Coordination of Executive Compensation Strategies with ESOPs

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Overview

1. The NCEO has published a very fine book on executive compensation in an ESOP environment. This presentation, however, deals with the sometimes overlooked and surprising strategic linkages between such compensation and ESOP operation.

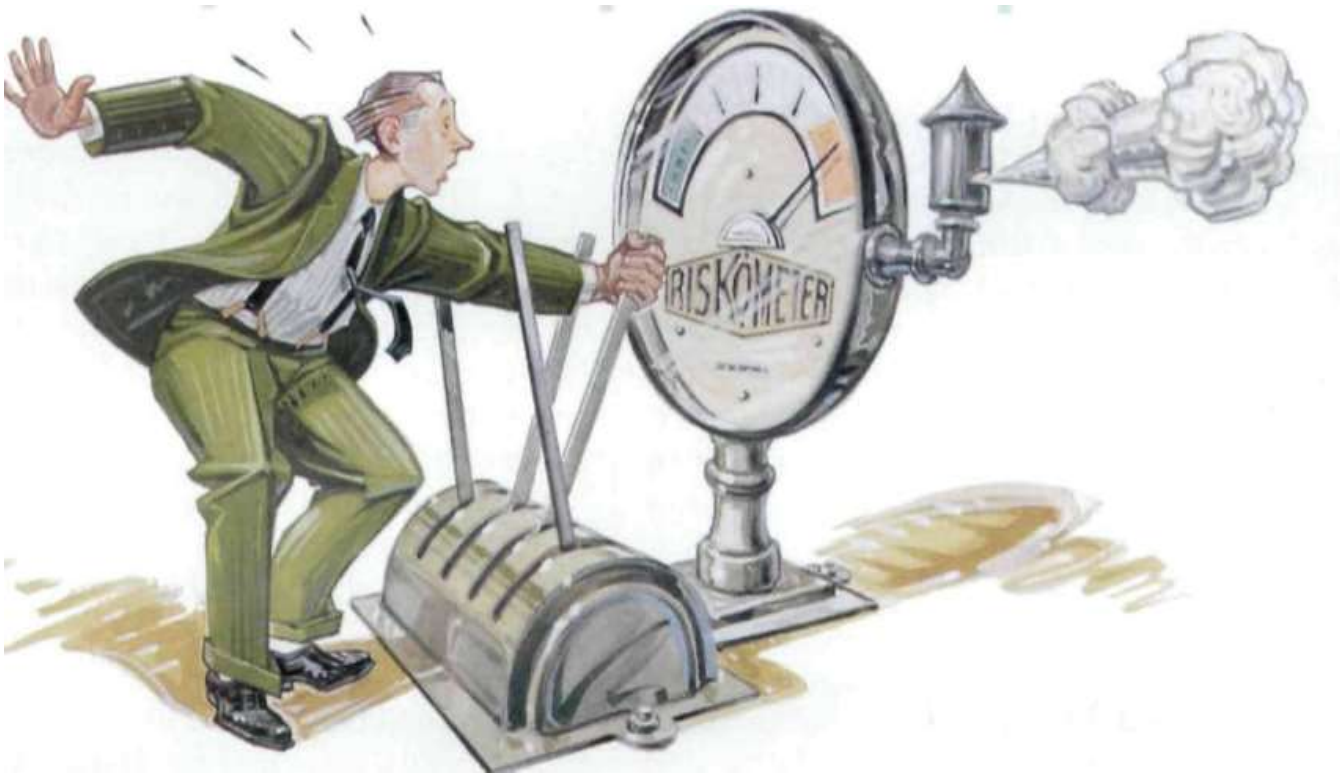
2. The best strategies for deferred, discretionary equity, equity-equivalent and cash compensation plans are treated here. A few case studies are summarized.

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.)

Why the Focus on Benefit Coordination?
A Law of Management Physics

The law of unintended consequences



Pushing Lever "A" May Really Reward Key Executive "B", but You May Trip over IRC 409(p), 409A, Valuation Issues…and Employee Perception Problems.

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Why the Focus on Benefit Coordination?
A Law of Financial Physics

Risk & Reward: The Divorce That Will Never Happen

Risk?

Equity Stakeholders

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?

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Important Types of Discriminatory Plans

1. **Discriminatory Cash Incentive Compensation**
2. **Simple Stock Bonus Taxable to the Executive & Deductible to the Company.**
   - **New issue shares are dilutive to the shareholders, including the ESOP**
3. **Restricted Stock**
   - **Can be voting and non-voting, in both S and C corporations, providing great flexibility in benefits.**
4. **Stock Options**
5. **Deferred Compensation**
   - **Can be a "defined benefit" or a "defined contribution" model.**
6. **Phantom Stock and Stock Appreciation Rights**
7. **Management Stock Purchase Plan**

To mention a few…
Our job here is to understand what works and why in an ESOP company with all of the interconnecting pieces.

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NCEO Executive Compensation Survey

1. **Between April and June of 2014, the NCEO conducted an online survey among ESOP companies on executive compensation.**

2. **We received a total of 374 usable responses from a diverse group of ESOP companies.**

3. **For more details about the study and the full report, visit our website: http://www.nceo.org/ESOP-Executive-Compensation-Survey-Results/m/87/.**

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Summary of Compensation Offered

% of companies offering each type of compensation*		CEO	CFO	COO	Top Div VP	Top HR Prof	Top Sales Exec	Top M/P/S VP
All Companies	Cash Incentive Pay	75%	82%	78%	80%	74%	80%	77%
	Stock-based Compensation	29%	31%	31%	30%	24%	26%	34%
	Qualified Retirement Plans	52%	51%	53%	53%	52%	53%	51%
100 or fewer employees	Cash Incentive Pay	69%	74%	73%	72%	66%	72%	63%
	Stock-based Compensation	19%	20%	24%	-	17%	21%	19%
	Qualified Retirement Plans	48%	48%	44%	46%	50%	49%	40%
More than 100 employees	Cash Incentive Pay	78%	85%	81%	83%	77%	83%	84%
	Stock-based Compensation	34%	36%	34%	37%	26%	29%	41%
	Qualified Retirement Plans	54%	53%	58%	56%	53%	55%	56%

***Percentages are figured from among respondents who answered the base pay question for that officer.**

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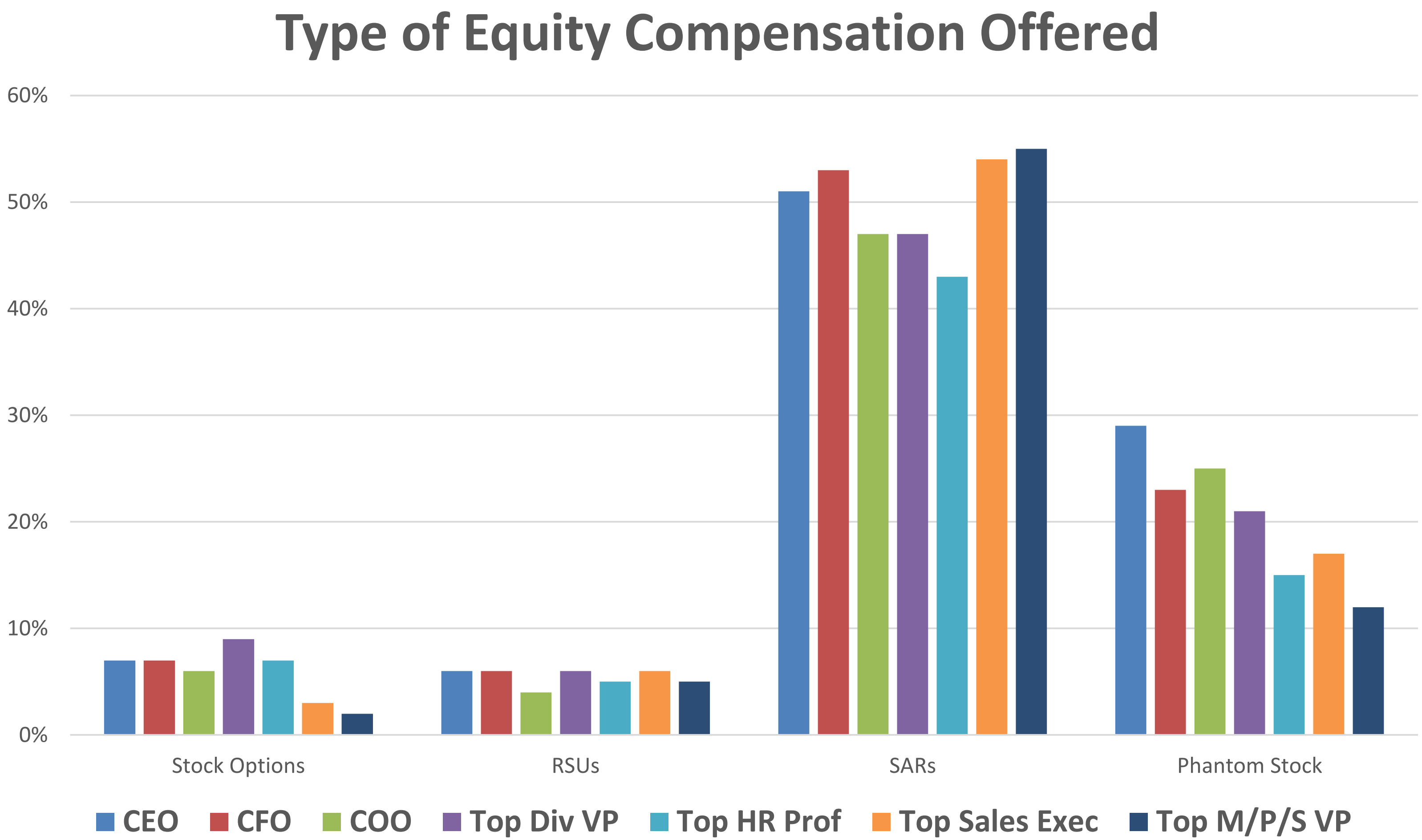
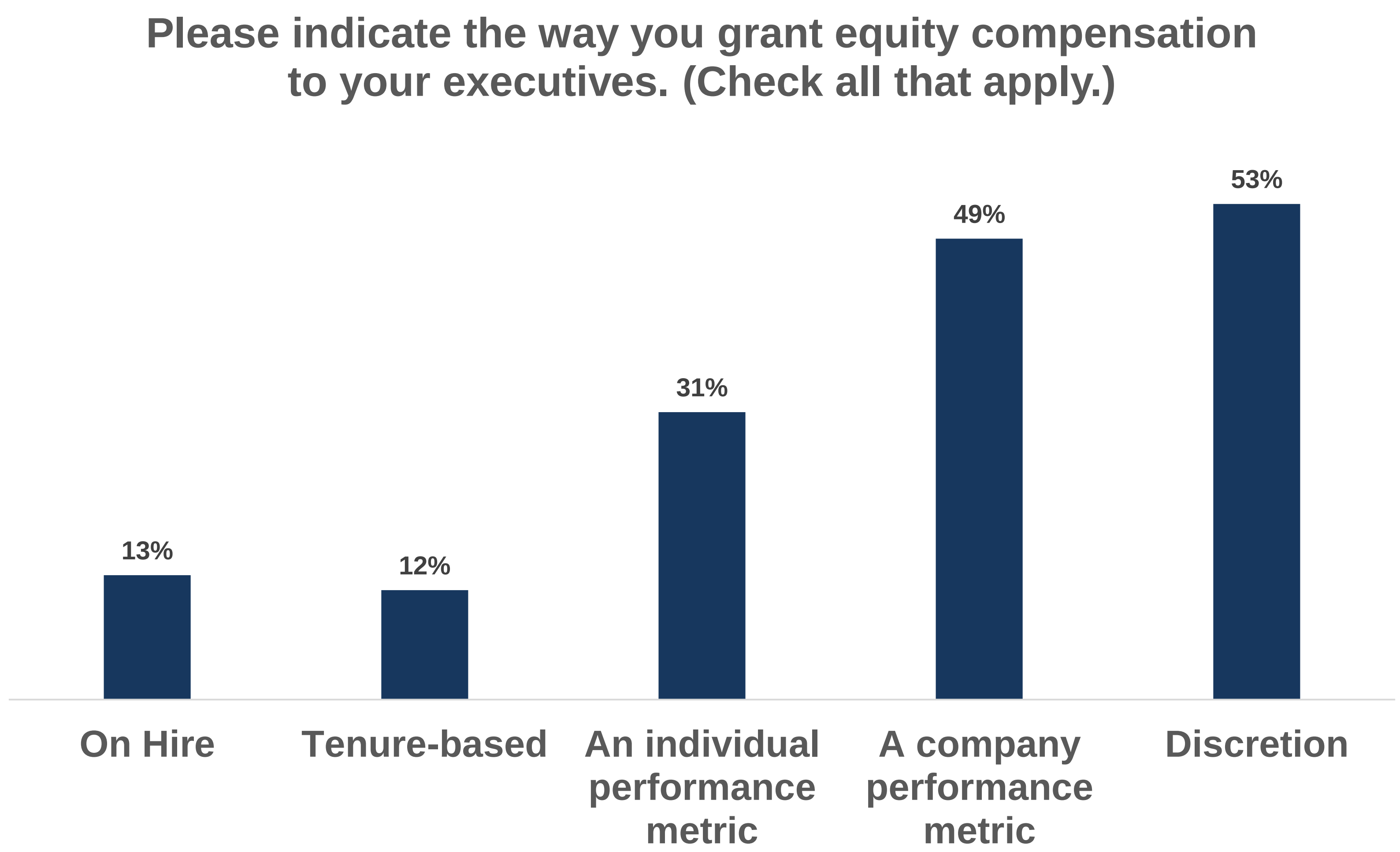
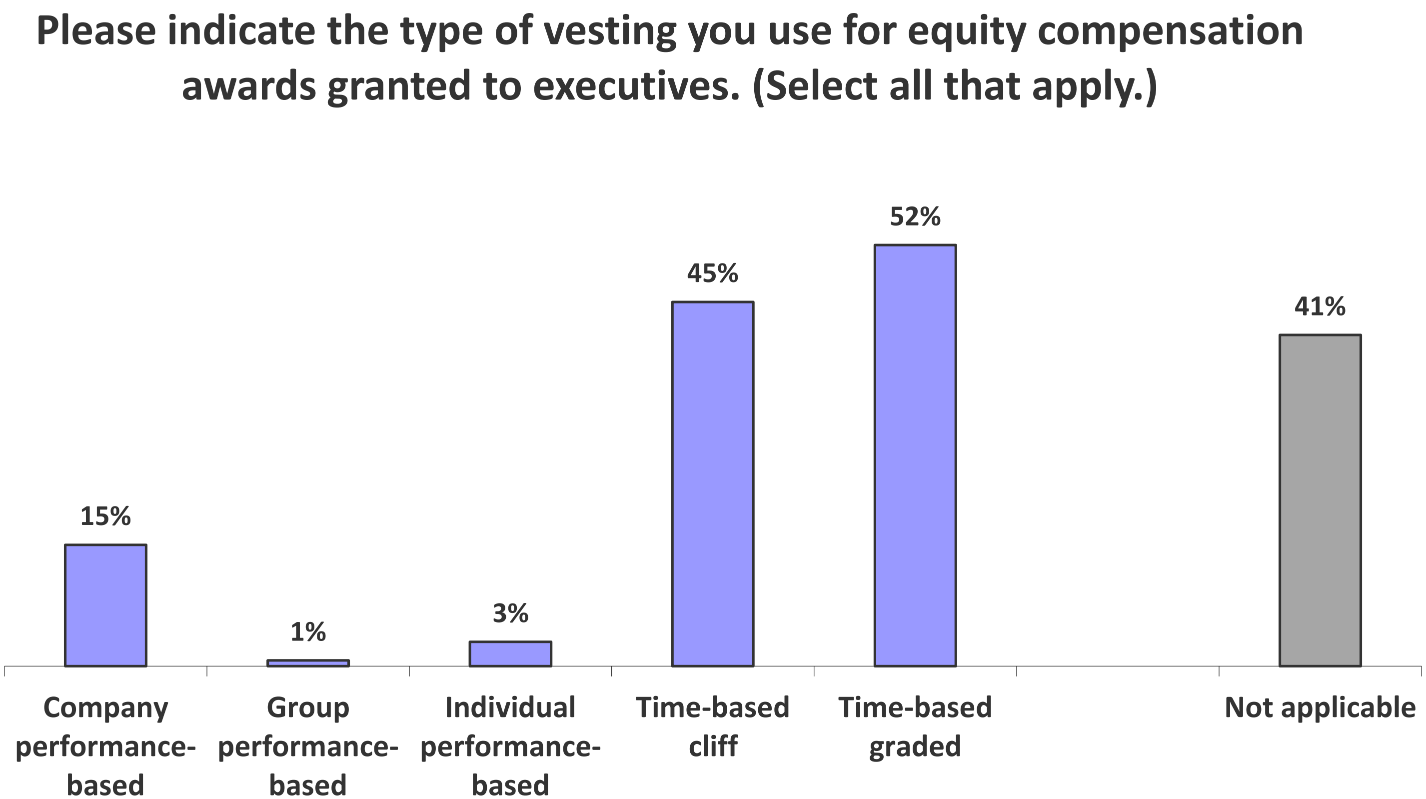
Equity Compensation



Granting Equity Compensation

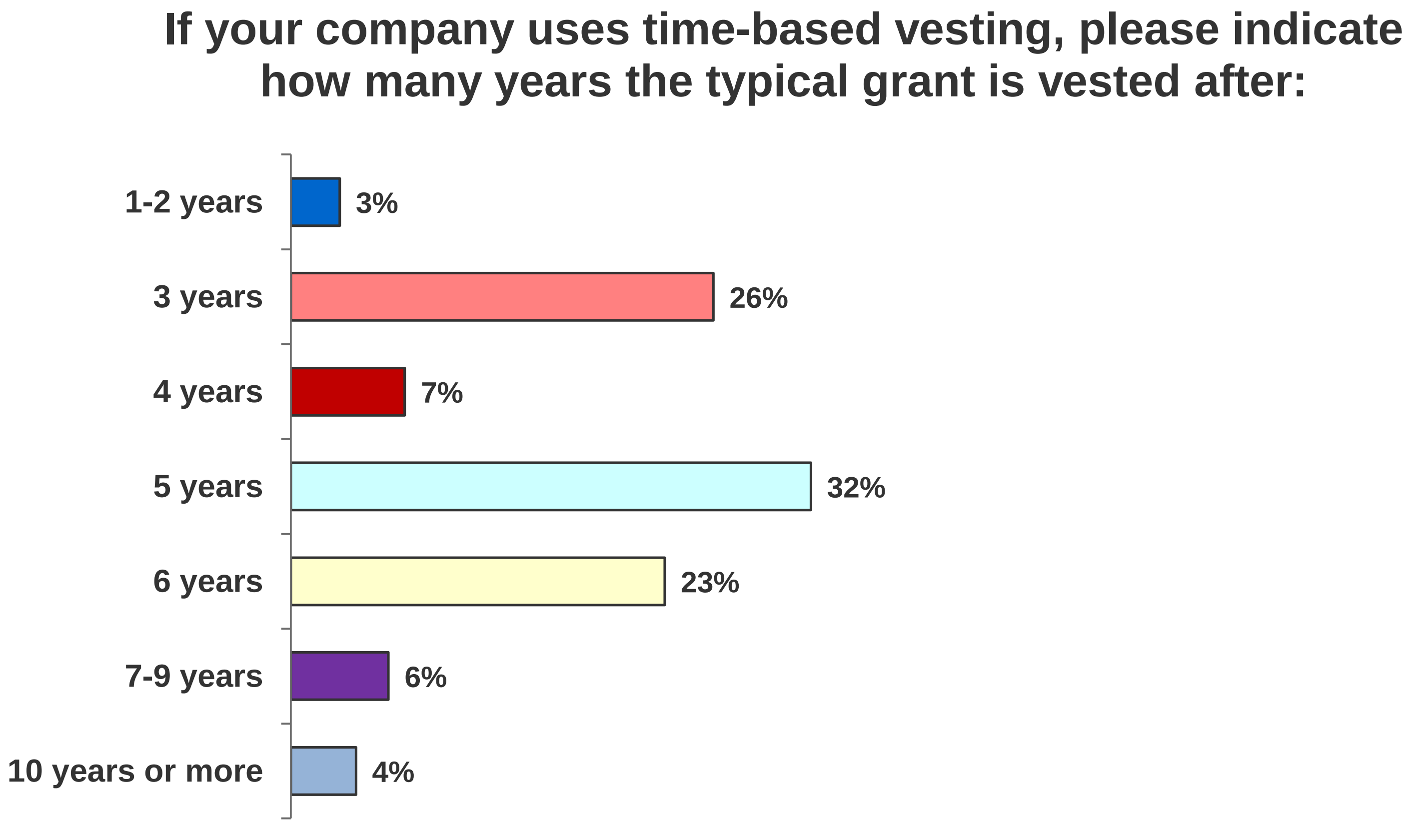


Vesting for Equity Compensation



Among respondents who grant equity compensation awards
N=157

Time-Based Vesting



Using incentives to drive performance is seen as essential to many companies.

*"We find performance bonuses incentivize employees, **especially when clearly laid out**." [emphasis added]*

"Base pay at market, cash bonuses based on annual performance, stock based on multi-year performance. We want to keep people focused on near and long term, plus on individual as well as total team performance."

"Those who can easily influence profits because they have authority over sales (salary should be less than half their compensation, with bonuses and commissions totaling more than one half), and those who cannot easily influence profits (e.g. CFO), so their salary should constitute most of their total compensation package."

1. Communication is key.
2. Companies are balancing long and short-term goals, and individual and company performance.
3. One company describes a distinction based on influence over profit.

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Stock Options with a Majority Interest ESOP

A Cautionary Tale of Unintended Strategic Consequences

1. The 200-employee S corporation, a service company with knowledge workers, was well suited to be an ESOP company.
2. Key employees needed to be incentivized and stock options representing 18% of the equity had been issued. The options did not participate in the profits or losses.
3. The ESOP owned the remaining 82%, so the company was functionally tax-exempt.
4. The tax exemption and the motivated key executive group caused the share price to appreciate at an average of 17% annually for 5 years. Good, right?
5. The options were "in the money," participants were happy….
6. But what about the stock repurchase obligations of the 82% ESOP?

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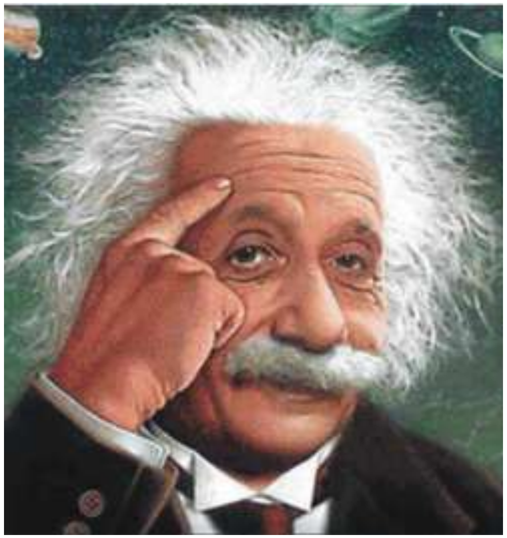
Stock Options + 82% ESOP + 17% Growth



Let's see if we can figure this out.

1. The ESOP stock repurchase obligations projected over the coming decade were $13.8 Million cumulatively, if future growth reverted to just 5% annually.
2. If the 17% annual appreciation continued, the 10-year cumulative buybacks were $27.9 Million.

1. While the option holders could enjoy the significant upside, they will want a market for their shares after they exercise the options. Can the ESOP make a market without impairing the value for others in the option program?
2. The very high growth rate is not sustainable.
3. The end game for many option holders is a strategic sale of the company
4. The management's desire to manage the share price for long-term sustainability and lower repurchase costs conflicted with the minority option holders desire to accelerate the share price appreciation.

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What Was Right, What Was Wrong with This

1. Thoroughly incentivizing key players was a great idea
2. Linking the options directly to the share price appreciation meant that the ESOP stock buybacks increased exponentially with the corresponding increase in the option value.
3. The options were treated as "synthetic equity" under IRC § 409(p) anti-abuse rules – which put an upper bound on the totality of options and the ESOP ownership by option holders
4. Option holders who paid to exercise them would typically look for a liquidity event for their shares – a cost to the company (given the gains) in addition to the repurchase obligations.
5. If after exercise, the new shareholders kept their stock – the corporation would have taxable minority shareholders in this S corporation – no longer 100% tax exempt.

This is just one example of some unintended consequences…Let's look at the data on what companies have actually been doing for key folks.

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Deferred Compensation with an ESOP?

1. Discriminatory deferred compensation is just a promise of the company to pay ordinary income to an executive at a later date in compliance with 409A (and 409(p) for S corporations).
2. Any "funding" is an asset of the corporation: in a 100% S ESOP, the assets go untaxed to the DC plan, accumulate untaxed and are taxed to the recipient when paid out.
3. This obligation can take the form of a defined benefit in the future or a pay-as-you-go plan to accumulate a benefit over time based on an evaluation of executive performance annually.
4. The defined benefit has an NPV which is a hit to value (not generally recommended with an ESOP)
5. The pay-as-you-go can be tailored each year to reward the executive and have the desired effect on the stock value.

Here's an example =>

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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**

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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

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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

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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

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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>**

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What About Current Cash Compensation?

1. **First, base compensation and cash bonuses must be peer group competitive; a compensation study can readily ascertain that.**
2. **Performance bonuses should be a percentage of base comp and tied to individual results.**
   - **<u>They are needed in nearly all cases</u>, but do not always effectively recruit or retain key personnel…can be viewed as a kill-and-eat benefit.**
3. **To have your key people align their interests with the fate of the company, the delayed gratification of success and the potential for loss are critical. Just as for any owner – again the appropriate risk and reward.**

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Employee Perceptions

Who Benefits and How?

1. **Fairness is a huge deal for executives (and employees)…often as important as the financial benefits.**
2. **Some folks will always think you are moving the peas under the shells. You can't worry all that much about them.**
3. **You can focus on those who are both important and responsive to incentives.**
4. **Companies will always need to have an 'elite' group – care must be taken to focus less on status and more on the alignment of interests.**
5. **Disclosure? The availability of special programs and their general outlines will be part of the inevitable information leakage, but specific terms and conditions should be confidential.**

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Some 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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Some 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) Recruit, 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)

<u>Key Executives</u>

Unfunded

No Guarantee

Greater Return

Last in Line

Risk

Reward

<u>Non-Key Personnel</u>

ESOP Funded

No Guarantee, but Lower Risk

Lower Return

First in Line for Funding & Payouts

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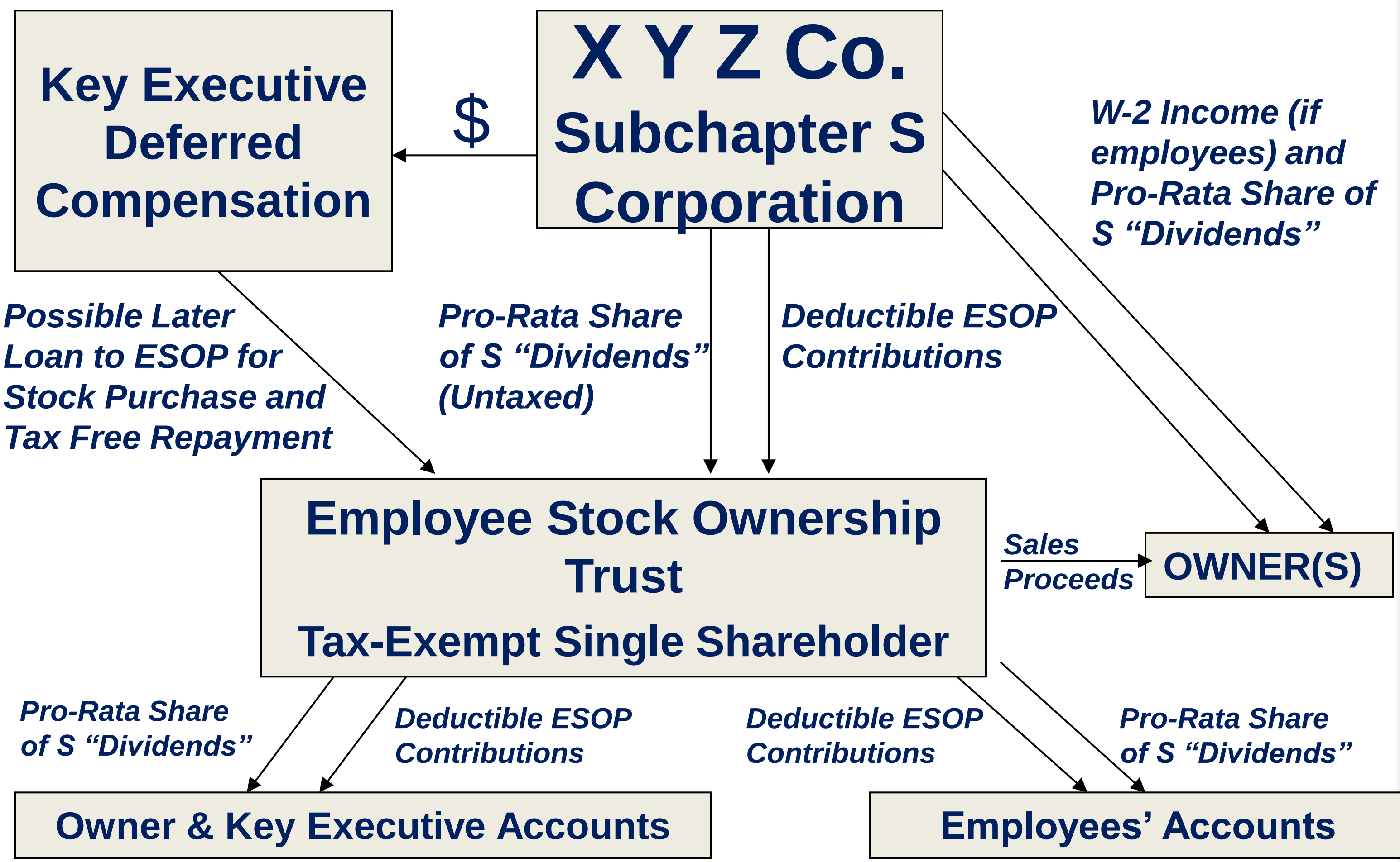
A Helpful Diagram for Discussion
Private Company Example: The Sub S ESOP

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



When Considering Benefit Structures, Take All Benefits into Account!

Questions?

Thank You!

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