NCEO

Key Executive Compensation in ESOP Companies

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WHY ARE THERE...?

1. An ESOP valuation expert
2. A corporate advisor/employee benefit counsel, and
3. An ESOP transaction designer & repurchase obligation specialist

All on the same panel dealing with key executive compensation?

(Because all of the pieces of your ESOP puzzle affect each other and must be carefully interconnected.)

Overview

1. The best strategies for deferred, discretionary equity, equity-equivalent and cash compensation plans are treated here. A few case studies are summarized.
2. We do not deal with the many excellent reports and studies on the design of current cash compensation and bonus packages. We can't cover it all now.
3. What we have seen lacking in terms of best practices in both the literature and real world is the coordination of disparate qualified and non-qualified plans.
4. This is a brief review of approaches to key executive compensation plans which can be integrated into an ESOP company's benefit structure to recruit, reward and retain key players, while complying with DOL and IRS rules of the road (409A, 409(p), etc.).

What Works & What Doesn't

1. In short, while there is far from a magic template that fits everyone in putting this puzzle together, you need to see what has been good for executive comp in ESOP companies and what hasn't been so good.
2. First, never forget the laws of financial physics – particularly the inseparability of risk & reward.
3. In setting up discriminatory compensation plans, you are apportioning risk and reward differently for different groups.

Risk and Reward

(The Divorce That Will Never Happen)

Risk?

Chairperson
CEO
Major Shareholders

Rising Management
Key Executives

Supervisors

Rank & File

Reward?

It is the responsibility of the board of directors or the compensation committee it establishes to properly apportion financial benefits. How should this be done?

Example of a Pay-As-You-Go Simple Defined Contribution Deferred Compensation Plan

A company wanted to reward its key players, but did not want to commit to a defined benefit at the vesting point, say in 10 years.

Defined Contribution if Net Profits Exceed:			$ 750,000
	DOB	Salary	DC %
Executive 1	6/28/1970	$ 231,424	20.00%
Executive 2	10/7/1979	$ 77,750	16.00%
Executive 3	4/18/1978	$ 87,190	15.00%
Executive 4	3/1/1960	$ 141,134	15.00%
Executive 5	9/18/1966	$ 128,588	18.00%
	Annual Accrual if Target Hit:		$ 116,119
Defined Contribution if Net Profits Exceed:			$ 1,000,000
	DOB	Salary	DC %
Executive 1	6/28/1970	$ 231,424	25.00%
Executive 2	10/7/1979	$ 77,750	21.00%
Executive 3	4/18/1978	$ 87,190	20.00%
Executive 4	3/1/1960	$ 141,134	20.00%
Executive 5	9/18/1966	$ 128,588	23.00%
	Annual Accrual if Target Hit:		$ 149,423

Another Company Wanted to Define a Benefit at 10 Years Equal to a Projected Number

Defined Contribution if Net Profits Exceed:			$ 750,000
	DOB	Salary	DC %
Executive 1	6/28/1970	$ 231,424	20.00%
Executive 2	10/7/1979	$ 77,750	16.00%
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	Assume 10 Years of These Accruals:		$ 116,119
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Let's ask our ESOP valuation expert about the difference in the impact on value: The pay-as-you go, if the targets are met vs. the defined benefit at 10 years of either $1.16 Million or $1.49 Million?

Rules of the Road: Compliance

1. IRC Section 409A applies to most forms of deferred compensation
2. For such purposes, deferred compensation essentially means compensation for services performed in one year that is payable in a subsequent year
3. With the exception of stock options and SARs (if the exercise price is at all times equal to or greater than the fair market value of the underlying shares as of the date of grant), it is likely that any long-term incentive plan will be subject to IRC Section 409A

IRC SECTION 409A CONSIDERATIONS

1. Simply put, IRC Section 409A requires that deferred amounts be payable only upon the occurrence of one of the following:
   a) death
   b) disability
   c) termination of employment
   d) a specified date
   e) a change of control
2. Other than those dates and times as specified in the plan, payments cannot be accelerated or further delayed

IRC SECTION 409A CONSIDERATIONS

1. There is one exception available under IRC Section 409A that allows a participant to make an election, at least twelve months prior to a scheduled payment, to postpone the scheduled payment by a minimum of five years
2. There is also an exception for short-term deferrals (i.e., amounts paid before the 15th day of the third month of the following year.
3. The penalty for a Section 409A violation is immediate taxation on the purportedly deferred amount plus a 20% penalty

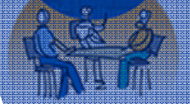
S CORPORATIONS ONLY: IRC SECTION 409(P)

1. IRC Section 409(p) is the so-called "anti-abuse“ excise tax that can apply to an ESOP/S corporation if too much value (taking into account ESOP stock, synthetic equity, non-qualified deferred compensation and actual stock ownership) is concentrated too heavily in the hands of “disqualified persons” (high percentage owners).
2. Although 409(p) is quite complicated and beyond the scope of this outline, a 409(p) violation can trigger adverse income tax treatment for the disqualified person and a 50% excise tax on the corporation
3. The key point: <u>Proper coordination of all facets of your incentive programs can avoid this nightmare.</u>

A Cautionary Tale of an Uncoordinated Strategy: Stock Options + ESOP

1. Established an ESOP in 2000, over time acquired 88% of the shares, paid off the ESOP loans and grew to have 200 employees.
2. Had discretionary equity in the form of options representing 12% of the company.
3. The 12% were strongly incentivized to get their options "in the money" and grew amazingly, averaging 30% for six of the next eight years (prosperous defense contractor).
4. The option value was tied directly to the majority interest ESOP value, so that the 30% price appreciation for the 12% options grew the 88% ESOP repurchase obligations at 30% also.
5. Had a valuation which mentioned the 'repurchase obligations,' but with no definitive projections.
6. And then, after the nice years of high earnings and share price appreciation, they saw the profits flatten out at a level which could not support the existing ESOP payout policy <u>and</u> capitalize further high levels of growth. Ouch!

Can We All Have this Earnings "Problem"? Please?



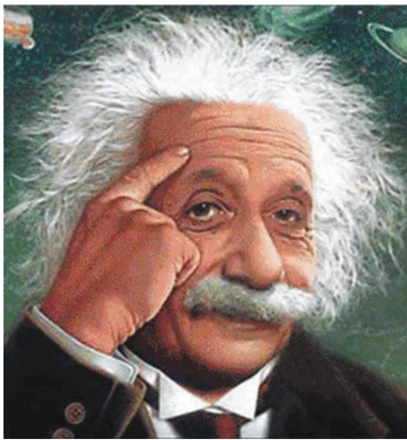
1. **While this company had to be sold to comfortably retire the stock repurchase obligations, the goal originally was to remain locally owned and operated.**

2. **What could have been done with some foresight relative to planning and executive compensation strategies?**

3. **What do experienced benefits counsel and ESOP appraisers have to say about this?**

Some Features of the System Engineering of this "Plan"

1. **The value for the minority shareholders was directly coupled to the majority interest ESOP "fair market value" valuation.**
2. **The minority group had an exceptional incentive to grow the company (a good thing), but this grew the retirement plan stock value equally (a problem).**
3. **Lest we say, "I'd never do that…" let's note that there are analogs of these issues in many compensation programs.**



You didn't need to be this guy to figure out a better solution.

What Our "Simple System" Owners Could Have Contemplated if the End Game Was Not a Sale

1. The executive benefits could have been decoupled from the ESOP stock FMV share price, but dependent on enterprise growth (i.e. they could grow faster than the stock price, within prudent fiduciary constraints):
   a) The entire equity risk of the private company did not have to be pushed off on the retirement plan.
   b) Discriminatory deferred compensation booking a liability would have slowed the company value growth, permitting retention of the original objective.
   c) Other forms of equity comp (e.g. restricted stock) could have diluted ownership percentages, but still not impaired the ESOP from a fiduciary viewpoint.
2. Key executives would have had personal plans which incentivized growth while recruiting/rewarding/retaining them and their ultimate replacements.

Equity Based Compensation

1. Many forms of equity based compensation
   - SARs, SERPs, Phantom Stock (most common in ESOP companies)
   - Options & Warrants
2. All result in some sort of dilution to the ESOP and/or other shareholders
   - Equity based compensation is a *claim on the equity* of the Company
   - Offsets to dilution
     a) Provides incentive to create additional value for all shareholders
     b) Attract and/or retain qualified executives
     c) Performance based
   - Must be careful not to "over-dilute"
     a) Reasonable levels of equity compensation
     b) ESOP companies subject to IRS section 409(p) "synthetic equity" limits

Treatment in Valuation

1. Generally remove any expense and liability from income statement and balance sheet, respectively, and take into consideration the value of the synthetic equity (claim against equity) separately.
   a) Equity compensation represents a liability of the Company
2. Two methods:
   a) Subtract the liability associated with the plan OR
      - Most common method for SARs, SERPs, and Phantom Stock – assumption is units/shares will never be "outstanding"
      - Iterative calculation because amount of liability impacted by dilution from synthetic equity
   b) Add any proceeds from exercise and divide by the fully diluted shares outstanding assuming issuance of the synthetic equity
      - Most common method for Warrants & Options

Treatment in Valuation - Examples

Stock Appreciation Rights Example

			Percent	Owner
Concluded Equity Value Before Considering Additional Claims on Equity		$26,500,000	100.0%	ESOP & Company Executives
Less: Aggregate SARs Liability		-$2,600,000	9.8%	Company Executives
Concluded Fair Market Value of Equity		**$23,900,000**	**90.2%**	**ESOP**
Common Shares Outstanding	100,000			
Fair Market Value Per Share (rounded)		**$239.00**		

Options Example (assumes they are "in the money")

			Percent	Owner
Concluded Equity Value Before Considering Additional Claims on Equity		$26,500,000	93.0%	
Proceeds From Exercise of Options (1)		$2,000,000	7.0%	
Concluded Fair Market Value of Equity		**$28,500,000**	**100.0%**	
Common Shares Outstanding	**100,000**		**90.9%**	**ESOP**
New Shares From Options Exercise	10,000		9.1%	Company Executives
Fully Diluted Shares Outstanding	110,000		100.0%	ESOP & Company Executives
Fair Market Value Per Share (rounded)		**$259.10**		

(1) Exercise price of $200.00 per share

FIDUCIARY CONSIDERATIONS

1. Since the issuance of any equity or synthetic equity can have a potentially dilutive impact on the ESOP, it is important for any plan to be in the best interest of the ESOP plan participants
2. As a result, one of the primary objects of the plan should be to identify and select a group of people to be incentivized and rewarded to drive value for everybody
3. For example, in the case of a SAR, you are rewarding a group of individuals based only on appreciation in the value of the company stock. If the value goes up, that's good for everybody
4. Overall compensation program should be in line with compensation practices for comparable-type positions in the industry, perhaps taking geography into account

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FIDUCIARY CONSIDERATIONS

1. Document everything you do – even notes during meetings.
2. Take care that those affected directly by a compensation decision are not directly making the decision.
3. An independent institutional fiduciary as part of a decision making group (Trustees or Board members) can be helpful: Those conflicted out can abstain while the independent party makes the call.
4. A compensation committee and often an independent compensation study are (very) good ideas.

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Don’t Get Lost in the Weeds: Keep Your Objectives at the Forefront

The company's challenge is to find the right combination of programs that will:

a) attract, retain and reward key management employees who are in a position to make a difference

b) reward short-term results without sacrificing the long-term

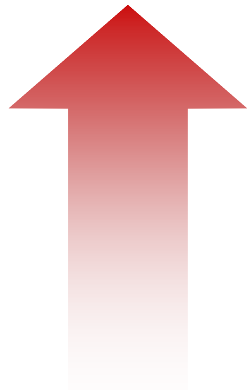
c) reward long-term results while balancing the short-term

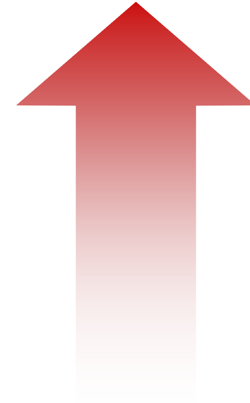
d) align the interests of key management employees with the interests of the company and its shareholders – including shareholder/employees

e) identify specific goals and tie compensation to the attainment of those goals – "You get what you reward"

Remember the Governing Philosophy: Some General Features of Compensation Packages

(All 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

A Helpful Diagram for Discussion
Private Company Example: The Sub S ESOP

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

Key Executive Deferred Compensation

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X Y Z Co.
Subchapter S Corporation

W-2 Income (if employees) and Pro-Rata Share of S "Dividends"

Possible Later Loan to ESOP for Stock Purchase and Tax Free Repayment

Pro-Rata Share of S "Dividends" (Untaxed)

Deductible ESOP Contributions

Employee Stock Ownership Trust
Tax-Exempt Single Shareholder

Sales Proceeds

OWNER(S)

Pro-Rata Share of S "Dividends"

Deductible ESOP Contributions

Deductible ESOP Contributions

Pro-Rata Share of S "Dividends"

Owner & Key Executive Accounts

Employees' Accounts

Thank You!

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