Role of the Employee Stock Ownership Plan trustee

A Q&A with Neil M. Brozen, CPA, Ventura ESOP Fiduciary Services

What is a trustee and what do they do in an ESOP transaction?

As a qualified retirement plan (QRP) an employee stock ownership plan (ESOP) holds the plan assets in a trust for the benefit of the participants. The trustee holds those assets and is the legal owner. The participants are called "beneficial owners".

A company employee may serve as the trustee, but this person is not an independent trustee since they are also a plan participant or employee. The trustee of any QRP is not legally required to be independent, but independence is highly recommended for any ESOP transaction (e.g., purchase of company stock, sale of company stock to a third party, etc.) All trustees, whether internal or independent, are fiduciaries. As a fiduciary, they are required to act solely in the best interests of the participants and their beneficiaries.

How do you define the role of a trustee on a transaction?

In a transaction to purchase company stock, the ESOP trustee acts as the buyer on behalf of the plan participants and the trust. In that purchase the trustee cannot pay more than fair market value for the stock. Fair market value is determined by the trustee's valuation firm. In addition, the terms of the financing must be commercially reasonable, and the transaction must be fair from a financial perspective.

Let's discuss more about the trustee's other duties & responsibilities:

Sale of the company

When a company's board of directors decides to put the company on the market for sale, the trustee is required to review the transaction to make an investment decision to sell only if the value of the offer is greater than the projected share value in the next 3–5 years. The trustee cannot consider future employment when helping to sell a company.

Annual stock valuation

We define an "ongoing trustee" as a trustee who holds the trust year after year for the benefit of the participants. An ongoing ESOP trustee is to determine the fair market value of the shares owned by the ESOP on the last day of the plan year every year it is active. Each year the trustee engages an independent, experienced ESOP valuation firm to prepare a draft valuation report, which the trustee then carefully reviews to determine if the value reported is reasonable for ESOP administration. The resulting updated share price is then sent to the third-party administrator (TPA), who is responsible for preparing participant statements.

Board of Directors

The ESOP trustee must monitor the board of directors. This often includes attending one or more board meetings as a guest or observer to fulfill their duty. The trustee should prepare by reading the board package in advance, then actively participate in the meeting itself. The trustee relies on the board to fulfill its duty to monitor the performance of the management team and company.

On holding ESOP assets

The trustee is the legal owner of the stock and the custodian of trust assets. This means that the stock certificate should be in the name of the trustee, and they possess the certificate, unless it's held as collateral for a stock-acquisition loan. Any bank or investment accounts also need to be in the trustee's name, even if the assets are managed by a third party, often an investment advisor chosen by the company.

On managing money

The trustee is responsible for receiving contributions, dividends and distributions from the company as well as making loan payments if the ESOP borrowed money to purchase the company stock.

On participant accounts

Trustees are responsible for ensuring that participants receive their vested account balance when entitled to receive their distributions. Many trustees rely on a third-party administrator (known as a TPA) or a third-party payer to pay distributions, withhold taxes as required, pay the taxes to the IRS and issue appropriate tax forms to participants and file them with the IRS. The trustee wires funds to the payor of the distributions.

What's the difference between 'independent' and 'internal' trustee?

Approximately 60% of ongoing ESOP trustees are considered internal and are company employees. Many companies are hesitant to engage an independent trustee, feeling that they usually don't know as much about the company as internal trustees, are too costly, or that the Trustee has the right to make business decisions. However, internal trustees have many conflicts of interest, since they are usually members of the management team, on the board, are an ESOP participant, and/or may have an incentive plan that's tied to the annual share price. An internal trustee is usually a trusted insider, but may be influenced by their many roles in the company. An internal trustee is also less experienced in the rules and the roles of being a trustee. The choice of an independent or internal trustee is a balancing act.

The vast majority of ESOP transaction trustees are independent, as the transactions they oversee have significant risk, are usually complex, and are scrutinized by the Department of Labor. It would also be very difficult for an employee or group of employees to negotiate an ESOP purchase transaction because they would likely be negotiating with their boss.

Is there anything else you would like to add regarding the role of the ESOP trustee?

Being an ESOP trustee is complex and challenging. It is also very rewarding as the trustee represents the participants, and the ESOP gives participants real ownership in a company. In an era where other retirement plans are disappearing, ESOPs often provide employees with substantial retirement benefits without having to contribute any cash. I believe deeply in employee ownership.

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