How to Protect Employees Against Sharp Declines in Stock Value

ESOPs: Beyond the Basics

Ken Mogren
Winona Agency
Winona, MN
507.458.5408
kjmogren@hbci.com

Jerry Kaplan
McDermott Will & Emery
Chicago, IL
312.984.6955
jkaplan@mwe.com

Brian Yolles
StockShield, LLC
Los Angeles, CA
310.203.8844
brian.yolles@stockshield.com

Traditional Risk Mitigation Options

- ESOP Holds Other Assets
- Expanded Diversification Provisions
- Plan Design
- Separate 401(k)

Risks of Company Stock (J.P. Morgan)

Sector	Total % of companies experiencing "catastrophic loss", 1980 - 2014
All sectors	40%
Consumer Discretionary	43%
Consumer Staples	26%
Energy	47%
Materials	34%
Industrials	35%
Health Care	42%
Financials	25%
Information Technology	57%
Telecommunication Services	51%
Utilities	13%

Source: FactSet, J.P. Morgan Asset Management.

"Catastrophic loss" = 70% decline from peak value with minimal recovery, Russell 3000 stocks, 1980-2014

Risks of Company Stock (J.P. Morgan)

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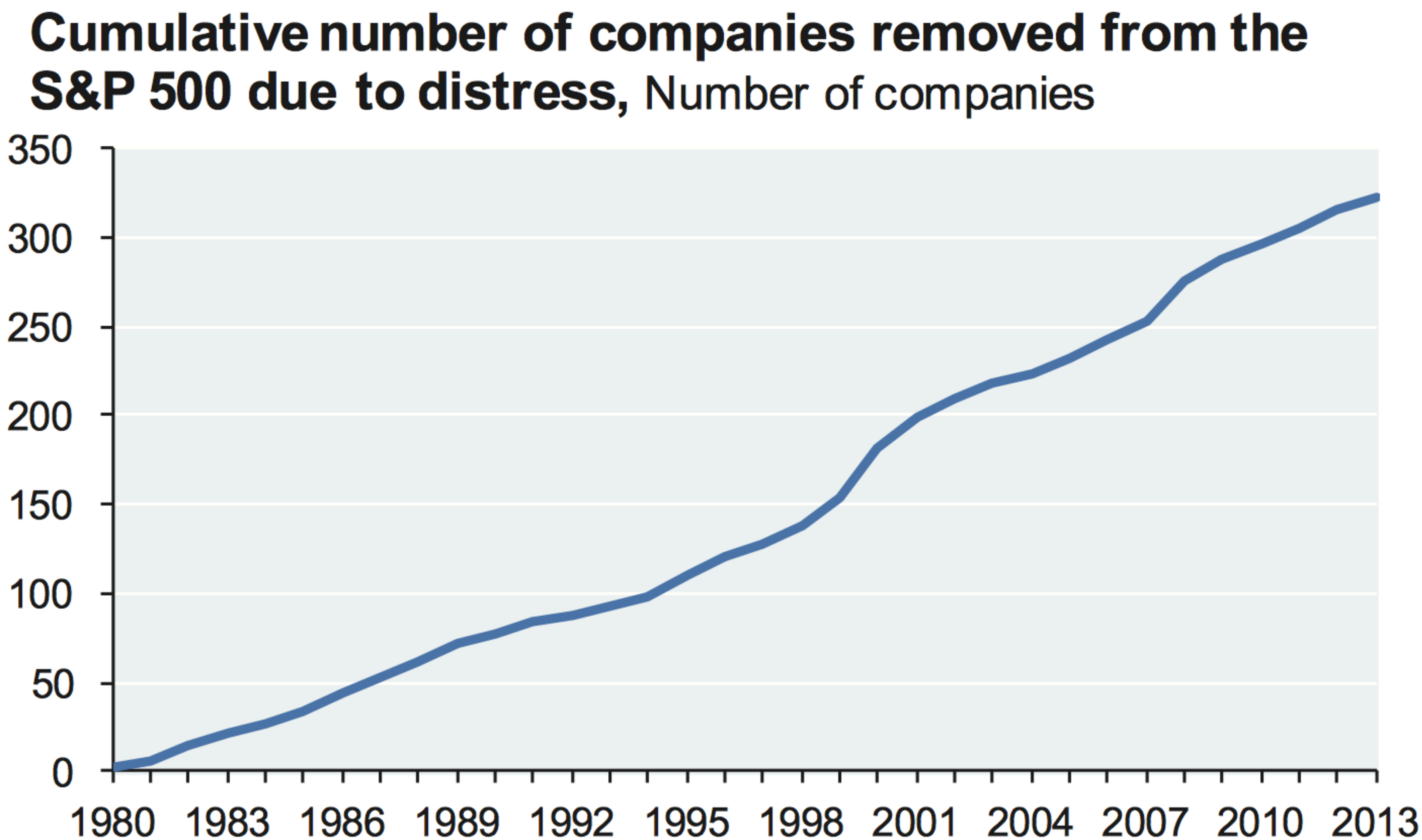

Source: FactSet, Bloomberg, Standard & Poor's, JPMAM. 2013.

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Louis Kelso on Protecting ESOPs

"The worker, who has only his labor to invest, is better off taking Andrew Carnegie's advice: 'Put all your eggs in one basket, and then watch that basket.' Through an ESOP the worker can invest both his labor and his capital in the one company whose profitability he can influence….**Insurance can be designed to protect employee shareholders against the possibility that the ESOP will not deliver the assets to which they are entitled."**

Louis Kelso and Patricia Kelso, "Employee Stock Ownership Plans: A Micro-Application of Macro-Economic Theory" (1977)

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The Concept: Risk Sharing

The Details

- 10 - 20 strong & healthy ESOP companies
- Small annual cash deposits into separate Trust
  - For every $1 million of company stock = as low as $2,500 (¼ of 1%)
- Cash invested in U.S. Treasury Securities
- Cash used to reimburse large losses on company stock over 5- or 10-year term
- If no large losses incurred, up to 100% of cash refunded (without interest); total cost could be de minimis
- ESOPs retain their stock's full upside potential (unlimited capital appreciation and dividends)

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High Standards for ESOP Fiduciaries

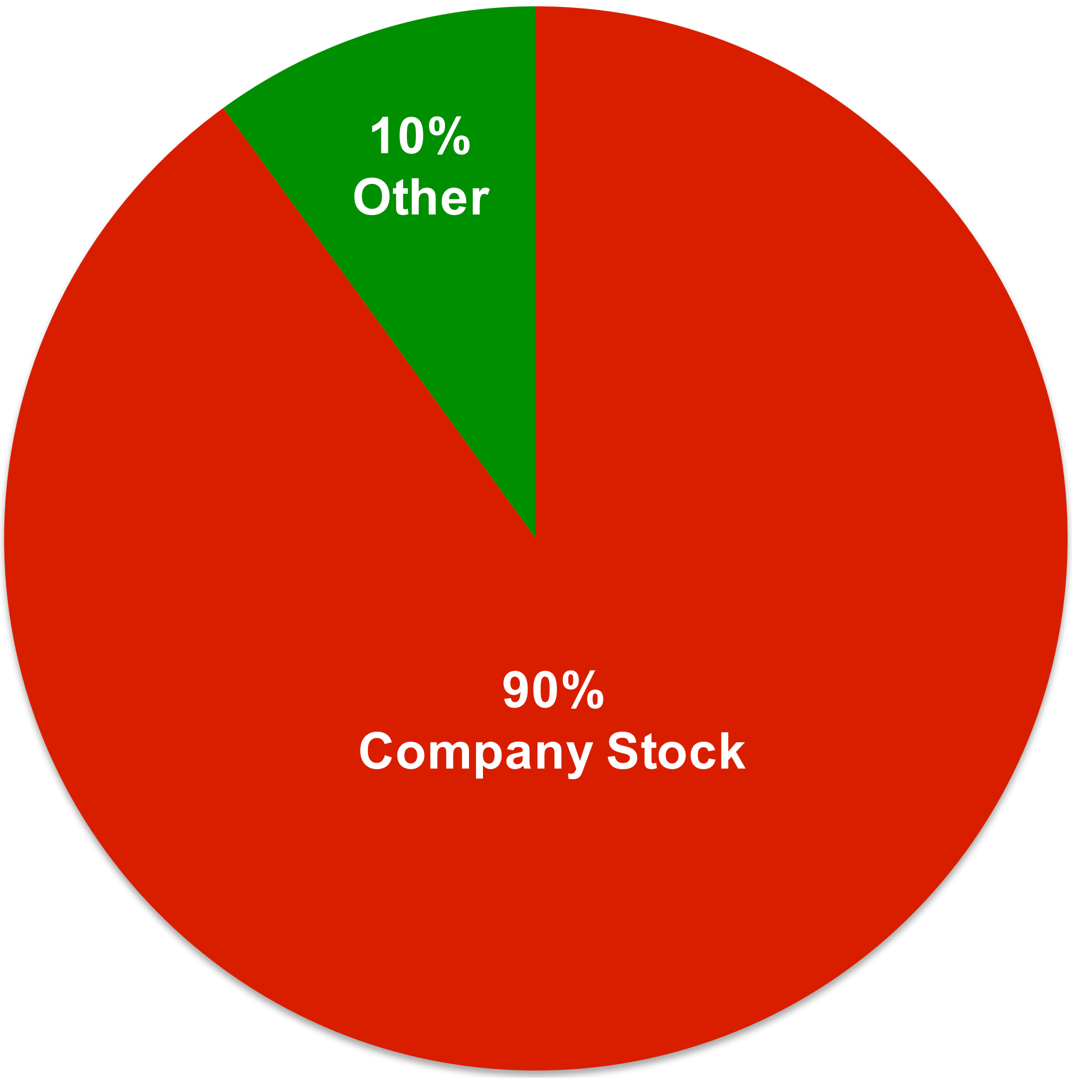
- **An ESOP is an ERISA retirement plan, not just employee ownership**
  - While ownership involves gains and losses, if losses can be prevented, fiduciaries are required to prevent them (as any prudent person would do)
    - *Investors and their fiduciaries regularly reduce risk of large losses due to concentrated stock positions*
  - Continuing duty to monitor company stock, ensure prudence, and dispose of company stock if not likely to provide financial retirement income for ESOP participants and their beneficiaries
  - Personal liability for losses resulting from fiduciary breaches

"Alternative Action" Pleading Standard

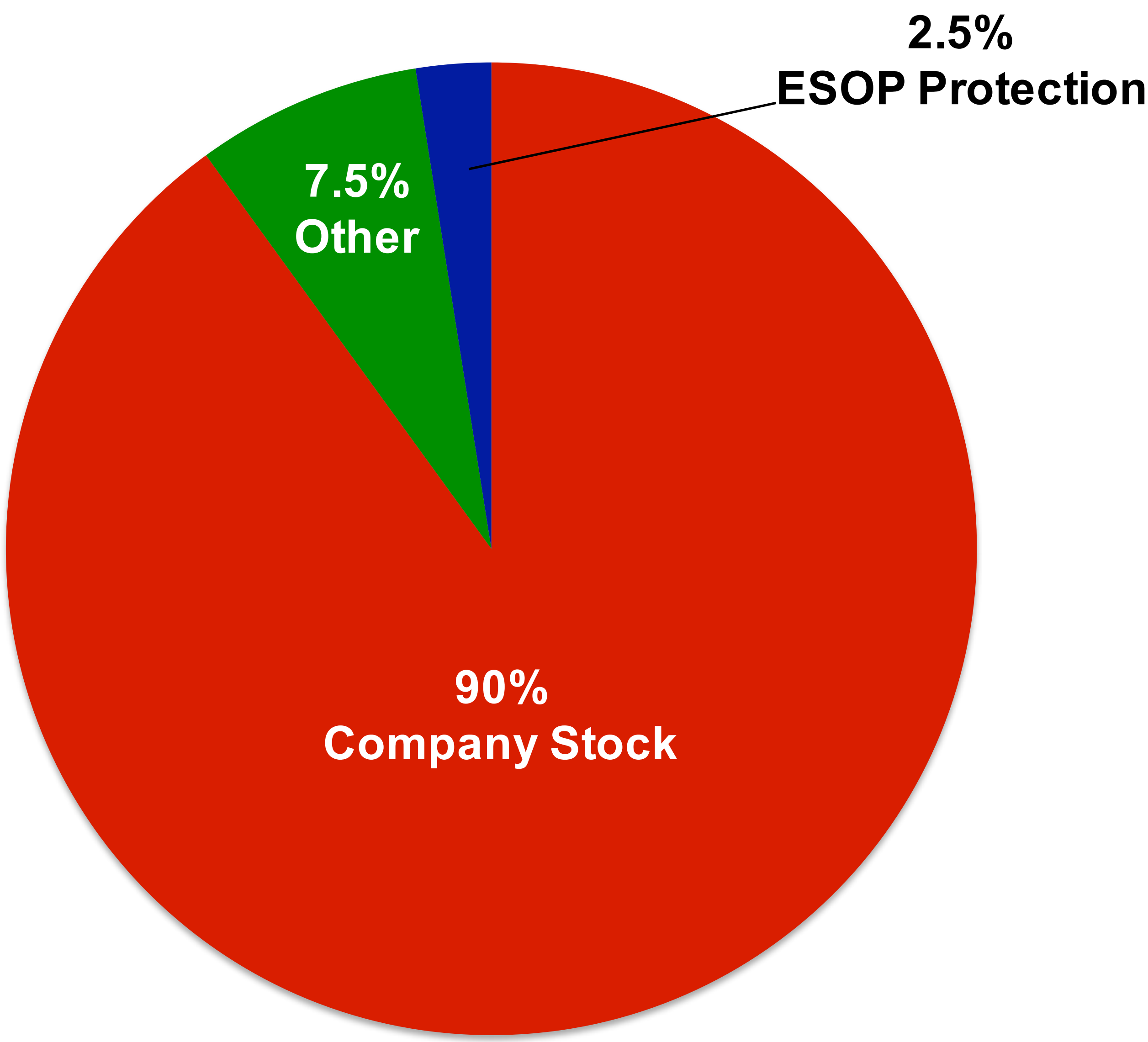
- *Hill v. Hill Brothers Construction* (March 2016) applied the Supreme Court's *Fifth Third Bank v. Dudenhoeffer* "alternative action" pleading standard in the private company context
- Although fiduciaries beat the claim on its merits, court found there can be fiduciary exposure for stock loss in private company ESOPs:

> ***"…[I]n order to state a claim for breach of the fiduciary duty of prudence, the Plaintiffs must plausibly allege an alternative action that the Defendants could have taken consistent with securities laws and that a prudent fiduciary in the same circumstances would not have viewed as more likely to harm the fund than help it"***

Example of Unprotected ESOP Portfolio



Example of Risk-Optimized ESOP Portfolio



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Wharton Professor Robert Stambaugh

- Fellow and former President of the American Finance Association:

  "I find that for wide ranges of risk tolerance and risk, portfolios whose returns reflect participation in the ESOP Protection Trust are substantially more desirable than the corresponding unprotected portfolios"

- ESOP participants like gains and dislike losses, *but not symmetrically*; a loss of a given magnitude is disliked more strongly than a gain of the same magnitude is liked

NCEO Founder Corey Rosen

- Vast majority of ESOP participants would prefer to sacrifice small amount of upside potential for security against major downside loss
- May help in the case of a lawsuit or audit
- Helps ESOP community address skeptics, restore growth in number of ESOPs (in decline since Enron)
- Prudent protection for ESOP Participants

  "Given the low cost of the ESOP Protection Trust, it seems only prudent to take advantage of this opportunity"

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Questions?

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