The ESOP trustee must work closely with the employer corporation board to effect any changes in sponsor company management. If the composition of the board of directors includes members of the sponsor company management, this task becomes even more difficult.

In considering whether to remove a director, the ESOP trustee should work closely with the outside directors (assuming the subject director is not an outsider). Usually, the outside board members will retain independent counsel to guide them through the process.

A decision should be made whether the termination is for just cause. Any employment contracts should be reviewed, and estimates should be made on the financial impact of the decision on the sponsor company.

It is the employer corporation board of directors that terminates an individual's employment, not the ESOP trustee. However, it is the stockholder who terminates a board position. Therefore, it is often preferable in such circumstances to first attempt a negotiated settlement.

*"Conflicts of interests may arise between the employer corporation board of directors and the ESOP trustee."*

*". . . it is the employer corporation board, not the ESOP trustee, that should make decisions about changes to the sponsor company management team."*

## BEST PRACTICES

The following discussion is intended to guide the ESOP trustee, the sponsor company management, and the employer corporation board of directors in implementing the recommendations for best practices regarding corporate governance. These recommendations are consistent with the two principal objectives of effective corporate governance:

1. eliminating or reducing conflicts of interests between stakeholders and
2. using the sponsor company's assets in a manner consistent with the best interests of stakeholders.

These best practices include the structure of the shareholder agreement and articles of incorporation, as well as recommendations for the structure of the employer corporation board of directors.

We recommend that the employer corporation board of directors be composed of both inside and outside members. In order to assure that directors are serving shareholders, we recommend that at least three-quarters of the board members are independent.

Further, we recommend that the number of board members is adequate for the size of the sponsor company. Sponsor companies that have too few directors may find that the board is stretched too thin. In that case, the board is not capable of performing all of its required duties.

The opposite situation is also true: sponsor companies that have too many board members drain company resources. In that situation, the potential for mismanagement increases.

The employer corporation's board should have an independent chairperson. Some observers argue that the CEO as chairman is valuable for providing the board with in-depth knowledge of the sponsor company's operations and financial position. However, an executive controlling the board's agenda diminishes the role of independent board members.

This situation is especially true in the case of the board's compensation committee. A compensation committee should be established and should be comprised entirely of independent board members. The compensation committee should use executive compensation to attract, retain, and motivate company managers on behalf of shareholders. However, the compensation committee should not pay excessive management compensation because that could undermine shareholder value.

Also, compensation should not be too low, as talented managers may leave the sponsor company in search of higher wages and bonuses. The compensation committee should focus on long-term goals and both reward superior performance and discipline poor performance.

The search for employer corporation directors should be completed by the nominating committee. This committee is responsible for establishing criteria for identifying and evaluating candidates for the employer corporation board as well as for executive management.

We recommend that the nominating committee be comprised entirely of independent board members. The nominating committee should determine the appropriate qualifications of potential directors before its search begins, and should identify candidates that can bring the necessary skills and experiences that will assure the board will fulfill its fiduciary responsibilities to shareholders.

Staggered elections of the board of directors are not recommended. Advocates for staggered elections claim that it is in the best interests of shareholders that the board has

continuity. However, the problem that may arise occurs when one or more directors are not performing to the required standards.

With staggered board elections, it is challenging to remove inadequate employer corporation directors. With staggered elections, it may take several years to replace the deficient corporate directors.

Annual elections allow the shareholders (and perhaps the ESOP trustee, if the ESOP owns a controlling ownership interest) to replace directors in a more timely fashion.

Further, if the employer corporation directors know that they can potentially be replaced in one year's time, then the directors are more likely (1) to make careful decisions and (2) to be more active in the management of the sponsor company.

*"Corporate governance best practices are important to shareholders, regardless of whether the subject company is publicly traded, privately held, or ESOP-owned."*

## SUMMARY AND CONCLUSION

The recent corporate scandals could have potentially been avoided if the companies had an adequate corporate governance system. Accordingly, the media and the investing public have recently focused their attention on corporate governance best practices. Corporate governance best practices are important to shareholders, regardless of whether the subject company is publicly traded, privately held, or ESOP-owned.

In the case of an ESOP-owned employer corporation, the ESOP trustee plays an important role in determining the quality and effectiveness of the sponsor company's corporate governance systems. This influence is magnified if the ESOP trustee controls the majority of the sponsor company stock.

Ideally, the ESOP trustee, the sponsor company management, the employer corporation board of directors, and the non-ESOP shareholders should all work together (1) to create an effective sponsor company corporate governance system and (2) to strive to update, revise, and improve the sponsor company corporate governance best practices.

### Notes:

1. Lawrence D. Brown and Marcus Caylor, "Corporate Governance Study: The Correlation Between Corporate Governance and Company Performance," Institutional Shareholder Services, 2004.
2. Paul A. Gompers, Joy L. Ishti, and Andrew Metrick. "Corporate Governance and Equity Prices," *Quarterly Journal of Economics*, February 2003, pp. 107-155.

*David Burdette is an associate in our Atlanta office. David can be reached at (404) 475-2314 or [dpburdette@willamette.com](mailto:dpburdette@willamette.com).*