



Red Flags – How Can You Tell if You Need to Reevaluate Your Service Providers?

Presented by:

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Types of Service Providers

- Trustee
- Independent Valuation Expert
- Financial Advisor
- Lending Institution
- Accounting Professional
- Corporate Counsel
- ERISA Attorney
- ESOP Administrator
- Communications/Culture/Leadership Advisor
- Repurchase Obligation Assessor
- Benefits Advisor

Who is a Fiduciary?

- Who is a fiduciary under ERISA?
 - A person or entity that exercises discretion respecting management or disposition of a Plan's assets
 - Renders investment advice for a fee; or
 - Has discretionary authority with regard to the administration of the Plan
- Significant fiduciary issues involving ESOP's
 - Department of Labor (DOL) focus
 - Valuations and appraisals

DOL Challenges

- Overvaluation issues raised by DOL
 - Discounted cash flow
 - Comparables
 - Control premiums
 - Discount for lack of marketability
- DOL proposed adequate consideration regulations
 - Requires appraiser independence
 - Requires consideration of lack of marketability
 - Requires a reasonable basis for a control premium

ERISA Fiduciary Liability

- DOL Target Issues
 - Treating selling shareholder as fiduciary if he “influences” trustee or appraiser
 - Independence of ESOP fiduciaries
 - Diligence in ESOP valuation process with adequate documentation reflecting fully supportable fair market value
- ERISA Fiduciary Liability
 - Fiduciaries Personally liable for all losses suffered by the Plan
 - All forms of equitable relief available to DOL

ERISA Fiduciary Liability

- Disgorgement of Profits
 - Removal of Fiduciaries
 - 502(1) ERISA 20% Penalty
- Private Party Civil Actions
 - Typically Class Actions
 - Issues Commonly Raised in Private Actions
 - Reasonableness of Management Projections

Issues Raised in ERISA Litigation

- Undue reliance by Appraiser
- Inadequate Verification of Management Projections by Appraiser
- Vetting of Projections by Appraiser
- Inadequate Risk Assessment by Appraiser
- Lack of Realistic Projections
 - Employment Agreements with Management
- Control Premiums paid by ESOP
- Subsequent Stock Acquisition by ESOP
- Reasonableness of Indemnity Agreements entered into with Fiduciaries of ESOP Companies

Fiduciary Review

- Disgorgement of Profits
- Removal of Fiduciaries
- 502(1) ERISA 20% Penalty
- Private Party Civil Actions
 - Typically Class Actions
 - Issues Commonly Raised in Private Actions
 - Reasonableness of Management Projections

ESOP Trustee

- Internal Trustee or Institutional Trustee
- Experienced Trustee Staff
 - ERISA, Plan Valuation, Legal and Plan Administration
 - Trustee works with all Plan Providers
- Transaction Expertise and Ongoing Administration
- Strategic Advisor to the Board and management of the company

“Red Flags”

- Staff Turnover with in one of the professional groups
- Substantial change in valuation methodology not previously discussed with the Trustee
- Litigation associated with any of the professionals related to the Plan
- Conflict of Interest occurs
- Consistently under performance
- Lack of responsiveness

“Red Flags”

- Consistently find errors in the valuation reports
- Poor Documentation
- Lack of peer review process
- Frequent problems with annual allocations and distribution process
- Failure of the valuation firm to follow the DOL Fiduciary process in preparation of their report to the trustee
- Lack of good documentation to DOL Audit

Trustee Documentation Required

- Annual RFP to the Valuation Advisor to validate their continuation
- Documentation by the trustee to show with due diligence review process
- Trustee meeting minutes
- Trustee internal review analytics to validate its review of the valuation
- Excellent trust reporting system to coordinate plan administration with TPA
- If a service provider change is needed, have good documentation as to why

Valuation Expert

- Credentialed
 - American Society of Appraisers “ASA”
 - Association of Certified Public Accountants “ABV”
- Experienced
 - ESOP technical, case law, regulatory
 - Specific industry
- Unbiased
 - Unrelated party, not conflicted
 - No financial interest in outcome

“Red Flags”

- Unfamiliar with recognized valuation methodology and concepts
 - Application of appropriate methodology is essential
- Substantial change in valuation methodology from one year to the next
 - Change in methodology is not substantiated or warranted
- Does not conduct best practices
 - Breach of duty
- Errors in previous report
 - Math, conceptual, or grammatical
- Unfamiliar with current or evolving regulatory issues
 - Does not stay current

“Red Flags”

- Does not perform specific service
 - Fairness Opinions
- Does not request to see the repurchase obligation study
 - Circumstances depending

“Red Flags”

- Loss of credentialing status
 - Ethical violations
- Poor service
 - Lack of timeliness for responses or missed deadlines
- Gross negligence vs. ordinary negligence
 - Ethical or theoretical
- Conflicts of interest
 - “Two Hats”
- Unsubstantiated increase in cost or fees
 - Change of fee not warranted

Additional Advisor Needed

- Valuation report review
- Fairness opinion
- Shareholder transaction
- Unrelated ESOP valuation services

Questions ?

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