EXECUTIVE COMPENSATION IN ESOP TRANSACTIONS AND ESOP COMPANIES

ESOP ASSOCIATION

MID-ATLANTIC & CAROLINAS CHAPTERS

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KAUFMAN & CANOLES attorneys at law

CHARTWELL

The McLean Group

Matt Keene
Chartwell
(919) 615-0402
matt.keene@chartwellfa.com

Christopher L. McLean
Kaufman & Canoles
(757) 624-3171
clmclean@kaufcan.com

Andy Smith
The McLean Group
(703) 827-0233
asmith@mcleanllc.com

CHARTWELL

KAUFMAN & CANOLES

The McLean Group

KAUFMAN & CANOLES
attorneys at law

CHARTWELL

The McLean Group

DESIGNING A COMPENSATION PROGRAM

Seattle CEO to cut his pay so every worker earns $70,000

SEATTLE — Dan Price, chief executive of Gravity Payments, a credit card payment processing firm, stunned his 100-plus workers on Monday when he told them he was cutting his roughly $1 million salary to $70,000 and using company profits to ensure that everyone there would earn at least that much within three years.   He's already gained new customers, too. For some workers, the increase will more than double their pay. One 21-year-old mother said she'll buy a house.

Compensation Philosophy Statement

- Expresses company's intent regarding executive compensation
- Helps to evidence a reasoned process
  - Document, document, document!
- Often discusses:
  - Positioning on total pay
  - Aligning pay with corporate objectives
  - Process for setting pay
- Should discuss tie to company culture

Targeted vs. Observed Results

		Base Pay			
Source	**Revenue**	**Below 25th**	**26th - 50th**	**51st-75th**	**Above 75th**
2011 PFG Survey: Targeted Result	**$356**	**0%**	**43%**	**48%**	**9%**
Chartwell 2015-16 Actual Observations	**$124**	**32%**	**40%**	**20%**	**9%**

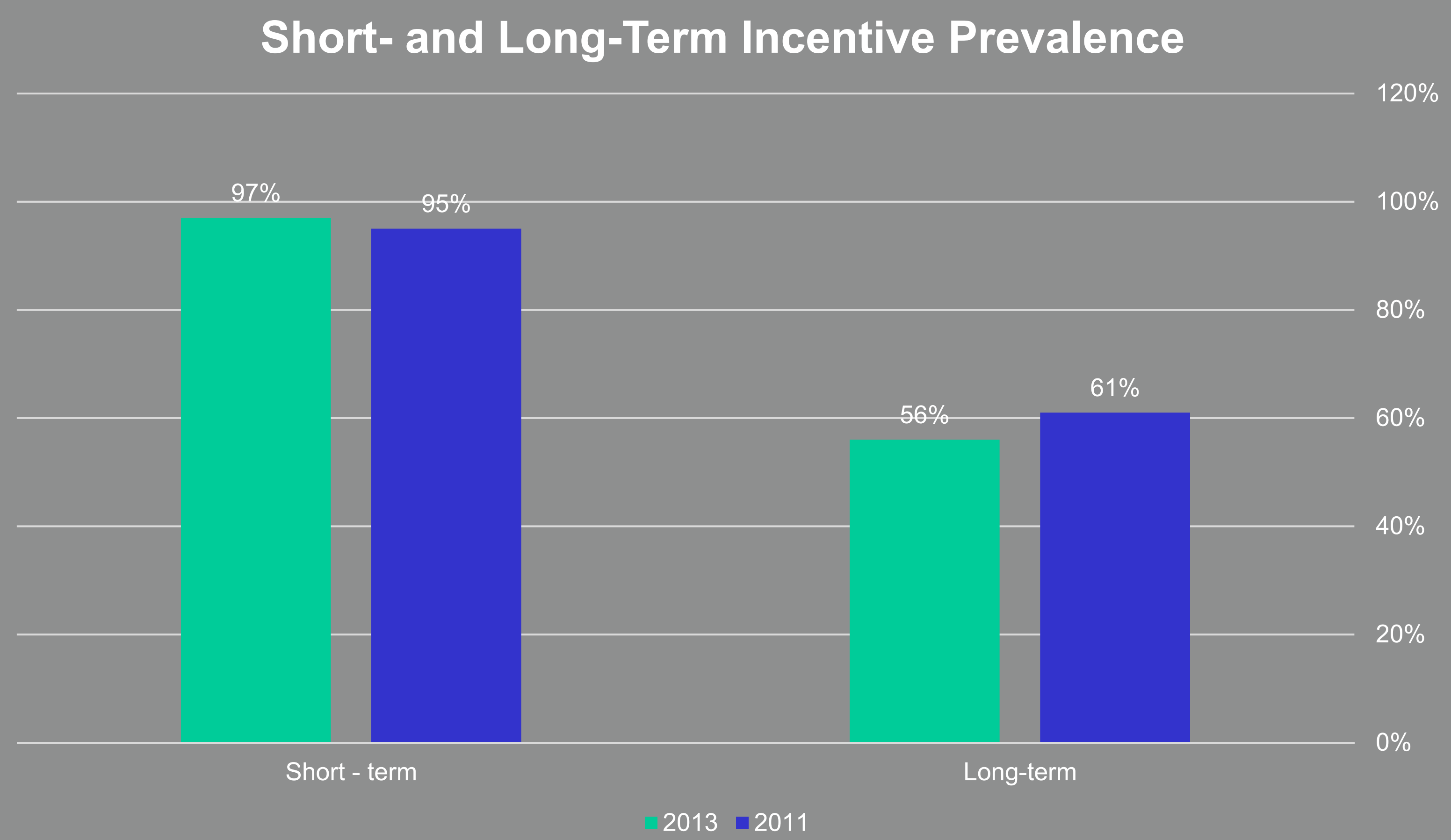
Source: Principal Financial Group 2011 Survey of Compensation Practices of Selected S Corporations with Majority ESOP Shareholder

Targeted vs. Observed Results

		Total Cash Compensation			
Source	**Revenue**	**Below 25th**	**26th - 50th**	**51st-75th**	**Above 75th**
2011 PFG Survey: Targeted Result	**$356**	**5%**	**23%**	**54%**	**18%**
Chartwell 2015-16 Actual Observations	**$124**	**13%**	**36%**	**36%**	**15%**

Source: Principal Financial Group 2011 Survey of Compensation Practices of Selected S Corporations with Majority ESOP Shareholder

Incentive Pay



Source: WorldatWork and Vivient Consulting: Incentive Pay Practices Survey: Privately Held Companies 2014

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"Benefits" of Long-Term Incentives

- Retention
- Recruitment
- Alignment of management interest with the shareholders (the ESOP)
- Motivates performance to achieve targeted financial objectives
- Wealth accumulation based on financial performance
- Targeted to key employees

Overview of Equity Incentive Plans for ESOP Companies

- Management incentive plans are not unique to ESOP companies
- These incentive plans can meet a variety of goals
  - Retention of key employees and contributors
  - Alignment of interests between management and shareholders
  - Provides performance incentives
- Can and should be used in 100% ESOP-owned companies
- Management incentive plans can take numerous forms
  - Profit sharing plans
  - Discretionary bonuses
  - Equity based compensation
- Equity based compensation will be our focus

Equity Based Deferred Compensation Vehicles

- Equity Based Awards
  - Phantom Stock (synthetic)
  - Stock Appreciation Rights (SARs) (synthetic)
  - Warrants
  - Restricted Stock Units (RSUs) (synthetic)
- Pure Equity Awards
  - Stock Options (can be either qualified or non-qualified)
  - Restricted Stock
  - Employee Stock Purchase Plan
- Cash Awards
  - Bonus Plan (short term or long term)
  - Incentive Payments
  - Nonqualified Deferred Compensation

Use of Phantom Equity Programs

- Phantom equity programs such as phantom stock and SARs are chosen for specific reasons
  - o Company may not want employees to own shares or may have no shares available to offer to employees
  - o Broader stock ownership may create control issues - and may raise securities law compliance issues
- There are also arguments against phantom equity programs
  - o Phantom Equity is generally not tax-efficient
  - o Awards may not be viewed by employees as valuable

Stock Appreciation Rights

- Participant receives a promise to pay the appreciation in value of a defined number of shares in the future
  - o Deferred award is based on appreciation in the equity of the company over the term of the award
  - o Participants can generally exercise SARs at any time after vesting
  - o Participant generally receives excess of value over exercise price in cash
  - o No risk of loss to participants
  - o Can be paid in cash or stock-settled
  - o SARs are taxable at exercise
  - o Can be designed to be 409A exempt

Value of Common Equity Awards

Value of One Share or Unit

	Grant 2015	2016	2017	2018	2019	Vest 2020	Payout Value
Share Price	$10	$11	$12	$13	$14	$15	
Restricted Stock or Phantom Stock	$10	$11	$12	$13	$14	$15	$15
Stock Option or SAR	$0	$1	$2	$3	$4	$5	$5

- Restricted stock or phantom stock are full value awards
- Stock options or stock appreciation rights are appreciation only awards

Internal Revenue Code Section 409A

Section 409A Overview

A deferred compensation plan must provide that deferred compensation can be paid only upon the occurrence of one or more of the following events:

- Separation from Service
- Disability
- Death
- Specified time or pursuant to a fixed schedule
- Change in Ownership
- Unforeseen Emergency

The plan must not permit acceleration of the time or schedule of payments under the plan – ("hair cuts" are no longer permitted)—certain exceptions to rule

Acceleration of vesting of deferred benefits is permitted

Section 409A (cont'd)

- The plan must irrevocably specify the amount, time of payment and form of payment of deferred compensation
- Violations of 409A will result in a 20% penalty, income inclusion, and additional interest rate on the tax on the income for an earlier year
- SARs do not constitute deferred compensation under 409A if structured properly
- Consult your lawyer and ask whether your company's plan is Section 409A compliant or subject to an exemption

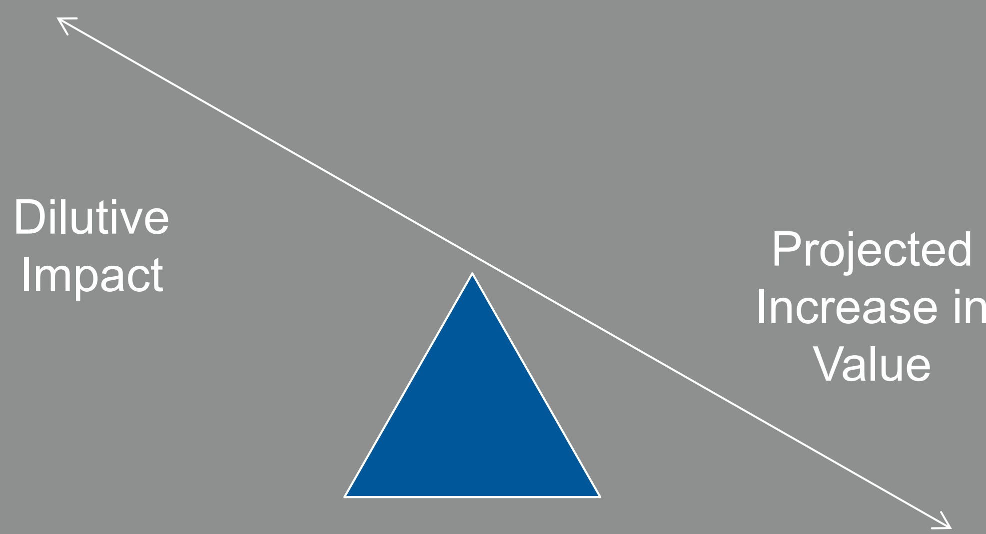
Valuation Impact

Valuation Methodology

- Valuation issue at the time of an ESOP transaction and annual valuation
- Intrinsic Value Method
  - Based on the difference between the FMV of the underlying stock and the “exercise” or “strike” price on the derivative security
  - Affects the valuation for the cash impact to the company upon exercise (treasury stock method)
- Option Pricing Method
  - Values the derivative security inclusive of speculative value
  - Typically based on the use of the Black-Scholes Option Pricing Formula

Analysis of Economic Dilution

- Comparison of economic dilution vs. projected increase in value
- Dilutive impact should not be “unfair” to ESOP
- Analysis performed with assistance/input from financial advisor, attorney, and compensation consultant



Examining Impact of Economic Dilution

- No established test to confirm "unfair" economic dilution
- Trustee's examination of economic dilution should be a comprehensive, interactive process:
  - Financial Advisor
  - Compensation Consultant
  - Attorney
  - Accountant
- Show your process – discuss and document

Implementation

Implementing Executive Compensation Arrangements – How is the ESOP Involved?

- Corporate Governance Issues:
  - Approval of executive compensation arrangements may come from the Board of Directors, an appointed Compensation Committee, or the Company's Shareholders
  - Board has duty to act in best interests of company shareholders (shareholders elect the board)
  - Interested/conflicted Directors may desire outside review
  - Compelling reason for independent Board member(s)
  - Compensation consultant reports to independent Board member(s)
- Trustee represents ESOP's interest as a shareholder
  - Heightened scrutiny where there are no independent Board members
- Trustee's duty as an ERISA fiduciary is to act solely in the interests of ESOP participants and beneficiaries
- Fiduciary prudence – review/monitor the impact of executive compensation arrangements

Prudent Reviewing/Monitoring Executive Compensation Arrangements

- Questions for prudent review and monitoring of executive compensation arrangements:
  - What process is required for formal approval of the plan/arrangement?
    - Board approval?
    - Committee approval?
    - Shareholder approval?
    - Trustee Consent?
  - Examine independence of decision – are there any direct or indirect conflicts of interest?
    - Involve independent consultants and outside Directors
  - Have the appropriate processes and procedures been observed in making the decision?
  - Were alternative plans/arrangements considered?
  - How was the key group of management personnel determined?

Reviewing/Monitoring Executive Compensation Arrangements (Cont.)

- How was the amount of compensation determined (e.g. use of an independent compensation consultant)?
- How were the performance incentive goals determined (e.g. input from compensation consultant, accountants, attorney, financial advisor to ESOP)?
- Are the performance incentive goals consistent with:
  - Company's business plan for long-term growth (discrepancy between goals and business plan are problematic)
  - Cash flow projections applied in an annual valuation?
- Have any non-competition/non-solicitation provisions been negotiated?
- Are there any "2nd Class of Stock" concerns? (S-Corp)
- What happens in the event of a change-in-control?
- Does the arrangement comply with 409A? (Attorney)
- How is the plan modified/amended?

Important Features For Consideration In Reviewing/Monitoring Executive Compensation

- Performance vesting of awards
  - Time vesting not enough in many instances
  - Trend is to also have performance hurdles for at least a portion of vesting of awards (ROI, EBITDA growth, etc.)
- Forfeiture for cause provisions
  - Prevents payment to bad actors
  - May be in plan, award or employment agreements
- Clawbacks
  - Requires repayment for issues arising after awards vest
  - Restatements of earnings, other material irregularities
- Specific provisions for change of control payments
  - Escrows
  - Earn-outs

POTENTIAL PITFALLS

Do Incentives Work?

- They may not motivate employees over the long run (motivation is intrinsic)
- They could produce burnout
- They may lead to myopia if improperly structured
- If properly structured, they can:
  - Solidify link between employees' efforts and successful company outcomes
  - Make employees feel like valued partners
  - Encourage creativity in spurring results

GENERATIONS AT WORK

MILLENIALS	GENERATION X	BABY BOOMERS	SILENT GENERATION
Invented the word: **Work-Life Integration**	Invented the word: **Work-Life Balance**	Invented the word: **Workaholic**	Invented the word: **Lifer**
Value open communication and positive reinforcement	Work smarter, not harder	Work ethic equals hours worked	Believe promotions, raises and recognition should stem from tenure
Value leadership and training	Look for a person to whom they can invest loyalty	Less importance placed on productivity	Take pride in working long hours
Need personal fulfillment	Work is a source for lifelong learning	Value meetings	Loyal to employers, expect the same
Value job title and vacation time	Expect to enjoy their work and have fun doing it	Teamwork is critical to success	Posses superb inter-personal skills
Seek out co-workers who help them achieve	Value control of their time	Can be intimidated by computerized processes	Measure work ethic on timeliness, productivity

FINAL POINTS

Conclusions

- Equity incentive compensation plans are important to help align the economic interests of management and the ESOP
- If performance based, equity incentive compensation plans are not immediately dilutive to the ESOP and are only related to future appreciation
- Best performance-based measures:
  - Achievement of certain financial benchmarks (i.e. revenue and profitability)
  - Debt repayment
  - Impact vesting
- The value of the equity holders' interest is diluted by the value allocable to the derivative security

Communicate

- Assumptions:
  - o Employees understand our bonus drivers
  - o Executives understand LTIP awards
- Reality:
  - o Program details are often misunderstood
  - o Companies miss a chance to reinforce the link between employee efforts, key company goals and successful outcomes

QUESTIONS?

Matt Keene
Chartwell
(919) 615-0402
matt.keene@chartwellfa.com

Christopher L. McLean
Kaufman & Canoles
(757) 624-3171
clmclean@kaufcan.com

Andy Smith
The McLean Group
(703) 827-0233
asmith@mcleanllc.com

APPENDIX

Why Mid-term Incentives

- We see strong interest in mid-term incentives (3-6 years)
  - Key employee retention
  - Fosters annual grants tied to performance (no "coasting" as sometimes seen with high-value, one-time grants)
- Repurchase liability for pay-at-separation LTIP can be pronounced and punctuated for both company and participant

Mid-term Incentive Example

Annual Grants; $100,000 Vested Value at Payout

Grant Year	2014	2015	2016	2017	2018	2019
2014	1,000	1,000	1,000			
2015		1,000	1,000	1,000		
2016			1,000	1,000	1,000	
2017				1,000	1,000	1,000
Total Units Outstanding	1,000	2,000	3,000	3,000	3,000*	3,000*
Cash Payouts						
2014 Grant				$ 100,000		
2015 Grant					$ 100,000	
2016 Grant						$ 100,000
Total Dollars to Exec	$ -	$ -	$ -	$ 100,000	$ 100,000	$ 100,000

*Post 2017 grants not shown to save space, but 3,000 total units are outstanding

Warrants

- Long-term certificate giving holder right to purchase securities at designated price
- Similar to stock options with some significant differences
  - o Warrants are generally freely tradable
  - o Taxation of warrants is subject to section 83
    - ➢Warrants issued in connection with the performance of services and without a substantial risk of forfeiture are subject to immediate income taxation
- Warrants are rarely used by private companies as a form of equity compensation—used more in connection with transactions.

Restricted Stock Units

- Restricted stock units are similar to phantom stock except that awards are paid in shares of the underlying stock
  - o Participant has right to receive shares at a future date or upon lapse of a risk of forfeiture
  - o Differs from restricted stock as there is not opportunity for a 83(b) election as there is no transfer of property on grant
  - o RSUs may or may not have a dividend equivalent
  - o RSUs carry no voting rights

SARs & Section 409A

A Stock Appreciation Rights Plan ("SAR") does not constitute deferred compensation for 409A purposes if (i) compensation under the SAR cannot be greater than the excess of the fair market value of the stock on the date of grant of the SAR with respect to a number of shares fixed on or before the date of grant of the right, (ii) the SAR exercise price may never be less than the fair market value of the underlying stock, when (iii) the SAR does not include any feature for the deferral of compensation other than the deferral of recognition of income until the exercise of the SAR.

Internal Revenue Code Section 409(p)

Equity Based Compensation and S Corporation ESOPs – Code §409(p)

- Non-allocation year
  - Non-allocation year occurs when 50% of ownership of S corporation stock is owned by “disqualified persons”
  - Ownership includes “deemed owned shares” and “synthetic equity”
- Disqualified person
  - An individual who owns at least 10% of deemed-owned shares
  - An individual, who with his family (family is broadly defined), owns at least 20% of the deemed owned shares
  - Synthetic equity included in calculation

Equity Based Compensation and S Corporation ESOPs -- The Impact of §409(p)

- §409(p) imposes a 50% excise tax on a "prohibited allocation" of stock in ESOP to disqualified person and value of "synthetic equity" owned by disqualified persons
  - o Tax is imposed on fair market value of deemed-owned shares held by ESOP for a disqualified person
- Prohibited allocations are treated as distributions and included in income of disqualified person
- <u>ESOP status will be lost if prohibited allocation occurs</u>
- §409(p) applies only to S corporation ESOPs. Does not apply to C corporations

What constitutes “synthetic equity” for §409(p)?

Equity-based deferred compensation programs

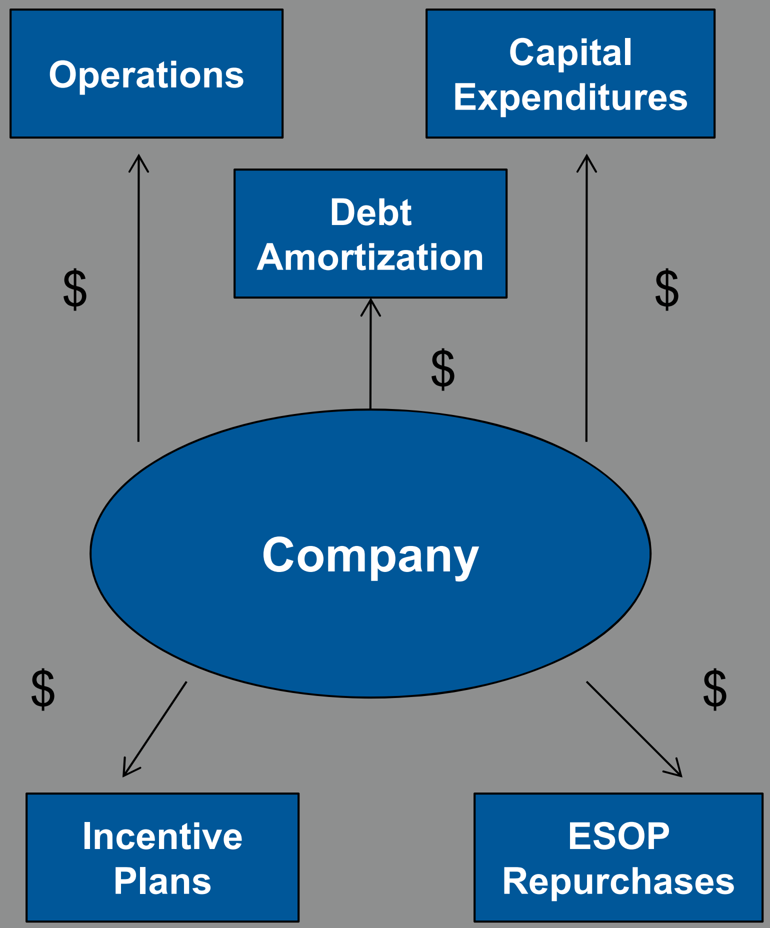
- o Stock appreciation rights, phantom stock, restricted stock units and other programs based on future value of underlying stock
- o Stock options, warrants, and restricted stock
- o Deferred compensation arrangements

Valuation Overview – Potential Impact on Annual Administrative Valuations

- The terms of the plan are key to analyzing the dilution, including the related "benchmarks"
  - o If performance based benchmarks, the dilution is generally related to future appreciation
  - o If benchmarks are strictly driven by the passage of time, the dilution may be more immediate
  - o The relevant "exercise" or "strike" prices for the plans are typically based upon the post-transaction ESOP values (which incorporates the effect of any transaction debt)
- Valuation approaches for the equity based compensation include an "Intrinsic Value Method" and an "Option Pricing Method"

Cash Flow and Valuation Impacts

- The dilution from the management incentive plans is incorporated into the annual ESOP valuations (i.e., management's "claim" to value)
- Consideration also needs to be given to the cash impacts of management exercising the units that they own
    - Cash is typically required to fund the obligation unless stock is issued (100% S-Corp considerations)
- Important because it impacts the amount of cash available to the company to fund operations, pay debt, expand and grow business, and fund repurchase obligations



Additional Concerns

- Understand the impact of arrangement on annual valuation
  - short-term vs. long-term
- Implementation in transaction
  - Negotiations can impact the final terms of the plan/arrangement
  - May see less sharing of analysis from fiduciary
- Non-transaction implementation
  - Focus on conflicts of interest
  - Successor trustee issues reviewing previously established plan
- Obsolescence of plan/arrangement
  - Unforeseen circumstances (e.g. significant downturn in economy)
  - Amendment and redesign concerns
- 409A issues
- Impact on repurchase liability, corporate acquisitions
- Communicating to ESOP participants

Trustee Focus in Reviewing Executive Compensation Arrangements

- Properly designed arrangement creates a “win-win” for both key management personnel and ESOP participants
- An effective design will achieve the following:
  - Entitlement to benefits comes from achieving real, measureable performance goals
  - Benefits should be EARNED
  - Satisfaction of performance goals(s) drives growth in Company stock value and offset any <u>economic dilution</u> of ESOP shares
  - Aggregate compensation paid to key management personnel is reasonable, yet competitive (analytical support from compensation consultant)
  - Long-term retention of key management personnel

Best Practices

- Review and understand existing corporate governance requirements
- Focus on independence of decisions (conflicts of interest)
- Use your teammates (financial advisor, attorney, compensation consultant, etc.) to assist you in examining the reasonableness of performance goals and compensation levels
- Understand impact on valuation
- Ask questions and document your process
- Remember your fiduciary duty – act solely in the interests of participants and beneficiaries (trustee) – act solely in the interests of shareholders (board of directors)