ESOPs and Executive Compensation

Who Benefits and How in an ESOP Company?

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Risk and Reward

(The Divorce That Will Never Happen)

Risk?

CEO

Major Shareholders

Rising Management & Key Executives

Rank & File

Reward?

It is the responsibility of the Board of Directors or the Compensation Committee it appoints to properly apportion financial benefits. How should this be done?

Things You Can Use to Compensate Key Executives

1. Stock options – two basic flavors:
   - Qualified (tax favored) incentive stock options (ISOs) and
   - Non-qualified (non-statutory) stock options (NSOs).
2. Deferred compensation – two basic models:
   - Defined contribution model (better for ESOPs), and the
   - Target or defined benefit model
3. Cash bonuses are always welcome
4. Restricted stock
5. Phantom stock or Stock Appreciation Rights
6. Management stock purchases
7. Mindless adulation

Note that these will generally impact ESOP share value in one form or another

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Characteristics of the Compensation Packages

(Both are Performance Driven: The Risk/Reward Should Differ)

Key Executives

Unfunded

No Guarantee

Greater Return

Last in Line

Risk **Reward**

Non-Key Personnel

ESOP Funded

No Guarantee, but Lower Risk

Lower Return

First in Line for Funding & Payouts

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How to Quantify the Risk/Reward Equation for Your ESOP Company

- Those higher up on the compensation scale should have a higher risk relative to compensation benefits.
- Conversely, the non-highly compensated should have a lower risk exposure.
- The ESOP is a *retirement* plan: Risk should be mitigated.
- Equity is by definition risky – but the ESOP equity can be supported to some extent by appropriate funding of the plan – not just the stock purchase costs, but also the stock repurchase obligations. These are the real retirement benefits for the participants.
- Thus, the relationship between key executive compensation and the repurchase obligation must be understood.

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Master of the Obvious

1. Any time that a cash, deferred cash or equity benefit is set aside for a key executive program, that represents a flow of value to a select group.
2. Such value flows are necessary to incentivize key producers.
3. Such value flows should build the business – not be a cost in a ‘zero sum game’ detracting from one group for the benefit of another.
4. There are two baselines to be established:
   - The base peer group compensation for the select executives. You or, better yet, an independent compensation specialist can perform this study.
   - The long term ESOP stock repurchase obligations for all employees. You or your knowledgeable ESOP service provider can perform this study.

OK. So We Have an ESOP. What Can We Pay Our Key Execs? How Does That Affect the ESOP?

1. The board or compensation committee looks at the results of a comparative compensation study or review of peer group data for your key players. You may have several categories of key people.

2. The base key player compensation is then set for the anticipated 'normal' growth and operation of the company.

3. The long-term emerging ESOP buyback obligations should then be estimated for a range of possible share price appreciations. (You must do this in any case for fiduciary reasons, not just to resolve the compensation conundrum).

4. Then the sensitivity of the ESOP payouts to changes in share price is known.

5. The ESOP repurchase obligations will be managed and funded for the exclusive benefit of the ESOP participants.

6. The performance based rewards for key-executives (whatever the form) will be set as a function of the growth of the company share price.

7. Let's see how executive compensation impacts ESOP benefits:

Sample Showing the Baseline Costs for All Long-Term ESOP Stock Repurchases

1. Employee census data, estimated stock values and corporate funding are analyzed to project the payouts from the mature ESOP to departing participants with vested accounts over the long term. The results are a range of values, and have a statistical error of about ±15%.

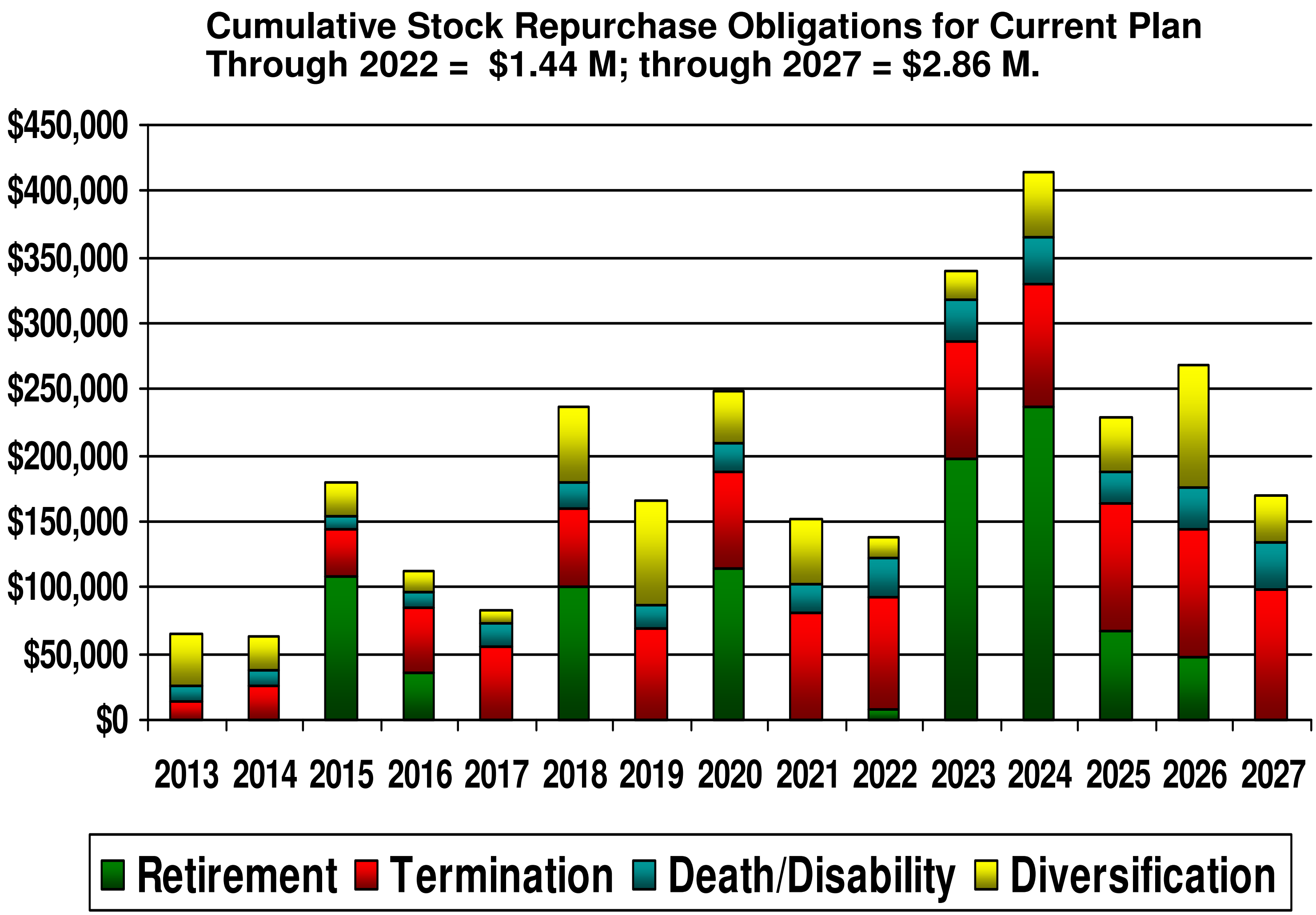
2. The payouts considered are all major components of ESOP distribution costs:

   . Retirements, assuming 95% retire at age 65; remaining 5% by age 68.
   . Vested terminations (current seven year vesting schedule)
   . Death and disability (Commissioner's 1990 CSO mortality tables)
   . Impact of moderate termination rates (turnover) on forfeitures
   . ESOP diversification elections (50% of eligible elect to diversify).

3. The following charts summarize detailed studies which bracket possible outcomes for annual share price appreciation rates of 2% to 10% and shows the pattern of payouts for the large, maturing ESOP over the next 15 years.

Baseline: Current Plan

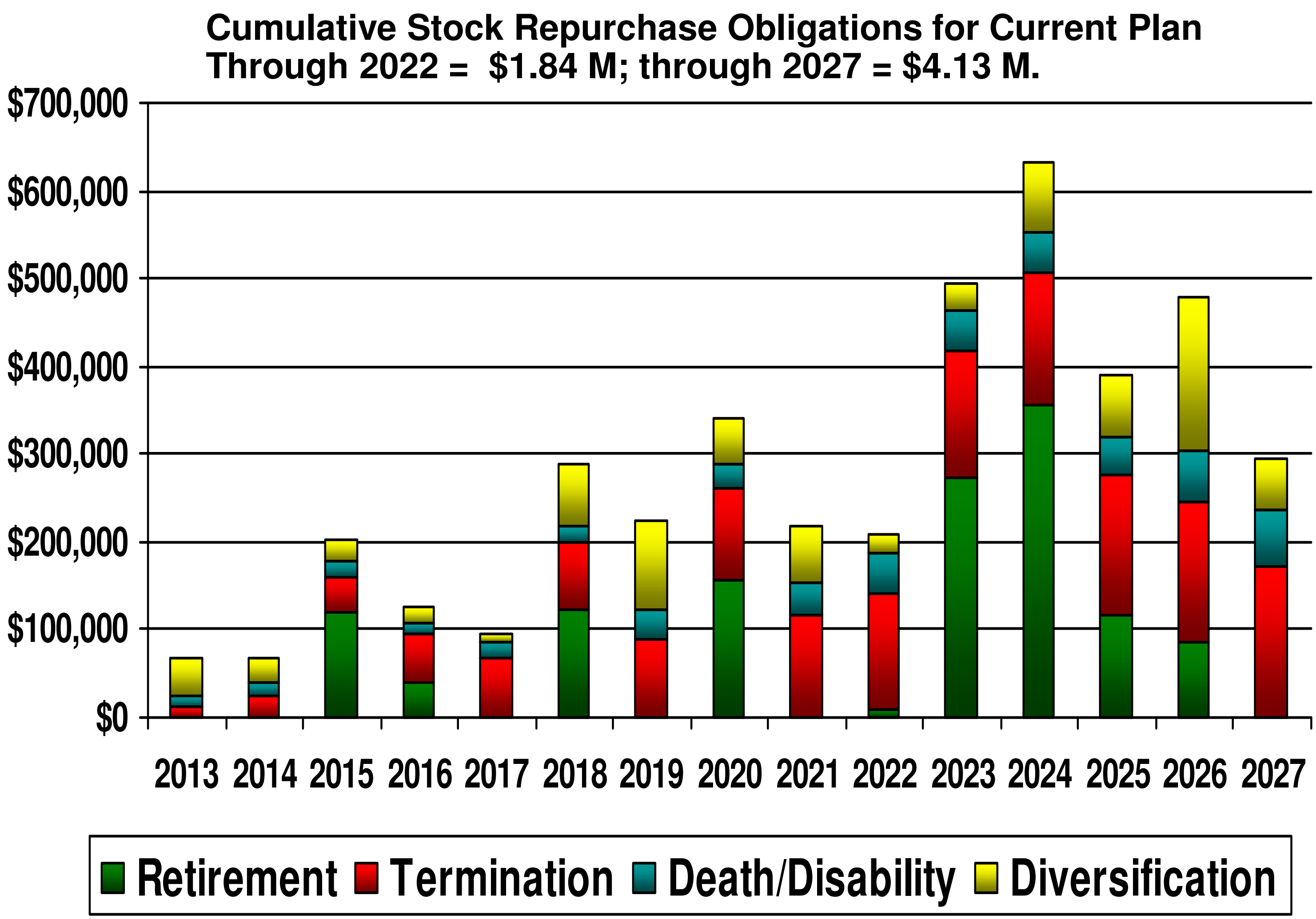
2%



Consistent share price appreciation of 2% annually; no new stock issues; average retirement @ age 65; diversification elections of 50% of eligible; mortality per CSO 1990 tables; 6 year graduated vesting schedule for new hires; total salaries and number of employees grow at 3% annually; moderate turnover model (Sarason Table T5).

Baseline: Current Plan

6%



Consistent share price appreciation of 6% annually; no new stock issues; average retirement @ age 65; diversification elections of 50% of eligible; mortality per CSO 1990 tables; 6 year graduated vesting schedule for new hires; total salaries and number of employees grow at 3% annually; moderate turnover model (Sarason Table T5).

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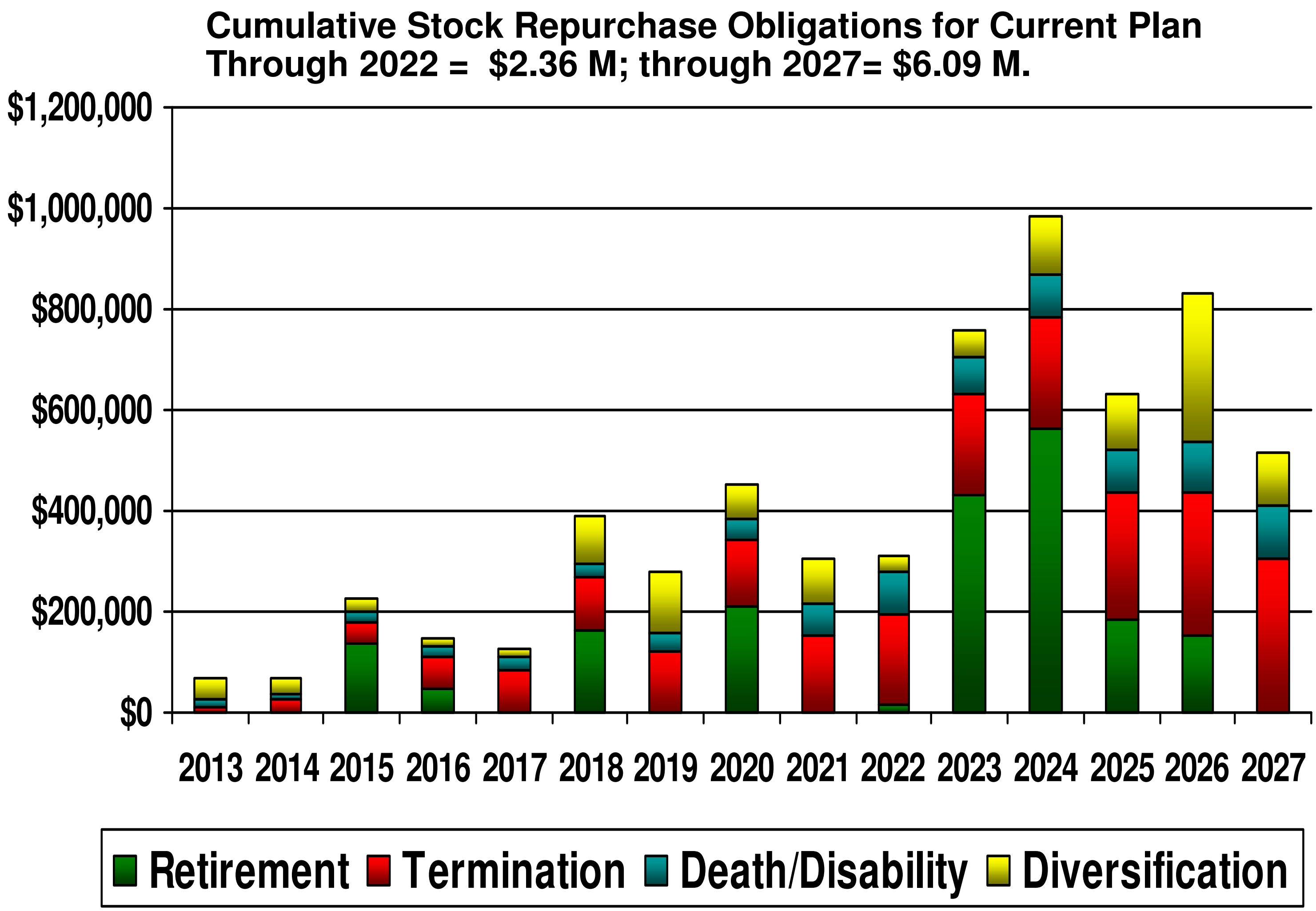
Baseline: Current Plan

10%



Consistent share price appreciation of 10% annually; no new stock issues; average retirement @ age 65; diversification elections of 50% of eligible; mortality per CSO 1990 tables; 6 year graduated vesting schedule for new hires; total salaries and number of employees grow at 3% annually; moderate turnover model (Sarason Table T5).

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So Depending On the Underlying Share Price Appreciation, The ESOP Benefits are….

Cumulative ESOP Payouts after:	10 Years	15 Years
Share Price Growth of 2%	$1.44 M	$2.86 M
Share Price Growth of 6%	$1.84 M	$4.13 M
Share Price Growth of 10%	$2.36 M	$6.09 M

?

If the 10% Growth Could Not be Achieved without Key Executive Efforts, How Should They be Rewarded?

Hint: They can receive discretionary equity or cash compensation. The latter can represent liquidity for company needs, ESOP repurchase funding and ultimately the executive benefit. This compensation may retard ESOP share price appreciation relative to the maximum.

One Example of Building Incentive Packages Fairly from the Baseline

Exceptional 10% Underlying Share Price Appreciation: Key Exec Deferred Compensation Plan is ‘Funded.’ This Balance Sheet Asset is Cash First for the ESOP Obligations and Second for the Key Executive Compensation.

‘Normal’ Underlying 6% Share Price Appreciation = Usual Bonuses, Profit Sharing

Underlying 2% Share Price Appreciation = No Compensation Incentives for Key Execs

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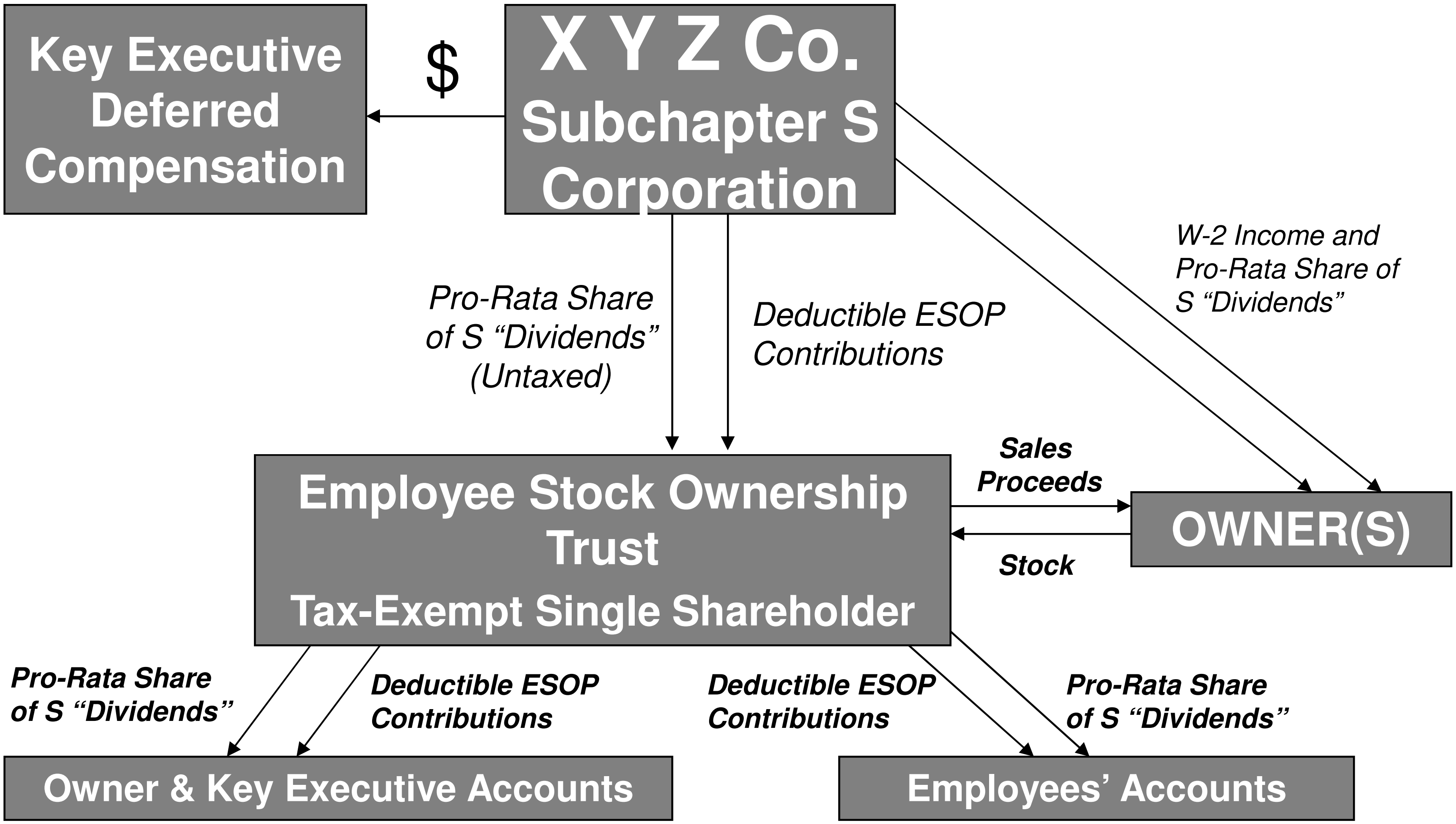
Key Executive Plans + Subchapter S ESOP

Tax Sheltered Stock Purchases + Build-Up of Key Executive Capital to Support Ownership Transition (Possible 100% Tax-Exempt Operation).



Note: The IRS counts key executive deferred compensation as a type of 'synthetic equity' for the Sub S IRC §409(p) anti-abuse testing. This is not typically an issue for properly designed plans with over 20 to 30 participants. For smaller plans, both the qualified (ESOP) plan and the non-qualified (deferred compensation) plan will need future coordination to comply with this interpretation of EGTRRA 2001 as well as IRC 409(A).

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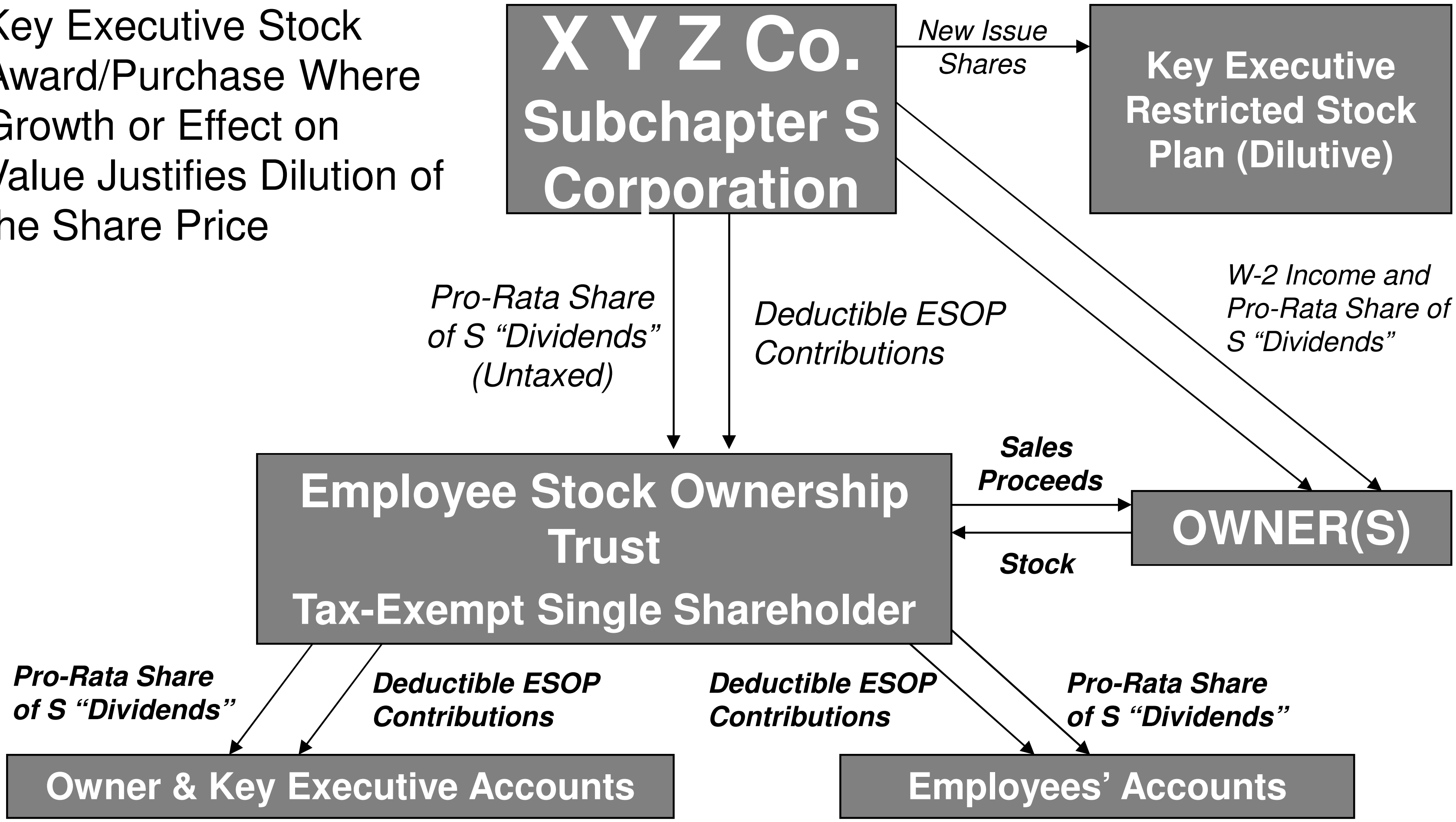
Key Executive Stock + Subchapter S ESOP

Key Executive Stock Award/Purchase Where Growth or Effect on Value Justifies Dilution of the Share Price



Note: The IRS counts key executive restricted stock a type of 'synthetic equity' for the Sub S IRC §409(p) anti-abuse testing. This is not typically an issue for properly designed plans with over 30 or so participants. For smaller plans, both the qualified (ESOP) plan and the non-qualified (deferred compensation and/or restricted stock) plan will need future coordination to comply with this interpretation of EGTRRA 2001 as well as IRC 409(A).

Some Things to Remember in the Design and Operation of the Benefit Allocation Process

1. Document, document, document whatever you do.
2. Allow for flexibility: In years when performance is down, the executive plan should provide for little or no funding; when the price is up – the plan should allow for funding in proportion to the upside.
3. Don't run the ESOP repurchase studies for just one set of input parameters – e.g. just one share price appreciation rate. Look at the effects of all variables.
4. Remember: All companies have stock repurchase obligations – putting equity in executive hands is either dilutive or otherwise affects value. Consider using deferred compensation structures with flexible cash accumulation to serve several purposes.
5. Sound, flexible financial models are required to pinpoint the appropriate designs.
6. Coordinate the disclosure of various compensation packages to the people involved in conformity with your corporate culture. Every case is a bit different and confidentiality is ultimately a Board decision.
7. Don't be deterred by apparent complexity. The underlying ideas are simple and can be tailored to fit your specific situation.