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Corporate governance in ESOP companies

by Tim Jochim

Corporate governance can be described as the legal and functional relationship among the shareholders, directors and officers of the corporation. The National Association of Corporate Directors (NACD) simply refers to corporate governance as to how a corporation is governed. In general terms, state corporation law determines the relationship among shareholders, directors and officers and the primary corporate governance document is usually the bylaws or code of regulations. As to corporations with publicly-traded securities, corporate governance is substantially influenced by the Securities and Exchange Act (the ‘Exchange Act’) and the Securities and Exchange Commission (SEC). As to corporations with a majority of their outstanding securities held by an employee benefit plan qualified under Section 401(a) of the Internal Revenue Code (the ‘Code’), corporate governance is substantially influenced by the Employee Retirement Income Security Act (ERISA) and the US Department of Labor (DOL). Because nearly all of such benefit plans are employee stock ownership plans (ESOPs), this discussion of the effect of ERISA upon corporate governance will be substantially limited to closely-held companies majority owned by their ESOPs.

Overview of ESOPs

An ESOP, as defined in Section 4975(e)(7) of the Code, is a special type of defined contribution pension plan qualified under Section 401(a) of the Code. An ESOP is unique among ERISA plans because it is exempt from certain prohibited transactions under ERISA, including investment primarily in employer securities and the issuance of debt for such purpose.

The primary application of ESOPs has been among closely-held corporations. Shareholders selling to an ESOP may be eligible for deferral or exemption from capital gains taxes while the corporation can fund the ESOP purchase with pre-tax contributions, pay principal on stock acquisition loans on a pre-tax basis, pay pre-tax dividends on stock in the ESOP (C corporation). An ESOP sponsored by a Subchapter S corporation is exempt from the unrelated business income tax (UBIT) applicable to other qualified plans holding S corp stock under Code Section 512 (other Code Section 401(a) plans can hold the stock of an S corporation, but are subject to Section 512 income taxes).

The trustee of an ESOP that holds a controlling interest in the sponsor corporation, whether discretionary or directed, has an increased level of fiduciary duty under ERISA and, as a controlling shareholder, is also a corporate fiduciary under the corporation laws of most states. In addition, ESOP participants have certain voting rights under Code Section 409(e). Accordingly, ESOPs have become a major factor in corporate governance where the ESOP constitutes the majority shareholder.

Corporate fiduciary standards

Corporate fiduciaries, consisting of controlling shareholders, directors and, to a lesser extent, officers, owe fiduciary duties to the corporation. Thus, directors must act with the care and diligence that an ordinary prudent person in a similar position would use under similar circumstances. If a director has reasonable reservations concerning a course of corporate action or inaction, there is a duty to object to management and to other directors. However, a director is not required to have expert knowledge or understanding and may have reasonable reliance upon such experts retained by the corporation.

If a director takes action, or fails to take action, that eventually proves to be erroneous or damaging to the corporation, the director has the benefit of the business judgment rule: a legal presumption that the director met the standards of ordinary good faith and ordinary diligence. This protection does not apply if the presumption is refuted by clear and convincing evidence of self dealing at the expense of the corporation, undisclosed material conflict of interest, lack of good faith, lack of ordinary or reasonable diligence, gross negligence, fraud or criminal conduct on the part of a director in the performance of duties to the corporation or in dealings with the corporation while a director.

ERISA fiduciary standards

The trustee of an ESOP, the sponsor corporation, the 'named fiduciary' and the plan administrator of an ESOP, among others, all have fiduciary duties under ERISA Section 404(a)(1), which requires both a standard of diligence and a standard of good faith higher than the standards that apply to corporate fiduciaries. This standard has been construed as being among the highest under the laws of the United States. The protection provided by the business judgment rule for a corporate fiduciary is *not* available to an ERISA fiduciary.

As set forth in *Reich v. Valley National Bank of Arizona, (NY, 1993),* the *'Kroy'* case, the ESOP trustee (including any fiduciary directing the trustee) is deemed to be a 'prudent expert' with respect to certain matters, including the fairness to the ESOP of transactions involving a controlling shareholder and the sponsor corporation. Heightened diligence and independent investigation are the standard procedural prudence requirements and go beyond the ordinary prudent person standard applicable to corporate fiduciaries.

ERISA duties of directors

Federal courts have held that corporate directors are acting as ERISA fiduciaries in the appointment and monitoring of other ERISA fiduciaries. *Tittle v. Enron,* (Tex., 2003), affirmed that the appointment and removal of ERISA fiduciaries is a fiduciary act under ERISA and opined that directors have a duty to monitor ERISA fiduciaries. Corporate directors have a duty to supervise and monitor the conduct of ERISA fiduciaries even though the directors may have no direct role in any transactions or operations involving an ERISA plan.

The settlement in *Johnson v. Couturier,* (Cal, 2009), makes it clear that corporate officers and directors will be held accountable under ERISA for egregious conduct with respect to looting the company of its value at the expense of the ESOP and its participants. In circumstances involving a company owned entirely or primarily by its ESOP, it seems directors acting in a corporate capacity may have a higher standard of duty than the standard that would normally apply under state corporation law.

Best practices for corporate governance

Federal case law (i.e., *Reich v. Valley National Bank, Tittle v. Enron* and *Johnson v. Couturier)* indicates that corporate governance in a closely-held company primarily owned by its ESOP is subject to the ERISA as enforced by DOL. In addition, certain provisions of the *Sarbanes-Oxley Act of 2002* ('SarbOx') are filtering down to majority ESOP companies even though SarbOx was intended for publicly-traded companies. Accordingly, best practices for corporate governance in a majority ESOP company would include a qualified independent outside ESOP Trustee, qualified independent outside directors (preferably a majority), a nomination committee, an audit committee composed primarily of outside directors, a compensation committee composed primarily of outside directors and restrictions on transactions with both ESOP and corporate fiduciaries. The latter would include a prohibition on company loans to officers, directors and ESOP fiduciaries.

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