ESOP Participants and Shareholder Rights

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Employee stock ownership plans (ESOPs) are about ownership. Corporate stock ownership through an ESOP is a "mediated" relationship. ESOP participants are intended beneficiaries rather than direct owners. While many companies establish ESOPs to allow participants to feel and act like owners, the ESOP's legal stock share ownership rests with one or more trustees who exercise the rights of ownership, subject to exceptions set forth in the law or in the implementing documents. This chapter describes ESOP participant entitlement to the rights and benefits of corporate stock ownership.

ESOP participant rights are governed primarily by the Employee Retirement Income Security Act of 1974 (ERISA). Corporate shareholder rights are granted under the corporate law of the state of incorporation. This chapter uses Pennsylvania corporate law where state corporate laws apply.

Rights of Stock Ownership

In the United States, most businesses of significant size and scope are owned and operated through corporations. Corporations are legal "persons" that have all of the general powers and legal capacity of a "natural person."[1]

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Corporations issue shares that represent a portion of ownership. The shares are personal property of the shareholder and represent entitlement to a proportional ownership of the corporation, and voting, dividend, conversion, redemption, liquidation, and other rights.[2]

Under Pennsylvania corporate law, shareholders have certain enumerated rights relating to corporate governance, corporate information, and tendering shares. Corporate governance rights consist generally of the right to get notice of shareholder meetings and the right to one vote per share owned in the election or removal of directors of the corporation, in proposed "fundamental changes" to the corporation, and in certain other corporate decisions.

A corporation must hold at least one meeting of shareholders annually.[3] Each shareholder is entitled to five days' notice of any shareholder meeting (ten days for "fundamental changes"). Any notice of a special meeting must specify the general nature of the business to be transacted.[4] Shareholders entitled to cast at least 20% of the votes that all shareholders are entitled to cast may call a special meeting of shareholders at any time as long as they give proper notice.[5]

The bylaws of the corporation operate as regulations for its shareholders, for instance, setting forth the specific time for the annual meeting and general procedures for shareholder meetings. The statute provides certain general rights, including the right of each shareholder to inspect a complete list of those entitled to vote at any meeting of shareholders[6] and the right to designate a proxy to vote on his or her behalf.[7]

Shareholders may elect or remove directors by vote of a majority of shares.[8] They may also vote to adopt, amend, or repeal the bylaws.[9] Shareholders must also approve any "fundamental changes" to the corporation, including amendment of the articles of incorporation, merger or consolidation, share exchanges, disposition of substantially all assets, division, conversion to nonprofit status, or voluntary dissolution.[10]

Corporations must provide each shareholder with an annual financial statement, including a balance sheet and a statement of income and expenses. The statements must be mailed within 120 days of the close of the corporation's fiscal year and must include a report by the accountant, if the accountant prepares the statements, or a statement by the person in charge of the corporation's financial records.[11]

Shareholders in privately held companies who properly dissent from certain corporate actions may demand payment from the corporation for the fair value of their shares.[12] Corporate actions subject to dissent include special treatment of shareholders of the same class, mergers, consolidations, share exchanges, divisions, and conversions.[13]

ESOPs as Shareholders

ESOPs are employee benefit plans and are primarily regulated under ERISA and related sections of the Internal Revenue Code (the "Code"). An ESOP is designed to invest primarily in stock of the employer that sponsors it.[14] The trustee is required to have exclusive authority for managing and controlling plan assets unless plan documents delegate that authority to a "named fiduciary."[15]

ESOPs may acquire stock of the sponsor only if such stock constitutes "employer securities" as defined in the Code. Employer securities are readily tradable common stock, or, if a corporation does not have that, then the securities are common stock that has voting power and dividend rights equal to those of the class of common stock with the greatest such rights.[16] An ESOP may acquire non-callable preferred stock so long as it is convertible at any time to common stock that meets the definition of employer securities and the conversion price is reasonable.[17]

ESOP Special Voting Rights

ESOPs must grant special voting rights to participants with respect to employer securities held by the plan. Participants are permitted to instruct the trustee as to all voting of shares of company stock allocated to the participant's account if the employer-sponsor has a registration-type class of securities (e.g., a class of publicly traded securities).[18] ESOPs in privately held companies must permit each participant to instruct the trustee on how to vote the shares allocated to his or her account when a proposal would merge, consolidate, recapitalize, reclassify, liquidate, dissolve, or sell substantially all assets of the company.[19] An ESOP may grant participants broader voting rights than provided by law. For instance, an ESOP may grant to participants the right to vote for the board

of directors of the company. These additional rights could be granted just on vested shares, although that is not common practice.

Voting of Unallocated Shares

The trustee of the ESOP generally retains the power to vote on behalf of shares held by the ESOP but not yet allocated to participant accounts. Although the issue has been raised primarily in connection with tender offers for ESOP shares, both the courts and the Department of Labor (DOL) have shown hostility toward participant direction of unallocated securities. One court flatly concluded that it would be a breach of the trustee's fiduciary duty to permit participant direction concerning tender of unallocated shares.[20] The DOL has asserted that participants may be considered "named fiduciaries" only for the limited purpose of giving directions to a trustee with regard to tender of stock in their individual accounts. The DOL's position is that tender of unallocated shares is "the exclusive responsibility of the trustee" regardless of plan provisions, and that the decision to tender implies the trustee's general fiduciary duty to determine the prudence of tender.[21]

Directed Voting of Allocated Shares

The courts and regulators have looked more kindly upon participant directions concerning shares allocated to participant accounts. In addition to clear statutory approval for this form of direction (see, e.g., Code Section 409(e)), the DOL has indicated comfort with ESOP participants directing the trustee in certain ESOP decisions.[22] But it has focused on procedural requirements to insure that directions are "proper" and on trustees' ultimate responsibility to take a directed action only if it is consistent with ERISA.[23] In the DOL's view, directions are proper when the participants make independent, uncoerced, and fully informed decisions in the absence of false and misleading information.[24] The DOL's focus on procedural fairness leads it to conclude, however, that if "participant employees are subject to pressure from the employer to vote their shares in a particular manner, it would be the duty of the trustee to ignore any direction given that is the result of such pressure."[25] In the absence of affirmative directions regarding allocated shares, the trustee

must take exclusive responsibility for decisions regarding those shares.[26] An ESOP may permit participants to direct the trustee concerning plan investments and tendering of shares, including buying and selling employer stock, but participants are not automatically entitled to give such direction, except when participants who are 55 years or older diversify their accounts.[27]

Participant direction concerning purchase and sale of employer stock in a privately held company may raise issues concerning compliance with federal and state securities laws.[28] Some companies have dealt with this by having employees vote in a non-binding advisory election.

The trustee does not have an unbridled obligation to follow proper participant directions concerning the voting and tender of employer securities. ERISA requires that a trustee act in accordance with the ESOP document only to the extent that it is consistent with the trustee's other fiduciary duties as set forth in ERISA.[29] The trustee must therefore determine whether participant directions are for the exclusive purposes of providing benefits and defraying reasonable expenses and if they are prudent.[30]

There may be a greater practical hurdle to trustee override of participant directions concerning voting of employer securities (as opposed to tender of employer securities). The decision to tender can be quantified to a significant degree and involves a direct financial judgment. A trustee can expect scrutiny of the decision to tender based upon financial results to participants.

The decision to vote employer securities for or against certain directors, in contrast, is likely not quantifiable. Unless the candidate favored by participants is clearly inappropriate or lacks qualifications, it is extremely difficult for a trustee to determine compulsion to override their directions.

Pass-Through of Incidental Ownership Rights

ERISA is silent as to pass-through of other incidental rights of stock ownership to plan participants. While the ESOP trustee may act as shareholder on behalf of the plan to exercise the rights granted to shareholders under corporate law, including obtaining corporate information and examining corporate records, the trustee has no direct duty to convey

this information to plan participants. The trustee also has no direct duty to convey information received in its capacity as trustee, such as the appraisal report regarding the value of company stock prepared by an independent appraiser. Participants have only the right to the reporting and disclosure set forth in Title I of ERISA regarding plan investments and individual benefits and options under the plan. Participants may obtain additional information held by the trustee "only to the extent that they relate to the provision of benefits or the defrayment of (plan) expenses."[31]

There may be some linkage, however, between the trustee's fiduciary duty, ability to obtain relevant corporate information, and obligation to honor plan participants' voting instructions on pass-through matters specified in Code Section 409(e) or on additional pass-through voting or tender matters set forth in plan documents. For instance, assume that a privately held 51 percent ESOP-owned corporation receives a merger offer from a publicly held corporation. The merger offer, by its terms, would render the ESOP a minority rather than a majority shareholder. At the same time, the merger offer, set forth as an exchange of the ESOP sponsor's stock for that of the company making the offer, appears, based upon current public market prices, to provide the ESOP with public company shares having a value significantly in excess of the current appraised value of the privately held company shares held by the ESOP (either on its face or in the opinion of a financial advisor).

The plan document must provide that participants direct the trustee as to voting of ESOP shares for or against the merger. Participants would undoubtedly deem relevant both current financial information regarding the prospects of the ESOP company and the most recent independent appraisal of ESOP stock. The trustee's fiduciary duty (and vulnerability to third-party legal action) probably dramatically increases if plan participants do not have access to all available information when they tell the trustee how to vote on the merger. This is certainly the position of the DOL.[32]

Could a plan participant successfully sue for information in the above hypothetical situation? A fiduciary must act prudently on behalf of plan participants and for the exclusive purpose of providing benefits and defraying reasonable expenses. How might a fiduciary demonstrate that it is prudent to withhold information from plan participants as they

decide whether to exchange all of the assets held by the plan for essentially a different investment? The answer appears to be that it cannot.

This analysis probably does not extend, however, to incidental rights of ownership unrelated to ESOP participants' exercise of voting rights. For instance, it is hard to argue that, absent specific plan provisions, a trustee should pass through to ESOP participants the right to call a special meeting of shareholders. Indeed, it would be quite difficult for ESOP participants to prove, absent highly unusual circumstances, that a trustee's calling of or failure to call a special meeting of shareholders, by itself, constitutes a breach of fiduciary duty.

Similarly, the dissenter's rights granted by statute to Pennsylvania corporation shareholders probably do not apply to ESOP participants, absent specific plan provisions, even if an ESOP participant instructs the trustee to reject a proposed "fundamental change" to the corporation. For instance, imagine in the earlier hypothetical that an ESOP participant voted against the merger and instructed the trustee to exercise dissenter's rights. That is ultimately a decision to sell the dissenter's shares, which is an investment decision. If, as in most cases, the decision to tender stock is reserved to the trustee, then the ability to exercise dissenter's rights as a mechanism to force redemption of shares is probably also exclusively a decision of the trustee. The trustee, of course, must as part of its fiduciary duty consider whether to exercise dissenter's rights as to some or all of the ESOP's shares, and a disgruntled participant may ultimately litigate whether that duty was properly exercised.

Conclusion

Shareholders have significant rights in a Pennsylvania corporation beyond voting on "fundamental changes" as set forth in Code Section 409(e)(2). The plan fiduciary has the legal duty to exercise these rights on behalf of the ESOP and no direct obligation to pass through these rights to ESOP participants. ESOP participants have no formal right to information about the employer company generally available to corporate shareholders. The trustee may, however, be obligated to provide additional corporate information to ESOP participants to the extent necessary for them to exercise voting rights set forth by statute or in the plan document. The trustee's exercise or failure to exercise incidental

shareholder rights also is part of the fiduciary duty and is subject to review in the same manner as a trustee's performance of other fiduciary duties such as voting and tender.

Notes

1. Pennsylvania Business Corporation Law of 1988, 15 Pa.C.S. §§ 1501-1502 (hereinafter referred to as "PBCL").
2. See, e.g., PBCL § 1521.
3. PBCL § 1755.
4. PBCL § 1704.
5. PBCL § 1755(b)(2).
6. PBCL § 1764.
7. PBCL § 1759.
8. PBCL §§ 1725, 1726.
9. PBCL § 1504
10. PBCL, Chapter 19.
11. PBCL § 1554.
12. PBCL § 1574.
13. PBCL § 1571.
14. Treas. Reg. 54.4975-11(b) ("A plan constitutes an ESOP only if the plan . . . is designed to invest primarily in qualifying securities.")
15. Id.
16. Code § 409(l).
17. Code § 409(l)(3).
18. Code § 409(e)(1).
19. Code § 409(e)(2).
20. *Danaher Corp. v. Chicago Pneumatic Tool Co.*, 633 F. Supp. 1066 (S.D.N.Y. 1986).
21. *DOL Op. Ltr. re: Polaroid Stock Equity Plan*, 1989 Lexis 51; 16 BNA Pension Reporter 390 (Feb. 23, 1989).
22. Id.
23. *DOL Op. Ltr. re: Profit-Sharing Retirement Income Plan for the Employees of Carter Hawley Hale Stores, Inc.,* 1984 Lexis 52 (Apr. 30, 1984).
24. Id. *See also* Secretary of Labor's Amicus Brief in *Harris v. Texas Air Corp.*, Civil Nos. 87-2057, 87-2143, 87-2226 and 87-2266 (D.D.C.) *summarized in* Rizzo et

al., "ESOP Case Law: Fiduciary and Corporate Sponsor Concerns," *Journal of Employee Ownership Law and Finance* 4, no, 2 (spring 1992).

25. DOL Op. Ltr. Apr. 30, 1984.
26. *Reich v. Nationsbank of Ga., N.A.,* 1995 U.S. Dist. LEXIS 5328, 19 Employee Benefits Cas. (BNA) 1345 (N.D. Ga. Mar. 29, 1995).
27. Code § 401(a)(28)(A) (ESOP participants 55 or older with more than 10 years of participation under the ESOP may direct the plan as to investment of 25 percent of his or her account; this percentage increases to 50 percent for participants 60 years or older with 16 or more years of participation under the plan.) Proposed legislation, the Pension Preservation and Savings Expansion Act of 2003, H.R. 1776, would give ESOP participants certain rights to diversify if the plan holds employer securities that are readily tradable on an established securities market.
28. *International Bhd. of Teamsters v. Daniel*, 439 U.S. 551, 99 S. Ct. 790, 58 L. Ed. 2d 808 (1979) (employee interests in employee benefit plans are not securities absent voluntary contributions or voluntary participation).
29. ERISA § 404(a)(1)(D).
30. ERISA § 404(a).
31. *Acosta v. Pacific Enterprises*, 14 Employee Benefits Cas 1991 (9th Cir. 1991).
32. DOL Op. Ltr Apr. 30, 1984; *Harris v. Texas Air Corp.*