

CLIENT ALERT

CORPORATE GOVERNANCE OF ESOP COMPANIES

Written by: Robert W. Edwards & Steven B. Greenapple

Since the passage of the Sarbanes-Oxley Act of 2002, the importance of corporate governance in American companies has become a hot topic in the business press. And even though Sarbanes-Oxley does not apply to private companies, corporate governance is now a common agenda item at ESOP conferences and meetings around the country.

Why are private ESOP companies becoming more interested in corporate governance?

There are three main reasons. First, ESOP companies are beneficially owned by their employees, which means that they tend to have a larger number of “owners” than comparable non-ESOP companies. And, like shareholders in public companies,

ESOP participants have an economic stake in the growth and successful operation of their employer, but are (in most cases) not actively involved in management. So the ESOP participant is in many ways comparable to a shareholder of a public company. Second, the ERISA fiduciary rules that apply to ESOP fiduciaries are process-oriented, and many of the Sarbanes-Oxley standards can readily be adopted by private companies. One way of complying with the procedural prudence requirements that apply to ESOP fiduciaries is to require that the ESOP-owned company establish clear governance proce-

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dures. Finally, a growing body of survey data shows that companies with good governance procedures (whether or not they are ESOP-owned) tend to outperform their competitors.

What are the major areas of governance concern?

Corporate governance issues arise in a variety of situations, but two areas tend to come up repeatedly in ESOP companies. ESOP fiduciaries usually pay close attention to the number of independent directors and the process for their selection. Often the ESOP fiduciary will negotiate for at least a minority of independent directors on the Board, and it is increasingly common for the fiduciary to suggest that a nominating committee or other formalized director selection process be put in place.

The second area of interest is the establishment of a Board committee structure. Stock exchange rules gen-

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erally require public companies to establish independent audit, compensation and nominating committees. In this context “independent” means that a majority of the committee members are not officers or employees of the company, or lawyers, accountants or other paid consultants of the company at the time they are serving on the committee. Our experience has been that an increasing number of ESOP companies, especially larger businesses that experienced an ownership transition before the ESOP was installed, are adopting or seriously considering governance

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changes that establish Board committees under written charters that clearly spell out the committee’s duties and responsibilities. This structure establishes a controlled process that leads to more thorough and transparent decision making. A typical result is a structure that includes at least an audit (and/or finance) committee, a compensation committee, and a governance (or nominating) committee.



What should my company do?

Establishing a sound corporate governance structure should be an important goal of every ESOP fiduciary. There is no single governance structure that can be applied universally to every ESOP-owned company. But there is a clear need for each ESOP-owned company to look closely at its current governance structures and make changes where warranted.

Several of our ESOP clients have asked us to conduct a “governance review” of their companies. A governance review involves analyzing the company’s present by-laws and charter documents to determine whether its stated governance procedures are being followed, and suggesting possible changes in the current structure. The review includes consideration of how the company’s corporate governance structure is (or could be) better integrated with the ESOP governance structure established in the plan documents. Though not required, a governance review is evidence of compliance with the ESOP fiduciary responsi-

bility requirements and can also lead to improvements in the company’s decision making process.

If you have any questions about Corporate Governance contact Rob Edwards at 401-632-0480 or by email at redwards@sfglaw.com or contact Steve Greenapple at 973-540-9292 or by email at sgreenapple@sfglaw.com.

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Want to learn more about Corporate Governance?

Watch a replay of last month’s Client Webcast on Corporate Governance presented by Steve Greenapple. Just visit SES Advisors’ webcast archive at:

www.sesadvisors.com/knowledge/webcasts

Our Next Client Webcast:
August 14, 2007
Mychelle Holloway and Tina Fisher of SES Advisors will present the answers to frequently asked ESOP administration questions.

CONSIDERATIONS FOR CHOOSING VESTING SCHEDULES FOR ESOPs UNDER PENSION PROTECTION ACT 2006

Written by: Diane Fanelli- Senior ESOP Administrator and Principal for SES Advisors, Inc.

The dust has settled since the passage of the Pension Protection Act of 2006 and now qualified plan sponsors are in the process of choosing which vesting schedule, of the two mandated by the law, they will use for their plans. Let's review the two choices: a three-year cliff schedule - 100% vested after three years of service, or a six-year graded schedule- 20% vested after two years and an additional 20% each year up to 100% after six years of vesting service. Generally, the new schedule

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applies to contributions made on behalf of plan years beginning on or after December 31, 2006. The new schedules are only applicable to the accounts of participants who perform services for the company after the effective date.

For ESOPs that had an outstanding acquisition loan as of September 26, 2005, the plan does not have to comply until the plan year following the earlier of the date the acquisition loan is fully repaid or was scheduled to be repaid.

Depending on the circumstances, the vesting schedule may be applicable as early as January 1, 2007. Although you are not required to amend the plan until the last day of the plan year beginning on or after January 1, 2009, sponsors of ESOPs should begin to contemplate the implications of their choice of vesting. When the new rules become applicable, you must choose your schedule and communicate it to employees.

Some considerations for leveraged ESOPs are how to maximize the exemption period for compliance by carefully scheduling loan repayments. For example, let's say you had a loan outstanding on September 26, 2005 scheduled to be fully repaid by December 31, 2015. Your financial goals may be to prepay that loan by 2009. If instead you make cash contributions that are not used for debt service (if permitted) or took a second loan, you could minimize payments on the first loan and extend the deadline for compliance. If you have re-



VESTING SCHEDULES FOR ESOPs UNDER PPA '06

cently repaid a loan in full or intend to accelerate loan payments, let your administrator know.

The savings gleaned from this in many cases are minimal. For example, if you intend to switch from a seven-year to a six-year graded schedule, 20% of an account one year earlier may have little bottom-line impact. However, the stakes are more substantial if you currently use five-year cliff vesting. No matter which of the two new schedules you choose, your repurchase liability can be dramatically stepped up. Also, any participant who has 3 years of service on the date that a new vesting schedule is implemented must be given a choice between the old and the new schedule. PPA allows you to avoid the paperwork of the election by granting the better of the schedules to any person to which the grandfather applies. This effectually results in a 20%, 40%, 60%, 100% schedule after 2, 3, 4 and 5 years respectively to affected participants if you switch from five-year cliff to six-year graded vesting.

Another consideration for ESOP companies is the added administrative cost and communication difficulties with electing to apply the new

vesting only to contributions made after the effective date. At a minimum, the number of recordkeeping data fields doubles! If your plan is relatively new or your employee turnover rates are not unreasonably high, you should consider applying the new schedule to all account balances of those who actively participate after the effective date. It's easier to communicate the change if you apply the new schedule to all account balances: it is good news for participants and it won't impact your plan administration fees.

Each ESOP situation is unique and we encourage you to talk to us about your concerns regarding the vesting under PPA.

To Contact Diane Fanelli call 215-508-1600 or email dfanelli@sesadvisors.com.

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Mark was named partner in Steiker, Fischer, Edwards & Greenapple in January of 2007. He has substantial experience in the areas of U.S. income taxation of corporations and individuals, which he draws upon in structuring corporate transactions and tax-qualified retirement plans.

Mychelle Holloway, Senior ESOP Administrator—
Mychelle has almost ten years experience in ESOP administration and consulting and holds the designations Certified Pension Consultant and Qualified Pension Administrator from the American Society of Pension Professionals and Actuaries (ASPPA).

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