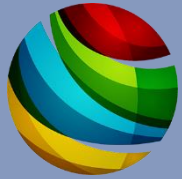


The DOL and ESOPs

Best Practices for a DOL Audit



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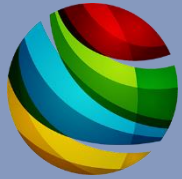
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The Players

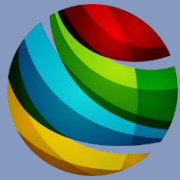
- Department of Labor
 - Broad authority to oversee the welfare of wage earners, job seekers and retirees and assure work-related benefits and rights
- Employee Benefits Security Administration (EBSA)
 - Agency within the DOL that administers and enforces the provisions of ERISA
 - Assure the security of the retirement, health and other workplace related benefits of America's workers and their families



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What does the DOL look for?

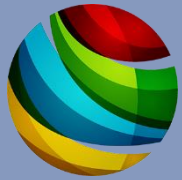
- Breach of Fiduciary Duty
- Exclusive benefit rule (duty of loyalty)
- Prudent Expert Rule
 - “With the care, skill, prudence and diligence . . . that a prudent man acting in a like capacity and familiar with such matters would use”
- Diversification of plan assets
- Compliance with plan documents



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What does the DOL look for?

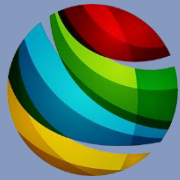
- Prohibited Transactions
 - Certain transactions between the plan and “parties in interest” are prohibited
- Conflicts of Interest
 - Between Plan and Fiduciary



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Am I a Fiduciary?

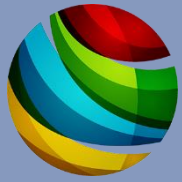
- Fiduciary by definition
 - Persons who, by their title, are defined as fiduciaries of the plan
 - The Plan document specify one or more “named fiduciaries”
- Fiduciary by function
 - Exercises discretionary authority or control over management of plan or plan assets
 - Exercises discretionary authority or responsibilities in administration of plan
 - Renders investment advice



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Not All Acts are Fiduciary Acts

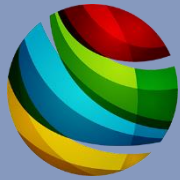
- Persons performing only ministerial duties are fiduciaries if:
 - No discretion to make decisions regarding plan assets or administration and/or
 - Do not in fact exercise discretion regarding plan assets



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Fiduciary Act v. Ministerial Act - Example

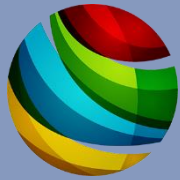
- Fiduciary Acts - Determinations as to:
 - Eligibility
 - Benefits
 - Investments
- Ministerial Acts - Responsibilities as to:
 - Explanation of plan provisions of the plan to others
 - Calculation of benefits according to plan formula
 - Preparation of communications
 - Maintenance of records



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Fiduciary v. Settlor Functions

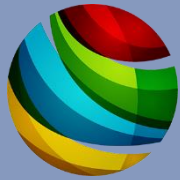
- Certain functions related to the plan are not fiduciary in nature (sometimes referred to as “settlor” functions):
 - Establishing plan
 - Amendment and termination of plan
 - Choosing plan design and
 - Setting employee contribution levels
- Investment decisions are always a fiduciary function
- Administration is only a fiduciary function if there is discretion



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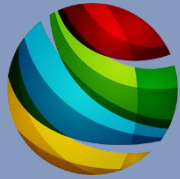
Potential of Breach of Fiduciary Duty

- Imprudent selection of fiduciaries
- Imprudent selection of investment choices
- Failure to monitor those with fiduciary responsibility
- Putting self-interest over participant interests in decision making and voting



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DOL Authority



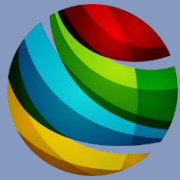
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- Sanctions for Breach of Fiduciary Duty
 - Civil penalties
 - Criminal liability of up to \$100,000 (\$500,000 for company) or 10 years imprisonment for individuals
 - Excise tax for parties in interest of 15%

- DOL has broad authority to investigate
 - Subpoena power

BEST PRACTICES

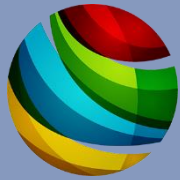
- Meet regularly, keep minutes, and read plan documents (e.g., SPD)
 - Don't forget about investment oversight for any non-stock assets held in plan
- DOCUMENT, DOCUMENT, DOCUMENT!
- Demonstrate prudent process
- Check fiduciary liability insurance policy to make sure it covers all named and functional fiduciaries



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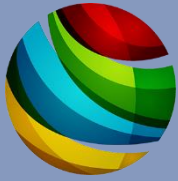
Self-audit and Correction programs

- Review plan document and check against plan operation periodically
 - ESOP loan amortization, definition of compensation used for allocations, distribution timing, etc.
- If a problem is found considering IRS/DOL correction programs



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Valuation of Stock in ESOP



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- Public Company, 👍 easy-peasy

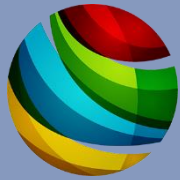
- Private Company, ⚠ watch-out!
 - ERISA 408(e)(2): ESOP not a prohibited transaction if “adequate consideration” is paid
 - 408(b)(17): “the fair market value of the asset as determined in good faith by the trustee or named fiduciary”

Valuation of ESOP Stock: Initial Steps

- Is there going to be a sale of stock either to or from an ESOP?

From a administrator's perspective:

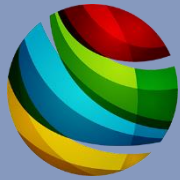
- Valuation advisor hired by...
 - The Trustee (not the Company)
- Provide accurate information to the valuation advisor
- Review information provided for completeness/obvious issues



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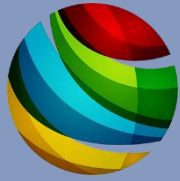
Valuation of ESOP Stock

- Why does this matter for non-trustees?
- Recent DOL Complaint:
 - “The Company and directors had the requisite knowledge, education, and experience to recognize that the Trustee was causing the ESOP to enter into a transaction for more than adequate consideration.”



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Problems in ESOP Valuation: Projections and Data



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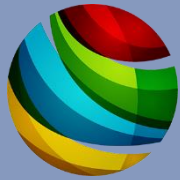
- “High Hopes, With No Backup”

- There will be trouble if valuation:
 - Relies on unreasonable data or projections
 - Does not reconcile conflicting information
 - Does not account for other known (or reasonably known) issues

Best Practices in ESOP Valuation: Projections and Data

- Provide all the data possible to the valuation advisor, including:
 - return on assets
 - return on equity
 - EBIT margins
 - EBITDA margins
 - ratio of capital expenditures to sales
 - revenue growth rate
 - ratio of free cash flows (of the enterprise) to sales

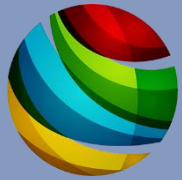
- Review projections and assumptions for obvious mistakes



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Best Practices in ESOP Valuation: Internal Emails

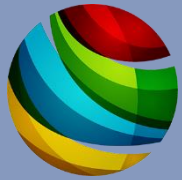
- DOL will push for internal correspondence
- If you try to resist, they will subpoena your emails
- Take away: “Let’s discuss.”



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Problems in ESOP Valuation: Choice of Advisor

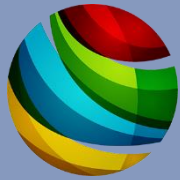
- Cannot rely on an adviser who:
 - Is unqualified
 - Has conflicts of interest



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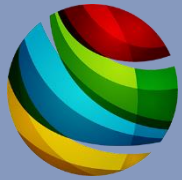
Best Practices in ESOP Valuation: Choice of Advisor

- Cannot hire valuation advisor who has ever performed work for:
 - The plan sponsor;
 - a committee of employees of the ESOP sponsor*
 - The seller (if the ESOP is a buyer), buyer (if the ESOP is a seller) or other counterparty in the transaction;
 - The investment bank or other consultant who is structuring the transaction



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Suggested Response to Enforcement

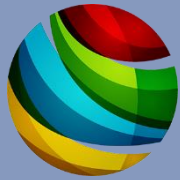


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- Regarding trustee fiduciary responsibility:
 - In valuations, appraisal firm must always be independent and qualified
 - Trustee must do his/her own check of the appraisal once complete
 - Ensure plan operations are factored into the valuation
 - Make sure debt service is manageable
 - Financing terms for seller notes should be reasonable
 - Processes should be documented
 - Valuation approaches and assumptions need to be properly considered and weighted

Other Hot Audit Topics

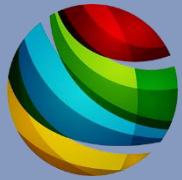
- Proper amortization of the ESOP loan and related share release
- Excessive compensation paid by the company, especially to related parties
- Any related party transactions
- If the plan is a KSOP, how quickly salary deferrals are deposited to the trust



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Why me?

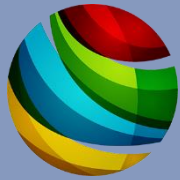
- Potential reasons for being selected
 - Computer targeting (Form 5500)
 - Referrals from IRS
 - News reports
 - Participant complaints



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We have been notified of an audit – now what?

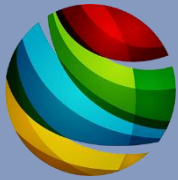
- Employer will typically receive letter notifying them of audit and requesting documents
- Lots of documents . . .
 - Plan document
 - Trust agreement
 - Insurance/annuity contracts
 - Form 5500 and auditor's report
 - Summary Income Statement
 - Benefit statements
 - Payroll reports
 - Agreements with service providers
 - Plan's loan policy
 - And more...



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We have been notified of an audit – now what? (con't)

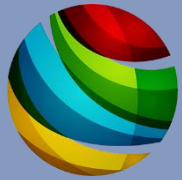
- On site-interviews
- Follow-up questions
- Deadlines to comply with request, typically 2 weeks
- Can request an extension



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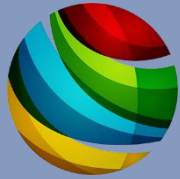
Best Practices for Audit

- Select one individual to be the contact point for the DOL
- Obtain Legal Counsel
- Assemble Documents
- Be timely, complete and organized



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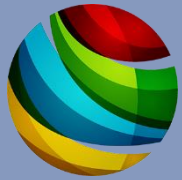
Closing the Audit



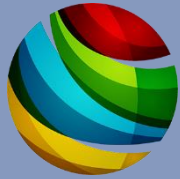
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- Potential approaches for closing audit
 - No-action letter
 - Voluntary Compliance Letter
 - DOL may instead allow discussions before issuing letter
 - If settlement not reached, may result in litigation
 - May be referred to IRS

Questions?



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