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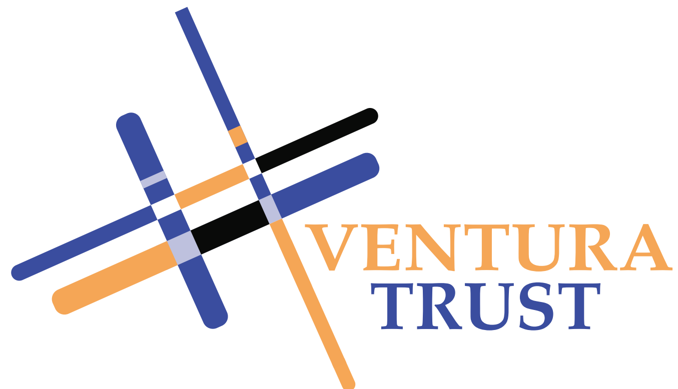

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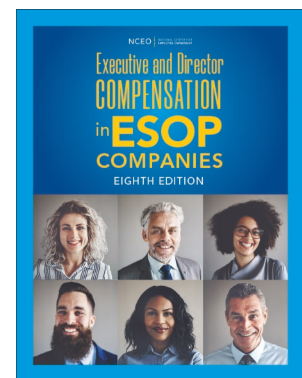

Fiduciary Issues for Trustees Regarding Corporate Governance and Executive Compensation

NEIL M. BROZEN AND ALEX PERRY

Executive compensation in privately held companies that are owned by employee stock ownership plans (ESOPs) can be comparable to executive compensation in non-ESOP companies and in publicly traded companies. These compensation plans begin with the executive's salary and bonus and may also include stock options (both qualified and nonqualified), stock appreciation rights (SARs), restricted stock, phantom stock, and supplemental executive retirement plans (SERPs). Companies that are 100% ESOP-owned and taxed as S corporations tend to avoid compensation arrangements that result in actual stock issuance to preserve the tax-exempt status of the company by virtue of the ESOP owning all of the issued and outstanding stock of the S corporation.

Executive compensation programs beyond salary and cash bonuses, if designed appropriately, can be in the best interests of the ESOP shareholder in that they have proven to be excellent tools for attracting, retaining, and rewarding top-quality management employees. It is often in the best interests of the ESOP trustee to encourage management incentive plans to align the interests of the management team with the interests of the shareholders, i.e., the ESOP, and, indirectly, the ESOP participants. An equity-based program like a SAR grant generally achieves this alignment of interests very easily, because the managers receive a benefit only if the stock increases in value. The same may not be true for programs based on such things as gross revenues or other milestones that are not necessarily tied to stock performance.

This chapter addresses the role of the ESOP trustee with regard to executive compensation in a majority ESOP-owned company.

Corporate Governance

Corporate governance involves the relationship between the trustee, board of directors, and executive management team. It is imperative that these groups work well together even when their responsibilities are well-defined, as there is a high correlation between strong corporate governance and successful ESOP companies.

Every ESOP, as a qualified retirement plan, is required to have a trustee. There is no requirement that the trustee be independent (in appearance or in

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fact), and the majority of ongoing trustees are not independent. Internal (or inside) trustees typically also serve as directors, officers, and/or ESOP participants. While there is no prohibition against multiple roles, managers, boards, and trustees must be aware of the potential conflicts of interests.

Most experienced ERISA attorneys highly recommend that clients engage an independent trustee for a transaction when the ESOP is buying or selling company stock. They may further recommend that the plan sponsor engage an independent trustee after the transaction. An independent trustee can be very helpful in addressing executive compensation issues where the participants in the programs may be conflicted if they are also acting as trustees. Independent trustees are required by law to act exclusively in the best interests of the participants and beneficiaries and will rarely act in any capacity other than trustee for the ESOP, e.g., they would not normally agree to be engaged to provide advice to management on compensation issues.

A trustee, as a prudent fiduciary, must weigh the interests of attracting, retaining, and incentivizing the best management employees with the dilutive effect that equity-based executive compensation will have on the company stock. The trustee will work closely with its financial and legal advisors to determine whether the overall design of the compensation arrangement is accretive to the company stock and that the arrangements are fair to the ESOP from a financial point of view.

ESOP companies are corporations (either C or S) and are required to have a board of directors like every non-ESOP corporation. There are no special ESOP legal requirements as to board size, composition, frequency of meetings, compensation, or committees. Best practices among ESOP companies for the board of directors include the following:

- *Size:* Three to seven members, with a possible increase in size over time.
- *Composition:* A mix of inside and independent directors.[1]
- *Meeting frequency:* Quarterly.
- *Board compensation:* A combination of annual and per-meeting fees.
- *Committees:* Audit, compensation, and nominating committees chaired by independent directors and operating under written charters outlining their responsibilities.

One of the main responsibilities of the board of directors is overseeing the CEO and executive management team. Executive compensation for the CEO and other members of the executive management team is therefore the primary ongoing responsibility of the board. The courts have been clear that the setting of executive compensation properly rests with the board of directors and that the board, in setting executive compensation, does not implicate a fiduciary duty under ERISA.[2] This responsibility increases the need for independent directors or may cause a board without any independent members to rely on outside compensation consultants. Despite the clarity the courts have provided as to executive compensation being the responsibility of the board, the courts have noted that “there is no precise formula or test by which the reasonableness of the compensation of corporate officers is to be measured.”[3]

The trustee does not have the right to attend board meetings, but if agreed to by the board, the trustee should participate at least once a year in key board meetings (in person or virtually) to allow the trustee to fulfill its duty to monitor the board. The trustee should be concerned if the board does not agree to allow the trustee to attend meetings or at least provide the trustee with copies of discussion materials and minutes of the board meetings. It would be desirable to get a commitment from the board at the time of the trustee’s acceptance of the appointment that the trustee will be able to attend board meetings as a guest and will be provided with minutes of the meetings.

1. Independent directors do not include employees, relatives, or persons who have received more than nominal compensation from the company.

2. *Eckelkamp v. Beste,* 201 F. Supp. 2d 1012 (E.D. Mo. 2002), *aff’d,* 315 F.3d 863 (8th Cir. 2002).

3. *Id.* at 1026.

Role of the ESOP Trustee

Trustees are responsible for reviewing executive compensation issues because all equity-based compensation has a dilutive effect on the ESOP's investment in company stock. These issues are commonly addressed at the time of the stock purchase transaction (and at any time afterward where a change in compensation is made) and include the following items:

- Reviewing post-transaction compensation for sellers and other management employees who were receiving salaries and bonuses before the company stock was sold to the ESOP;
- Setting forth a prescribed bonus arrangement for the executives; and
- Implementing a management incentive plan, and other related items.

Trustees favor management incentive plans that will increase the likelihood the company will meet or exceed the financial projections that were used in determining the price paid for the company. This includes a bonus plan that creates a bonus pool based on a percentage of actual EBITDA (earnings before interest, tax, depreciation, and amortization) that exceeds projected EBITDA from the transaction, as well as performance-based SARs that the board can issue if actual EBITDA equals or exceeds projected EBITDA. Again, ESOP trustees want to grow the value of the company stock investment for the ESOP participants and beneficiaries. It is important that the board consider compensation holistically and that total compensation from all sources (salary, bonus, and equity-based compensation) remain tied to market levels for the role. Put another way, compensation structure should provide reasonable incentives without becoming overly rich.

Reasonable Compensation

The board is responsible for determining the compensation of the CEO and other members of the executive management team. Board members may rely on a compensation committee and/or compensation consultants to assist them in determining appropriate compensation levels. Many ESOP-owned companies create a compensation committee of the board. This committee should be chaired by an independent director, and committee members are required to recuse themselves on the topic of setting their own compensation.

The trustee is responsible for making sure that the company stock value is not negatively affected by excessive compensation levels, and the trustee has a fiduciary duty to take action if it determines that the executive compensation is unreasonable and/or too dilutive. There is a wide variety of actions the trustee could pursue to deal with excessive compensation, such as consulting with the board of directors to express concerns about compensation levels or seeking to change the composition of the board of directors. In an extreme case, the trustee may contact the U.S. Department of Labor, or commence a shareholder derivative suit if the board is not responsive to the shareholders' concerns.

The trustee initially relies on its financial advisor to make an assessment as to the reasonableness of the executive compensation. The benefits offered under the executive compensation arrangements must be analyzed and compared with their dilutive effect on the company stock price to determine whether the compensation arrangements are reasonable and appropriate. It may be prudent for the trustee to engage a compensation consultant if the financial advisor believes the executive compensation is unreasonable and the trustee believes the board has not appropriately supported the compensation level. The NCEO has significant survey data that measures the market rate of equity-based compensation for executives in ESOP companies. This applies not only to ongoing ESOPs but also to cases where an ESOP company is being sold.

The sale proceeds the ESOP receives as a shareholder will be reduced if one or more officers are being paid excessive amounts for post-sale consulting agreements. In one instance, the proposed consulting agreement for the majority individual shareholder was equal to one-third of the value of the company (determined before the consideration of this agreement). The consulting agreement was for five years

(with a substantial death benefit) even though it was discovered that the shareholder had terminal cancer and was not expected to live more than six months after the scheduled closing. The trustees objected, and the sale was not completed. The company was sold a few years later on much better terms.

Boards may want to pay bonuses to the individual shareholders to compensate them for the tax they have to pay on their shares of the income, rather than paying a dividend (which creates a greater outflow of cash), to circumvent the S corporation second-class-of-stock rules when the ESOP does not own all of the shares of a company. However, this would be improper and could endanger the S election. Dividends are paid to all shareholders. The payment of bonuses in this case could be considered as a disguised dividend that does not go to all shareholders. This not only is unfair to the ESOP but also could be treated as creating a second class of common stock that disqualifies the S election.

It is irrelevant whether the trustee is directed or fully discretionary in determining its responsibility to oversee executive compensation. A directed trustee's fiduciary liability is theoretically lessened due to the trustee being directed by another fiduciary, but the ESOP trustee is charged with the ultimate duty of prudence. Therefore, if it would not be prudent for the directed ESOP trustee to follow directions from another fiduciary that it finds violative of ERISA, the ESOP, or not for the exclusive benefit of the ESOP participants and beneficiaries, the law requires that the directed trustee not follow the directions. For this reason, the ESOP trustee cannot blindly follow directions and must conduct its own analysis to determine that the executive compensation being put in place is fair to the ESOP.

Adding Independent Board Members

The first step in the process of adding an independent board member is for the board to determine the qualities and skills desired in the candidates. Do the board want the director to have marketing, finance, banking, business acquisition, technology, or other specific skills? Does the company want the director to be an expert in his or her line of business or industry? Should the candidate be an ESOP expert or at least familiar with ESOP companies? Should the candidate have experience growing companies or taking a company public? I strongly recommend that the board create a list of all characteristics or criteria it wants in candidates and prioritize these characteristics. This will allow the board to have objective measurements for evaluating the best fit of the candidates. All candidates should be excellent fits for the company's culture.

The next step is for the board to determine director compensation. The NCEO's Corporate Governance Survey is an excellent resource for director compensation. It includes compensation based on the size of the company and other factors. The board may consider reviewing the frequency of its meetings, term limits, and other related issues in connection with adding independent directors.

Some boards find it beneficial to create a nomination committee to coordinate the search once the full board agrees on the desired candidate characteristics. A three-member committee seems to be a common size and may include non-board members. This committee would be responsible for identifying candidates, presenting the list of initial candidates to the board, contacting and interviewing candidates, and presenting the list of candidates with evaluations to the full board. It is important for the full board to meet the top candidates. It is also beneficial to present the top candidates to the trustee for its input.

The next step is to create a list of potential candidates who match the characteristics the board determined were the most important. The company's ESOP advisors (such as the trustee, attorney, third-party administrator, and appraiser) and other business advisors (such as the corporate counsel and CPA) are an excellent place to start because they may know people who are excellent candidates. CEOs and directors of other ESOP companies can be another source of candidates. It is also likely that existing board members know business owners, senior executives, consultants, and so on who would be excellent candidates. In addition, the NCEO maintains a list of qualified people who are willing to serve as directors of ESOP companies.

Case Study 1: Independent Fiduciary Review of Proposed Executive Compensation Program

Facts: ABC, Inc. is a majority-owned ESOP company that purchased shares from various family members over the years. The sole remaining family member is the CEO of the company. ABC is in an industry characterized by shrinking margins, technological competition, and a declining customer base. Five years ago, it was forced to freeze executive salaries (including that of the CEO) and eliminate most bonuses. In response to market pressures, however, it successfully refocused its business on the most profitable sectors, eliminated overhead, and added additional businesses. The result of the foregoing steps is that it expects to return to profitability. It has not yet become profitable, however.

The board of directors proposed an executive compensation program for a group of key managers, including the CEO. The ostensible purpose of the program was to restore the bonuses eliminated five years ago. The proposed program was a combination of retention bonuses (60%) and incentive bonuses (40%) based on revenue and net income targets. The incentive component could be settled in shares of ABC at the discretion of the board.

Analysis: The independent fiduciary conferred with counsel and its financial advisor and identified the following concerns about the program:

1. Lack of a cap on the amount of dilution of ESOP shares in the event the incentive component was settled in stock rather than cash
2. Overweighting of retention vs. incentive (the trustee felt that the percentages should be reversed)
3. Lack of independent benchmarks for determination of reasonableness, e.g., engagement of a compensation consultant to provide an independent view of the proposed program
4. Conflicts of interest among board members, two of whom were covered by the program

As a result of these factors, the financial advisor to the independent fiduciary indicated that it was unwilling to issue a fairness opinion that the independent fiduciary required to approve the program.

Result: The plan was not adopted as proposed. A substitute program is under consideration.

Observation: The approval of a significant incentive compensation program must be preceded by a well-thought-out analysis that takes into consideration the potential negative impact on the ESOP.

Case Study 2: Failure to Have Independent Fiduciary Review of Modification of Phantom Stock Program

Facts: In *Chesemore v. Alliance Holdings, Inc.*, 3:09-cv-00413-wmc (W.D. Wisc. July 24, 2012), in an opinion dealing with many fiduciary issues, the court held that where a person was the ESOP trustee and also was in a corporate position to modify his own compensation, amending his phantom stock award to cause it to be paid in cash upon a change in control constituted a violation of the self-dealing rules (ERISA Section 406(a)), which created a prohibited transaction and also created many other fiduciary problems for the fiduciary.

Observation: Having an independent fiduciary with the power to decide the compensation issue could have completely avoided this violation. However, an independent fiduciary may not have made the same decision—which would have benefited not only the other stakeholders, but the fiduciary as well.

About the Authors

Neil Brozen provided ESOP trustee services for two institutional trustees from 2005 to April 2016 and began providing individual trustee services in July 2016. He has been responsible for managing more than 300 ESOP transactions as well as 200 ongoing ESOPs since 2005. Neil serves on the board of the Employee Ownership Expansion Network (EOX) as well as the advisory committee of Employee-Owned S Corporations of America (ESCA). He previously served on the board of the NCEO and the board of governors of the ESOP Association. He is a frequent national speaker on various ESOP issues and has contributed to several NCEO publications. Neil is extremely passionate about employee ownership. He previously worked for the IRS, Arthur Andersen & Co., and several private companies, and had his own management consulting firm.

Alex Perry, ASA, is a director with Ventura ESOP Fiduciary Services, a nationwide provider of independent ESOP trustee services. Before joining Ventura in 2018, he spent eight years providing valuation and financial advisory services for closely held businesses, primarily in connection with ESOPs as well as for financial reporting, gift and estate, and incentive plan purposes. Alex is an Accredited Senior Appraiser in business valuation and is a member of the NCEO, the ESOP Association, and the American Society of Appraisers.