ESOP | Report

October 2018 | The Voice of The ESOP Association | *Serving the Entire ESOP Community*

Inside this issue:

New Notions of Ownership

Our shifting views on personal property just might open the door to greater employee ownership.

It was not that long ago that a key appeal of owning personal property—like a car or a house—was a combination of two things: freedom and control.

Owning a car meant you had the freedom to travel wherever the road took you. (And some places where the road didn't even exist.) It also meant a level of control over how and when you traveled, and how you treated the car you used. (By comparison, try painting your rental car metallic umber or replacing the steering wheel with a fuzzy one and see how far you get.)

Owning a home meant greater control over your monthly expenses, since you were no longer at the mercy of a landlord who could jack up your rent. It also meant the freedom in your "castle" to do as you pleased, when you pleased—including keeping strangers out of your home, if you wished.

These benefits of owning personal property, though, run counter to the reality of owning a business—as many employee owners can attest.

Owning a business means you take on responsibility for your product, your customers, your brand—everything. And that responsibility never takes a vacation. That doesn't exactly mesh well with the idea of driving your car off whenever you please, the breeze blowing through your hair, does it?

This disconnect between the ownership of personal property and business property often causes people to stumble when they first learn of employee ownership. They expect employee owners to have the freedom to do what they want, and to control day-to-day aspects of the business. But that is not how most employee owned businesses operate.

As a result, when some people are introduced to employee ownership, their outsized expectations can lead to crushing disappointment. As many in the ESOP community have noted, this disconnect is a fundamental challenge to explaining and expanding employee ownership.

But concepts of ownership are shifting, which may provide a new opportunity to help spread the word on ESOPs and shared capital more easily.

Today, people are far more willing to let strangers drive their cars and live in their homes—for a limited time, and for a fee. The notions of freedom and control are no longer absolute; owners of personal property are now willing to forego both freedom and control. In return, they are tapping the unused capital in their cars and homes.

In short, they are treating their personal property like business property—like something that should provide a return on investment.

There are parallels here to owners who share with employees the capital locked in their businesses. Like those who rent their homes and cars, these business owners are tapping that capital to get tangible returns. Those returns include greater participation from employee owners, who respond by investing more of themselves in the company.

These parallels are not perfect, but they don't need to be. It is enough to note that the longstanding, fundamental, and emotional connections we have regarding ownership are starting to shift, and in ways that may make it easier for a larger audience to grasp the notion of shared capitalism.

Perhaps we are seeing the beginning of a new period, in which it gets just a little easier to have conversations about ESOPs and employee ownership. That would be a great thing—and a great thought for this year's celebration of Employee Ownership Month.

Ownership Advantage

How is Your ESOP Communication Plan Working?

By John Williams, VP Sales & Marketing, Central States Manufacturing

You've got your ESOP communication committee in place. You have all your teaching and training materials prepared. You are ready to spread the word about how great the ESOP is and what it means to the organization and the employees.

But before you start this process it is important to take some steps to ensure your communication is both heard and understood.

This can be a challenge even for mature ESOPs that have had a communications committee in place for years. Everyone may start to take for granted that they know what the ESOP is and how it works. So, it may be time to assess how many of your employees actually know and understand what an ESOP is.

This article will offer tips for dealing with these kinds of situations. First, we will look at how soon you should start communicating. Next, we will look at reoccurring communication for the entire organization.

Recruiting and Hiring

Recruiting. It is never too soon to start showing that, as an employee owned company, you are different. Start by clearly communicating to job applicants that you want candidates who will fit in an ownership culture. You can even list this in the job description, which doesn't have to be limited to technical requirements. Ideally, your description might include language like this: Must be willing to learn, understand, and promote ESOP culture.

If using a recruiter, explain in detail the qualities a candidate should possess to be successful in an ownership culture. Also explain what an ESOP is and how it works.

You also might consider branding your ESOP in all postings or in the summary for your job listing. Statements like "employee owned" and "ownership culture"

ESOP Report

The Voice of The ESOP Association

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communicate quickly your organizational culture to candidates.

Hiring. Creating interview questions tailored to employee ownership competencies can help you and job applicants see right away if they will be a good fit. Along those same lines, consider having applicants meet with the members of your communications committee and some key employees before making a final hiring decision.

Remember: Failure to tell candidates what the ESOP is all about can lead to a bad hiring decision that will need to be dealt with later.

Onboarding

I can't overemphasize the importance of teaching during onboarding. Please don't confuse teaching with showing new hires some PowerPoint slides or handing them a book and then walking away.

Teaching should be a complete cycle. That cycle should include the following:

- Introducing new hires to what an ESOP is and how it operates.
- Showing what the ESOP means to them as individuals.
- Reviewing the roles and responsibilities of leaders and employees in an employee owned company.

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- Showing new hires how their roles affect the ESOP.
- Having them attend ESOP national or regional conferences, or an employee owner retreat.
- Asking new hires to explain to you what the ESOP is.

Teaching involves making sure that new hires have a complete understanding of what an ESOP is and what an employee owned culture looks like. You'll know you have done a good job when they are able to teach the entire cycle to someone else.

Recurring Opportunities

After only one day, people forget up to 80 percent of what they've learned, according to a University of Waterloo study. After a month, they forget 97-98 percent. Other studies show similar results.

To help employee owners retain what you teach them, repetition is vital. Below are ways you can help everyone remember and retain what you are communicating.

Include employee ownership messages in visual communications:

- Use the term "employee owned" in your advertising, including your logo and brand.
- Hang employee ownership banners in your office, break rooms, and on your manufacturing floor.
- Print employee ownership messages on T-shirts, jackets, hats, and business cards.
- Display your dedication to employee ownership on your intranet and your public website.

Reinforce ownership content in your meetings:

- During daily meetings, have employee owners tell the group what they did yesterday that positively affected the value of the company.
- At monthly meetings, review aspects of your ESOP plan, such as vesting, diversification, or how the stock price is determined.
- At annual meetings, review the roles and responsibilities of leaders and employees in an employee owned company.

Celebrate Employee Ownership Month:

- Have week-long celebrations, with a different theme each day.
- Make it fun, but also include an educational component each day.
- Make sure everyone is included. This isn't just an office party.

Celebrations are excellent ways to communicate. These kinds of events also help employees retain more of what they learn.

Summary

Whether your ESOP is brand new or has been around for 30 or more years, nothing is more important than communicating to all of your employee owners about the ESOP and what your employee ownership culture looks and feels like. It is not just the responsibility of the communication committee to do this; it sits squarely on the shoulders of leadership.

It takes effort and constant diligence to do this well. All leaders should ask themselves, "How is my ESOP communication plan working?" Your employees will be able to answer that question for you.

Calendar of Deadlines and Important Dates

Oct. 1-31	Employee Ownership Month
Nov. 8-9	Las Vegas Conference & Trade Show
Nov. 11-14	Leading in an Ownership Setting: The Program for CEOs, Session II
Feb. 1	Deadline for Entering AACE and Employee Ownership Month Poster
Feb. 8	ESOP Professionals' Forum
May 22	ESOP Association Annual Awards Banquet
May 23-24	Annual Conference

To see all national and chapter meetings, visit us online at: www.esopassociation.org.

The Washington Report

You Have the Power to Change Washington

By J. Michael Keeling, ESOP Association President

When I visit one of our 18 chapters (which draw more people each year), the majority of people I meet don't know who I am. So when I sit in the audience, someone at my table often will ask where I live. When I answer, "Washington, D.C.," I typically get a look or a verbal response that says, "Oh that must be awful."

That kind of response says a lot about how people view the seat of our national government—namely, that it is full of no-good politicians and sleazy behavior.

This view of our nation's capital and its inhabitants—particularly those who serve in Congress and who work for the Federal government, which is the largest employer in the world—may have led some members of the ESOP community to become complacent. "Forget about the elections," they say. "Who cares who wins? Nothing will change anyway."

> *Those who are most fed up with Congress... should care most about our upcoming elections.*

I would argue that those who are most fed up with the Congress and who take the dimmest view of the inhabitants of our nation's capital are the very people who should care *most* about our upcoming elections.

We all have a part to play in making this country better, stronger, and more just.

If you don't like Washington, guess what? You have the power to change it. And all you have to do is get involved.

What does this little sermon have to do with ESOPs?

Well, everything. If you love your ESOP, your ESOP account, the company you own, and the spirit of shared ownership, you had better be ready to defend it at the ballot box.

As I have said time and again at chapter meetings and at companies I visit, ESOPs did not fall from the sky.

ESOPs were created by the Congress and signed into law by the President. They are regulated primarily by the Internal Revenue Service and the Department of Labor's Employee Benefits Security Administration.

And any of those entities can make ESOPs impractical or nonexistent tomorrow.

Congress can vote to kill ESOPs. The regulatory agencies, unless stopped by Congress, can make life so miserable for the ESOP community that the number of ESOPs companies withers away to nothing.

Bottom line, if you care about your ESOP, even if you think Congress and Washington, D.C. is a rat hole, the best thing you can do is vote.

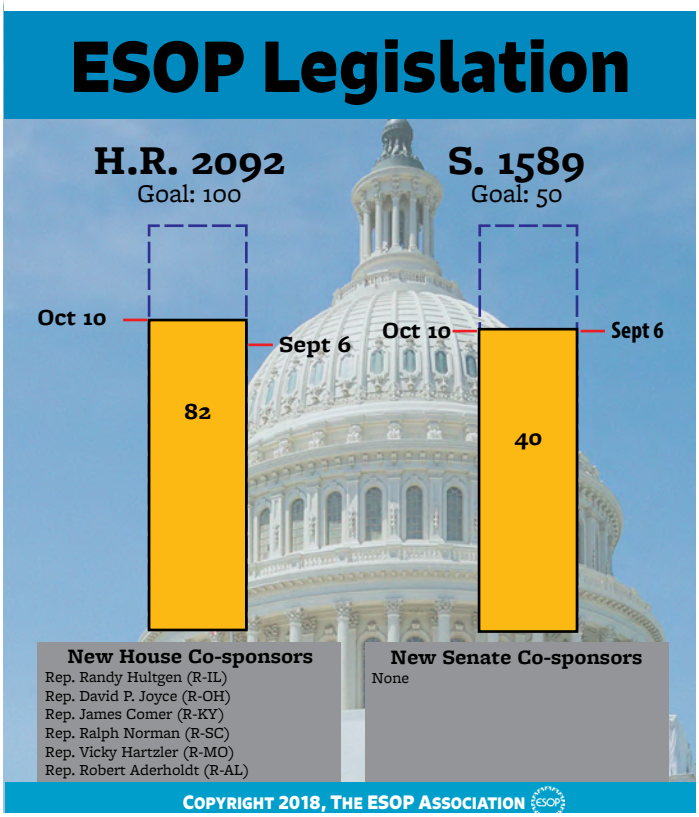
And this plea is especially important for this 2018 election. Why?

More than any time in recent memory, a large number of ESOP supporters in Congress may not be coming back. Some are facing stiff re-election challenges that may end their Congressional careers. Some are retiring. Others are running for political offices outside of Congress, such as the governorship.

Any who leave likely will be replaced by elected officials who have no prior experience with shared capital or employee ownership.

In short, there is a very strong possibility that 50 to 60 of our current ESOP supporters in the House will not be in Congress come January 1, 2019.

The worst-case scenario: Nearly half of the ESOP supporters serving on key Congressional committees—the tax and labor committees that have jurisdiction over the tax laws and ERISA—might not return to Capitol Hill in 2019.



The ESOP Association has never urged its members to vote for one political party or the other. If an ESOP advocate is running for re-election in your district and you don't care for that candidate, The ESOP Association will not urge you to vote for that person.

If, however, you do care for a candidate who supports ESOPs, please consider that even more incentive to vote for that candidate. (And perhaps take any additional steps you feel comfortable taking to help that candidate secure elected office.)

If you want to vote for a new person running for Congress, consider contacting that person—through the campaign office, a town hall meeting, or some other mechanism—and express how much your ESOP means to you and your fellow employee owners.

Finally, consider doing the same at the state level. Educate candidates for local and state offices about the benefits of ESOPs, and how they help you, your company, your community, and our nation.

Many of the women and men who serve in local and state offices move on to serve in Congress, so getting them to support ESOPs early on is always a good move.

In sum, be negative about your elected officials, if you like. If you choose, feel bad for me that I live in DC and have done so for 46 years. But do not walk away from voting. Decide what you believe in and what you want to see as national policy, and take action to protect and expand employee ownership through ESOPs.

In Appreciation

ESOP Community Mourns Loss of Robert Strickland

Robert Louis Strickland, the ESOP Association's Chair from 1983-1985, passed away September 21, at his home in Winston-Salem, N.C. As Chair, he was instrumental in relocating The Association from California to Washington, D.C., and in influencing The Association's first by-laws.

His commitment to broad-based ownership led to the establishment of the Lowe's ESOP after passage of ERISA. He was a key spokesperson for ESOPs before Congress in the 1980's, at a time when few in Congress knew or cared about employee stock ownership. A former member of the North Carolina state legislature, he was also a major figure in guiding North Carolina's university system, especially UNC, Chapel Hill.

When told of Strickland's passing, ESOP Association President J. Michael Keeling said, "Bob played a vital role in making The ESOP Association and employee stock ownership what it is today. We will always be grateful for his service to our community and our nation."

Representatives Ask White House to Curb Unfair ESOP Enforcement

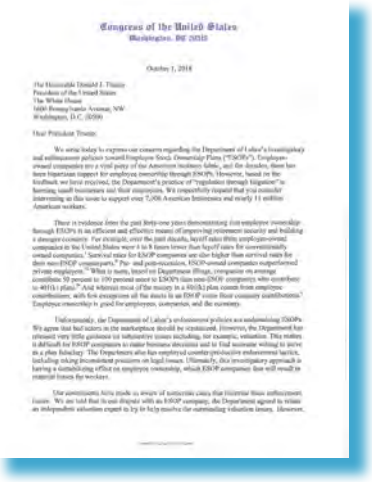
Letter Cites Aggressive Practices, Asks for Clear Guidance

President Donald Trump this week received a letter from 27 influential members of the House of Representatives, urging him to rein in overzealous and unfair enforcement of regulations that apply to ESOP companies.

The letter offers powerful support for ESOP companies, at a time when that support is sorely needed.

The Employee Benefits Security Administration (EBSA), a division of the Department of Labor, has a well- documented history of pursuing litigation against ESOP companies, while refusing to issue regulations that would offer those same ESOP companies a clear path to compliance.

The letter addresses this issue in its opening paragraph, stating that "the Department's practice of 'regulation through litigation' is harming small businesses and their employees."


Congress of the United States
Washington, DC 20510

October 1, 2018

The Honorable Donald J. Trump
President of the United States
The White House
1600 Pennsylvania Avenue, NW
Washington, D.C. 20500

Dear President Trump:

We write today to express our concern regarding the Department of Labor's investigatory and enforcement policies toward Employee Stock Ownership Plans ("ESOPs"). Employee-owned companies are a vital part of the American business table, and for decades, there has been bipartisan support for employee ownership through ESOPs. However, based on the feedback we have received, the Department's practice of "regulation through litigation" is harming small businesses and their employees. We respectfully request that you consider intervening at this time to support over 7,000 American businesses and nearly 11 million American workers.

There is evidence from the past forty-one years demonstrating that employee ownership through ESOPs is an efficient and effective means of improving retirement security and building a stronger economy. For example, over the past decade, tariff rates (this employee-owned companies in the United States were 4 to 8 times lower than tariff rates for conventionally owned companies.[1] Survival rates for ESOP companies are also higher than survival rates for their non-ESOP counterparts.[2] Pre- and post-recession, ESOP-owned companies outperformed private employers.[3] When it mattered, based on Department filings, companies on average contribute 50 percent to 100 percent more to ESOPs than non-ESOP companies who contribute to 401(k) plans.[4] And whereas most of the money in a 401(k) plan comes from employee contributions, with few exceptions all the funds in an ESOP come from company contributions.[5] Employee ownership is good for employees, companies, and the economy.

Unfortunately, the Department of Labor's enforcement policies are undermining ESOPs. We agree that bad actors in the marketplace should be scrutinized. However, the Department has released very little guidance on substantive issues including, for example, valuation. This makes it difficult for ESOP companies to make business decisions and to find accurate willing to serve as a plan fiduciary. The Department also has employed counter-productive enforcement tactics, including taking inconsistent positions on legal issues. Ultimately, this investigatory approach is having a chilling effect on employee ownership, which ESOP companies that will result in material harm to workers.

Our assessments have made us aware of numerous cases that illustrate these enforcement issues. We are told that in one dispute with an ESOP company, the Department agreed to retain an independent valuation expert to try to help resolve the outstanding valuation issues. However,

The representatives add that the Labor Department has used "counter-productive enforcement tactics, including taking inconsistent legal positions," and that the Department's actions could threaten "the system Congress carefully crafted to encourage employee ownership."

In addition to litigation, the letter notes, the department uses high-pressure tactics—such as prolonged investigations and the threat of legal action—against ESOP companies. One

investigation went on so long that a company had difficulty securing financing for three years running. In another case, a small business was told terminate its ESOP or risk being sued by the department.

In another case, the department retained an independent valuation expert—then disregarded his findings and sued the company anyway.

Although the Labor Department —and EBSA specifically—are tasked with protecting the value of employees' retirement savings, the department's "policies are putting workers' savings at risk as the excessive cost of responding to the department ultimately reduce the value of ESOP companies," the House members wrote.

The letter ends with a request for the department to collaborate "with the ESOP community to develop clear guidance with respect to valuation and other important issues."

The document is an important milestone in the battle to protect ESOP companies form unfair regulatory practices. The 27 representatives who signed the letter have significant influence and include one third of the members of the House Committee that oversees the Department of Labor.

Copies of the letter were sent to the Secretary of Labor, the Assistant Secretary of Labor in charge of EBSA, and the Solicitor of Labor.

Advisory Committee on Administration

Handling Compliance Testing Failures

By: Lori Stuart, QPA, Crowe LLP
Reviewed by: Barbara Clough, QPA, QKA Director, Newport Group

All qualified retirement plans, including ESOPs, must be operated in compliance with the plan document, ERISA, and the rules related to qualified retirement plans in the Internal Revenue Code (IRC). There are certain tests plans must satisfy at least annually. Some tests may only be necessary based on the plan design. It is important that your plan stay in compliance and that testing failures are corrected timely, in the proper manner, and if, necessary, coordinated with other compliance tests.

Here is a list of compliance tests typically performed every plan year for qualified retirement plans:

- Maximum Contribution Deduction Limits Test—Code Section 404(a)—determines that company contributions are deductible.
- Minimum Coverage Test—Code Section 410(b)—ensures that a minimum percentage of non-highly compensated participants are benefiting from contribution and forfeiture allocations.
- Annual Additions Limits Test—Code Section 415.
- Top Heavy Test—Code Section 416.
- S-Corp Anti-Abuse Test—Code Section 409(p) —applicable only to S Corporation ESOPs.

- Actual Deferral Percentage Test (ADP)—Code Section 401(k)—applicable to salary deferral contributions.
- Actual Contribution Percentage Test (ACP)—Code Section 401(m)—applicable to matching and employee after-tax contributions.

Other tests that may be needed, depending on plan design and operation, include the following:

- Fair Market Value Test—Code Section 4975(f)(7)—applicable if dividends or S-Corp distributions on shares allocated are used to fund loan payments.
- General Nondiscrimination Test—Code Section 401(a)(4)—if a non-safe harbor allocation formula is used.
- Compensation Test—Code Section 414(s)—if the plan uses a non-safe harbor definition of wages for allocation purposes, such as exclusion of bonus or commission.

Timing of Corrections

Most often, the correction of a testing failure is part of the annual allocation process. Your record keeper will determine the proper method based on the plan document and Employee Plans Compliance Resolution System (EPCRS), which is described in greater detail below.

Some testing failures may require a return of contributions (such as salary deferrals) to a participant by a certain deadline. If the return is not made by the deadline, the plan sponsor may incur penalties or may need to take other corrective actions.

If there is an excise tax or penalty associated with a testing failure, there are deadlines for filing the appropriate return and payment of the penalty. For example, if contributions exceed the maximum contribution deduction limit, a Form 5330 must be filed with the IRS to report the 10 percent excise tax penalty no later than the last day of the seventh month after the end of the company's tax year. This due date can be extended, provided the proper extension is filed before the initial due date.

Correction Method

There are prescribed methods for correcting testing failures. The IRS offers correction programs under the EPCRS. Revenue Procedure 2016-51 outlines the programs available.

EPCRS includes correction measures for compliance testing failures. Your plan document also should include how failed tests are corrected, as there may be more than one option available to correct the failure.

If you have a choice on the correction method, you need to understand the options and how they impact the company and participants.

If your plan document addresses how a testing failure is corrected, you need to follow the plan document even if another option is available. For example, let's say the allocation of the employer contribution in your ESOP fails minimum coverage testing using the ratio percentage test. Your plan document includes a provision that if this test is failed, you must make additional contributions to certain participants who were excluded from the initial allocation until the test is met.

There is another testing method for minimum coverage, the Average Benefits Test. Even if the plan would meet the requirements using the Average Benefits Test, it cannot be used if the plan document specifies the correction method to make additional contributions to otherwise excluded participants due to a failed ratio percentage test.

> *Some testing failures may require a return of contributions (such as salary deferrals) to a participant by a certain deadline.*

Salary deferrals (including Roth 401(k) contributions), employer contributions, and reallocated forfeitures for any individual participant in a limitation year (typically a plan year) cannot exceed certain limits. Your ESOP may include a prevention method to avoid excess annual additions. The prevention method will limit the employer contributions to the individuals who exceed the limit and reallocate the excess amounts to other participants who do not exceed the limit.

If your plan includes a prevention method, it is first followed before any correction method. A prevention method will reduce employer contribution allocations. Some companies would rather correct excess annual additions and return salary deferrals to a participant (their own money) before reducing an employer provided benefit.

Keep in mind that salary deferrals returned to a participant are taxable. And, if salary deferrals are matched, the matching contribution attributable to returned deferrals must be forfeited. Overall, the total return/forfeiture from deferrals and matching contributions should be equal to the total excess annual addition.

Testing Coordination

The tests for maximum contribution limits, annual additions limits and top heavy status are combined plan tests. This means you must combine the data from all your qualified defined contribution retirement plans together when performing the tests.

If a test is failed, the correction of the failure must be coordinated between the plans. In addition, the correction may impact the data used in the performance of another test.

If excess annual additions are corrected by returning deferrals and forfeiting employer matching contributions from the 401(k) plan, that will have an impact on ADP and ACP testing. Deferrals returned or re-characterized as catch-up contributions to correct the annual additions limit failure

are not included when performing the ADP test, and any employer matching contributions forfeited are not included in the ACP test.

Many times, the final annual additions limits test is not completed until well after the ADP test has been performed. If your 401(k) plan has a history of failing the ADP test, you may want to wait until the annual additions test is completed before finalizing the ADP test.

Most of the time, it is the highly-compensated employees who will have excess annual additions. Reducing the deferrals in the ADP test for highly compensated employees may decrease or eliminate ADP testing failures. Note that deferrals returned to a participant to correct an ADP testing failure are still considered in the annual additions test.

> *If you do sponsor both an ESOP and 401(k), testing coordination can get tricky if the plans have different plan and limitation years.*

If you do sponsor both an ESOP and 401(k), testing coordination can get tricky if the plans have different plan and limitation years.

Let's say the 401(k) plan year and limitation year (for testing annual additions) ends December 31. Your ESOP plan year and limitation year ends June 30. Which year do you use to test annual additions limits?

You test both years. For the 401(k) year ending December 31, 2018, you will test all annual additions in the 401(k) plan from January 1, 2018 to December 31, 2018, and all annual additions in the ESOP for the plan year ending June 30, 2018. For the ESOP year ending June 30, 2018, you will test the ESOP annual addition for that year along with the 401(k) annual additions for the period July 1, 2017 to June 30, 2018.

If a participant has an excess annual addition in either limitation year ending June 30, 2018 and the prevention method is used, the allocations for the ESOP year ending June 30, 2018 cannot be finalized until the test is performed for the 401(k) limitation year. If excess annual additions are corrected via returning contributions, there will need to be coordination between the limitation years if there is one participant with excess annual additions in both limitation years.

Compliance testing is a crucial part of the annual administration process and it can be complicated. The Plan Administrator (as defined by each plan) needs to ensure that all the necessary tests are performed, corrections are made, and—if applicable—excise tax returns are prepared for filing. Service agreements should list the tests to be performed.

The Plan Administrator determines who will complete excise returns. Your record keeper will assist you in performing the annual compliance tests and determining the corrections necessary.

Buying A Little Peace of Mind

Why ESOP Companies Should Consider D&O Insurance.

Ever since The ESOP Association's endorsed fiduciary affinity insurance program was launched almost 30 years ago, the need for ESOP companies to consider Director's and Officer's (D&O) Liability insurance in addition to fiduciary insurance has been evident.

Fiduciary liability insurance protects ESOPs and their trustees in claims and suits brought under ERISA for breach of their fiduciary duty. These claims may be brought by plan participants or the Department of Labor, for example.

D&O insurance covers the directors and officers and the corporation for claims brought by various sources, including shareholders. Since most, if not all, D&O policies have an ERISA exclusion, it is important to obtain separate fiduciary insurance.

Over the years, we have seen claims and suits against ESOP companies that allege breach of ERISA fiduciary duty (a fiduciary insurance claim) and allege misconduct by the directors and officers (a D&O insurance claim).

We recently saw a claim in state court brought by plan participants and alleging misconduct in managing an Ohio company. In an effort to get the case to a more favorable venue, the ESOP company attempted to remove the case from state to federal court, arguing the claims were governed by ERISA. However, the state court reaffirmed an earlier Sixth Circuit case that ERISA does not preempt state law involving shareholder derivative action and therefore suits brought by the ESOP plan participants (against directors and officers) are to be treated as company shareholders.

Properly written D&O insurance can provide coverage for derivative suits by shareholders, whether in an ESOP or not. It is therefore important that ESOP companies purchase both fiduciary and D&O insurance, and purchase these two coverage forms from the same insurer.

The minimum premium for a $1,000,000 shared limit for D&O and Fiduciary starts at $5,000.

For more information on either fiduciary or D&O insurance, please contact Jeffrey Gelburd, Vice President of Program Solutions at Murray Securus via e-mail at gelburd@murrayins.com or by phone at (717) 620.2476.

Employee Ownership Month Recognized

Four States Issue Proclamations. Is the Federal Government Next?

Indiana is the latest state to proclaim October as Employee Ownership Month. The proclamation was issued by Governor Eric J. Holcomb. Recently, the governors of Vermont, Iowa, and Nebraska also formally proclaimed October as Employee Ownership Month.

These are tremendous honors and show that elected officials at the highest levels are growing increasingly aware of the value that ESOP companies can offer to employees, businesses, and communities.

STATE OF INDIANA
EXECUTIVE DEPARTMENT
INDIANAPOLIS

Executive Order PROCLAMATION

TO ALL TO WHOM THESE PRESENTS MAY COME, GREETINGS:

WHEREAS, employee ownership is instrumental in helping Americans share in our nation's growth and prosperity by enabling citizens to accumulate wealth in the businesses where they are employed; and

WHEREAS, Employee Stock Ownership Plans (ESOPS), exist in approximately 7,000 companies in the United States, employing more than 14 million working men and women, holding assets of nearly $1.3 trillion; and

WHEREAS, studies have established that ESOP businesses are more profitable and productive, last longer in the marketplace and lay off fewer workers during downturns; and

WHEREAS, the sale of businesses to the employees offers fair compensation to retiring business owners, while also rooting companies in Indiana and providing their employee-owners with the opportunity to earn a secure and prosperous retirement; and

WHEREAS, Indiana has approximately 180 ESOP companies that provide retirement benefits for over 130,000 Hoosiers;

NOW, THEREFORE, I, Eric J. Holcomb, Governor of the State of Indiana, do hereby proclaim October 2018 as

EMPLOYEE OWNERSHIP MONTH

in the State of Indiana, and invite all citizens to duly note this occasion.

In Testimony Whereof, I have set my hand and caused to be affixed the Great Seal of State. Given at the City of Indianapolis, this 17th day of September the year of our Lord 2018 and of the Independence of the United States 242.

BY THE GOVERNOR: Eric Holcomb

The recognition of ESOPs also is evident at the national level. Sen. Tammy Baldwin has submitted Senate Resolution 665, which would designate October 2018 as National Employee Ownership Month. The resolution reads:

- Whereas employee-owned companies give workers a voice in corporate governance, and that voice helps the long-term well-being of the company;
- Whereas employee-owned companies often outperform non-employee-owned companies and show greater resiliency during challenging economic conditions;
- Whereas employee-owned companies face lower staff turnover, and workers experience greater job security at those companies;
- Whereas employee-owners feel better prepared to cover the expenses of life and retire with a greater sense of financial security; and
- Whereas employee-owned companies have a rich history in communities across the United States:

Now, therefore, be it resolved, that the Senate—

- (1) Designates October 2018 as "National Employee Ownership Month";
- (2) Supports employee-owned businesses; and
- (3) Acknowledges that employee-owned companies have a positive impact on workers, businesses, and communities.

At press time, the resolution had 14 co-sponsors: Sen. Pat Roberts (R-KS), Sen. Margaret Wood Hassan, (D-NH), Sen. Ben Cardin (D-MD), Sen. Chris Van Hollen, (D-MD), Sen. Jack Reed (D-RI), Sen. Sherrod Brown ([D-OH), Sen. Angus King, (I-ME), Sen. Patty Murray (D-WA), Sen. Amy Klobuchar (D-MN), Sen. Jeanne Shaheen (D-NH), Sen. Tammy Duckworth (D-IL), Sen. Todd Young (R-IN), Sen. Bernie Sanders(I-VT), and Sen. Roy Blunt (R-MO).

Foundation News

Foundation Trustees Are Honored for Meeting Fundraising Goals

For the Employee Ownership Foundation to meet its goal of expanding employee ownership, it needs reliable sources of ongoing financial support. The organization's trustees are vital in this regard and are asked to raise $5,000 each year to help support the Foundation's initiatives.

We honor the following trustees for reaching—and exceeding—their fundraising targets:

- J. Randall Bishop, J. Randall Bishop Consulting Services, Mt. Pleasant, SC.
- Carey Chen, Harrison, OH.
- Spencer Coates, Houchens Industries, Inc., Bowling Green, KY.
- Robert Schatz, ESOP Plus: Schatz Brown Glassman LLP, West Hartford, CT.
- Ron Cogan, Entertainment Partners, Burbank, CA.
- Andrew Todhunter, Kapco Global, Brea, CA.
- Hugh Reynolds III, Crowe Horwath LLP, Ft. Lauderdale, FL.
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Legal Update

Amicus Briefs Filed by American Society of Appraisers and the DOL

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In the case of *Brundle v. Wilmington Trust*, N.A., No. 15-cv-1494 (U.S. District Court for the Eastern District of Virginia), a federal District Court, following a bench trail that lasted six days, ruled against the defendant ESOP trustee and in favor of the plaintiff, a former employee of Constellis Group, Inc. and former participant in its ESOP. The court agreed with the plaintiff that the trustee engaged in a prohibited transaction under ERISA and approved the sale of Constellis stock to the ESOP for $29 million more than adequate consideration.

In the transaction at issue, the ESOP purchased 90 percent of the company's outstanding common stock from shareholders who either were founders or initial investors in the company. The sellers then converted their remaining 10 percent of common stock into warrants, resulting in the ESOP owning 100 percent of the common stock.

The court found that the trustee did not engage in a prudent process in evaluating the transaction. Although the trustee engaged an independent valuation advisor to appraise the value of the stock and render a fairness opinion, the court concluded that the trustee did not adequately "probe the assumptions and conclusions of the valuation," including the appraiser's decision to apply a 10 percent control premium to the guideline public company (GPC) method.

The trustee has appealed the District Court's decision to the Fourth Circuit Court of Appeals, and both the trustee and the plaintiff have submitted briefs in favor of their positions on appeal.

Individuals or organizations who are not parties to lawsuits but who have a strong interest in the lawsuit's outcome can file an *amicus curiae* (which is Latin for "friend of the court") brief. *Amicus* briefs can supplement the parties' briefs, highlight policy implications of the court's decision, and provide technical assistance or additional perspectives.

The American Society of Appraisers (ASA) and the Department of Labor (DOL) each recently filed an *amicus* brief highlighting the key fiduciary standard and valuation-related issues.

The ASA Brief

The ASA is a non-profit, professional organization that teaches, tests, and credentials business appraisers. It has a strong interest in ensuring that courts understand the need for qualified appraisers and their role in providing valuations required by law.

The ASA's brief focused on the serious policy implications the court's decision could have for ESOP appraisers and ESOP trustees.

The ASA's *amicus* brief points out flaws in the District Court's underlying reasoning and analysis. The brief highlights the clear-cut law that ESOP fiduciaries may use an independent appraiser's guidance as evidence of a good faith investigation into the stock's fair market value.

The ASA demonstrates the error in the District Court's opinion that the trustee should have probed specific "issues" identified by the plaintiff's expert with the benefit of hindsight. This creates a new fiduciary standard for ESOP trustees—one that is exceedingly difficult to meet and is inconsistent with previous case law, the DOL's proposed regulation, and recognized appraisal standards.

An ESOP appraiser's analysis requires a "point-in-time" judgment of the company's future financial performance based on current information, rather than an after-the-fact review.

Further, in previous cases in which courts found that the trustee was not reasonably justified in relying on the appraiser's valuation, there were "glaring defects" in the trustee's fiduciary process and in its oversight of the appraiser. (For example, those cases included concerns regarding the appraiser's independence or qualification, or the trustee's failure to provide the appraiser with accurate and current information.) That was not the situation in this case.

The ASA explains that it was reasonable for the trustee to rely on the appraisal in this case because the appraiser for the Constellis transaction was an independent, qualified ESOP appraiser. Its valuation for the Constellis transaction was prepared after a diligent process in which the appraiser took steps to verify and understand management's projections and gather information about Constellis's past financial performance.

The concern is that this case will create an untenable precedent. What will happen if thorough appraisals based on recognized appraisal standards can be undermined by "experts" in litigation who point to valuation "flaws" after the fact? Every appraiser and fiduciary will be exposed to potential litigation.

The ASA's brief also explains why the Constellis appraiser's original valuation was in line with appraisal

industry standards in its treatment of control and use of management projections.

According to recognized appraisal standards, a control premium is warranted when the buyer is obtaining a bundle of rights that minority shareholders cannot enjoy.

> *What will happen if thorough appraisals based on recognized appraisal standards can be undermined by "experts" in litigation who point to valuation "flaws" after the fact? Every appraiser and fiduciary will be exposed to potential litigation.*

That bundle can include many rights—including the ability to control the Board of Directors, the ability to reject unilaterally the company's sale, the power to limit management compensation, and the power to veto certain actions by the board.

The ESOP need not obtain all of these rights for a control premium to be acceptable. Indeed, the Constellis ESOP trustee was able to negotiate favorable terms for the ESOP upon Constellis's sale due to its controlling stake.

It is industry standard to conduct an appraisal using projections prepared by management. The Constellis appraiser asked questions of management to understand how the projections were built and how Constellis typically performed in comparison to its past budgets. This process was in line with recognized appraisal standards.

The Department of Labor's Brief

The DOL's *amicus* brief argues that a "stringent" standard of care should be imposed on ERISA fiduciaries, holding them to an "exacting" prudent man standard that places a heavy burden of proof on fiduciaries.

It is the DOL's position that an ESOP trustee may not blindly rely on an appraiser's work, rather, the trustee must scrupulously investigate the valuation and look "in the weeds" at all aspects of the deal.

The DOL's brief also argues that a control premium is not warranted unless the ESOP gains control of the Board of Directors, and therefore has "control in fact." It is the DOL's position that the mere fact that an ESOP owns 100 percent of the shares does not alone justify a control premium. Rather, according to the DOL, the ESOP must enjoy the rights accorded to a majority shareholder.

Conclusion

As the ASA and DOL amicus briefs highlight, the Fourth Circuit's decision will have lasting policy implications for ESOP transaction appraisals and the fiduciary standards for ESOP trustees. The ESOP community anxiously awaits the Court of Appeals decision.

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