

Key Executive Compensation in ESOP Companies

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Agenda

- **Part I – General Considerations**
 - **What is “Executive Compensation” and Types**
 - **Legal Considerations**
 - **ESOP Valuation/Fairness Considerations**
- **Part II – Implementation Considerations**
 - **Reviewing and Monitoring**

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PART I – GENERAL CONSIDERATIONS

What is Executive Compensation?

- **Executive compensation is composed of the financial compensation and other non-financial awards received by an executive from their Company for service to the Company**
- **Remember, it is the role of the Board of Directors to set the Executive Compensation for management team of the Company**

“Benefits” of Long-Term Incentives

- **R**etention
- **R**ecruitment
- **A**lignment of management interest with the shareholders (the **ESOP**)
- **M**otivates performance to achieve targeted financial objectives
- **W**ealth accumulation based on financial performance
- **T**argeted to key employees

Benefits of “Mid-term” Incentives

- **Growing interest in mid-term incentives (III-L years)**
 - **Key employee retention**
 - **Fosters annual grants tied to performance (no “coasting” as sometimes seen with high-value, one-time grants)**

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Equity Based Incentive Plans

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**

Overview of Equity Incentive Plans

- **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**

Stock Appreciation Rights (“SARs”)

- **Participant receives a promise to pay the appreciation in value of a defined number of shares in the future**
 - **Participants can generally exercise SARs at any time after vesting**
 - **Participant generally receives excess of value over exercise price in cash**
 - **No risk of loss to participants**
 - **Can be paid in cash or stock-settled**
 - **SARs are taxable at exercise**
 - **Can be designed to be voma exempt**

Internal Revenue Code Section 701A

Section 70M(A) 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

Section v0mA (cont'd)

- **The plan must irrevocably specify the amount, time of payment and form of payment of deferred compensation**
- **Violations of v0mA will result in a 10% penalty, income inclusion, and additional interest rate on the tax on the income for an earlier year**
- **Consult your lawyer and ask whether your company's plan is Section v0mA compliant or subject to an exemption**
- **Stock Options and SARs do not constitute deferred compensation under v0mA if structured properly**

Internal Revenue Code Section 701(p)

S Corporations Only: IRC Section vom(p)

- i. **IRC Section vom(p)** is the so-called “anti-abuse” excise tax that can apply to an **S-Corp ESOP** 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)
- ii. Although vom(p) is quite complicated and beyond the scope of this outline, a vom(p) violation can trigger adverse income tax treatment for the disqualified person and a x0% excise tax on the corporation
- iii. **ESOP** qualified status will be lost if prohibited allocation occurs
- v. The key point: **Proper coordination of all facets of your incentive programs can avoid this nightmare**

Valuation and Fairness Considerations

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Valuation Overview

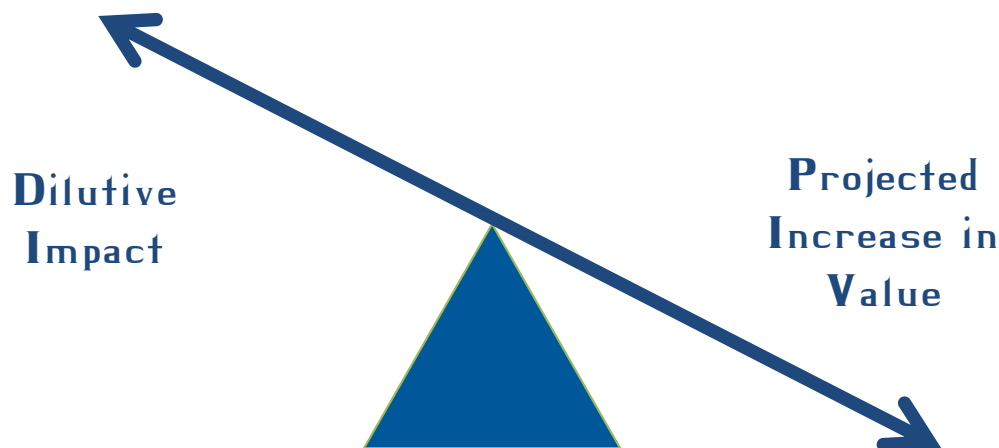
- **Valuation** is undertaken at the time of an **ESOP** transaction and, then, annual valuations thereafter
- **Make** sure that the **Executive Compensation** plans are being properly taken into consideration in **ESOP Valuations** (both transactional and annual)
- **Understand** what valuation method is being utilized to value the **Executive Compensation** plans/awards that are in place/issued
 - **Intrinsic Value Method** v. **Option Pricing**

Valuation Overview – Potential Impact on Annual Valuations

- **The terms of the plan are key to analyzing the dilution, including the related “benchmarks”**
 - **If performance based benchmarks, the dilution is generally related to future appreciation**
 - **If benchmarks are strictly driven by the passage of time (i.e. annual vesting), the dilution may be more immediate**
 - **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)**

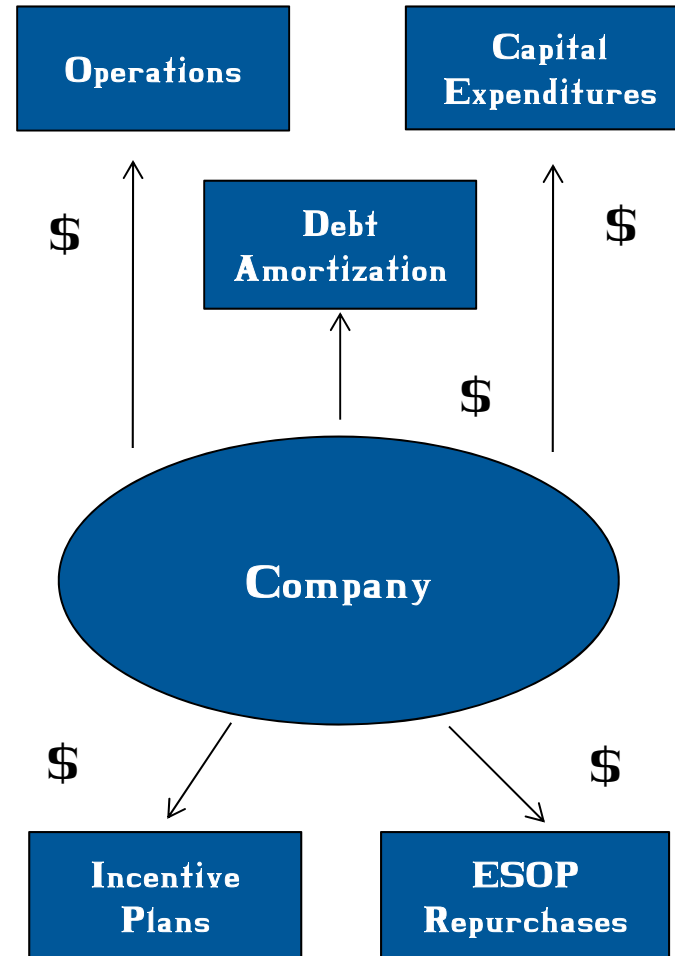
Analysis of Economic Dilution

- 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— **Document Process and Discussions!!!**



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 (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



Part II - IMPLEMENTATION CONSIDERATIONS

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

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

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 "11th Class of Stock" concerns? (**S-Corp**)
- **What** happens in the event of a change-in-control?
- **Does** the arrangement comply with **10b-18**? (**Attorney**)
- **How** is the plan modified/amended?

Reviewing/Monitoring Executive Compensation Arrangements (Cont.)

- **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

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, measurable performance goals
 - Benefits should be **EARNED**
 - Satisfaction of performance goals(s) drives growth in Company stock value and offset any economic dilution 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

Do Incentives Work?

- They may not motivate employees over the long run (motivation is intrinsic)
- They could produce burnout
- They may be shortsighted 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

FINAL POINTS

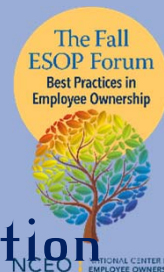
Don't Get Lost in the Weeds: Keep Objectives at the Forefront

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”

Additional Concerns

- **Understand the impact of arrangement on annual valuation**
 - short-term vs. long-term
- **Implementation in transaction**
 - **N**egotiations can impact the final terms of the plan/arrangement
 - **M**ay 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
- **voma** issues
- **Impact on repurchase liability, corporate acquisitions**
- **Communicating to ESOP participants**



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)**

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**

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- Christopher is a part of Kaufman + Canoles' ESOPs + Employee Benefits Group where he advises clients on a broad range of issues relating to qualified and nonqualified plans and corporate succession transactions. Christopher works with corporations and their shareholders in a wide range of M+A as well as exit transactions, including leveraged buyouts, stock sales and corporate redemptions, mergers, reorganizations, asset sales and purchases, and generational transfers.
- Christopher's employee benefits practice focuses on the design, implementation, maintenance and compliance of employee stock ownership plans. Christopher works with both ESOP Sponsors and ESOP Trustees in initial stock purchase transactions, second stage transactions and sale transactions of successful ESOP companies. Christopher also advises ESOP Sponsors in the management of mature ESOPs including evaluating repurchase obligation options, resolving administrative issues, counseling on acquisitions and secondary purchase transactions, and coordinating and designing executive compensation plans complimentary to ESOPs.
- Christopher's executive compensation practice involves a variety of nonqualified executive compensation plans. Christopher works with corporations in the design, adoption, implementation and compliance of nonqualified plans which have involved phantom stock, stock appreciation rights and other synthetic equity, stock options, restricted stock, deferred compensation and other executive compensation arrangements. Christopher also represents executives in the negotiation of executive compensation arrangements and employment agreements, taking an inclusive approach so to ensure the compensation structure is a part of the executive's broader trust and estate planning.

APPENDIX

Phantom Equity Programs

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

Warrants

- Long-term certificate giving holder right to purchase securities at designated price
- Similar to stock options with some significant differences
 - Warrants are generally freely tradable
 - 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**
 - **Participant has right to receive shares at a future date or upon lapse of a risk of forfeiture**
 - **Differs from restricted stock as there is not opportunity for a 83(b) election as there is no transfer of property on grant**
 - **RSUs may or may not have a dividend equivalent**
 - **RSUs carry no voting rights**

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**

Mid-term Incentive Example

Annual Grants; \$100,000 Vested Value at Payout

Grant Year	IIIV	IIIX	IIIL	IIIC	IIID	IIIM
IIIV	1,000	1,000	1,000			
IIIX		1,000	1,000	1,000		
IIIL			1,000	1,000	1,000	
IIIC				1,000	1,000	1,000
Total Units Outstanding	1,000	11,000	111,000	111,000	111,000*	111,000*
Cash Payouts						
IIIV Grant				\$ 100,000		
IIIX Grant					\$ 100,000	
IIIL Grant						\$ 100,000
	\$	\$	\$			
Total Dollars to Exec	-	-	-	\$ 100,000	\$ 100,000	\$ 100,000

*Post IIIC grants not shown to save space, but 111,000 total units are outstanding

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)

