EMPLOYEE OWNED 2019

Designing Executive Benefits in ESOP Companies

THE CONFERENCE & TRADE SHOW for ESOPs

Designing Executive Benefits in ESOP Companies

Cara Benningfield
Partner
BKD, LLP
cbenningfield@bkd.com

Frank "Chip" Brown
Sr. Vice President
TI-Trust
chip.brown@ti-trust.com

Mary Beth Gray
Managing Partner
Kleinbard LLC
mgray@Kleinbard.com

Preface

- Please fill out a session evaluation form and drop it off at the table outside of this room
- Your feedback on topics and presenters is important and will be used to develop subsequent TEA programs
- Take a moment to silence your cell phone
- Remember to get your CPE sheet stamped before and after each session for CPE credit

Setting the Stage

- ESOP provides long-term retirement benefits with an allocation formula that rewards all employees using a similar measurement (e.g., compensation or tenure or …).
- Because of limits determined by IRS guidelines as well as the ESOP allocation requirement, companies may want to provide additional benefits to certain key executives.
- In 100% ESOP companies, there may be a desire to avoid direct ownership of stock outside of the ESOP.
- Executive benefits should be designed to be consistent with the company’s (i) compensation philosophy, (ii) incentive structure for short-term performance and long-term retention, (iii) goals related to employee benefit expenses and (iv) compliance with relevant tax and benefit requirements.

EMPLOYEE OWNED 2019

Executive Compensation Overview

- Setting executive compensation levels is a business decision or judgment made in connection with the on-going operation of a business.
- Executive compensation is a business judgment which does not involve the administration of an ERISA plan or the investment of an ERISA plan's assets.
- Such a decision may ultimately affect a plan indirectly but it does not implicate fiduciary concerns regarding plan administration or assets.
- A business decision regarding salary levels does not meet this requirement.

The Process

- Board responsibility
- Keys
  - Avoid conflicts
  - Independent compensation committee and/or
  - Independent ESOP fiduciary oversight
- Obtain expert advice: e.g., by obtaining independent compensation study
- No conflict for board to set compensation for unrelated non-board members
- ESOP Trustee's Role
  - Monitor board
  - Board sometimes seeks "do not object" determination from trustee
  - Trustee may require independent compensation study
  - Trustee may consult attorney
  - Trustee will often consult appraiser regarding impact on ESOP value

EMPLOYEE OWNED 2019

Board Perspective

- Setting executive compensation and incentives a board responsibility
- Avoid conflicts of interest
- Consider independent compensation committee and independent ESOP fiduciary oversight
- Obtain expert advice: independent compensation study
- No conflict for board to set compensation for unrelated non-board members
- Get qualified third party advice
- Involve independent ESOP fiduciary
- Be fair
- Don't count on indemnification
- Record the process: write down not just what was done, but why

Trustee Perspective

- Trustee has a duty to monitor
- Notify trustee of equity awards
- Overall picture, does it make sense, who is included
- Understand the impact on the valuation
- Ensure that the valuation firm has accurate equity award information
- Management incentive plans are a key part of successful ESOP planning
- Key component of 100% ESOP owned companies
- Align interest of management and ESOP
- Often a mix of time and performance based management incentive

DOL Perspective

- Parrot Cellular – failure to consider deferred compensation liability in the valuation at the time of the transaction
- Sentry – failure to enter into employment agreements with lower compensation amounts vs. historical compensation amounts
- Tobacco Rag
  - failure to account for the dilutive impact on the stock of the warrants and stock appreciation rights issued as part of the stock purchase
  - adjustment to earnings for executive compensation, where no evidence indicated that the company's executives had agreed to cut their compensation
- Cactus Feeders - the purchase price failed to include sufficient adjustments for warrants and stock options
- Laser Skin Surgery –use of lower compensation in projections based on market data instead of actual higher compensation from employment agreements

The Process: (Bad) Example

- 2018 & 2019: approved restricted stock grants of 30%, subject to 10 year vesting with acceleration upon sale of company
- January 2020: commenced auction to sell company that would trigger vesting
- ESOP's share of sale went from 100% to 70% because of RSUs
- Price: $500,000,000 (5x 2018 ESOP value / 3.7x 2019 ESOP value)
- Management gave up no compensation to receive restricted stock
- No compensation study
- No independent board member
- Outside ESOP lawyer on board and received grant
- No independent trustee—inside ESOP trustees received grants

Board Participation is Key

- Capable outside directors are worth their weight in gold
- ESOP knowledge is secondary to industry and strategic expertise
- It is common to bring outside directors on as advisory directors to get a feel for their style before electing them to the full board

PAYING THE RIGHT EXECUTIVE SALARIES

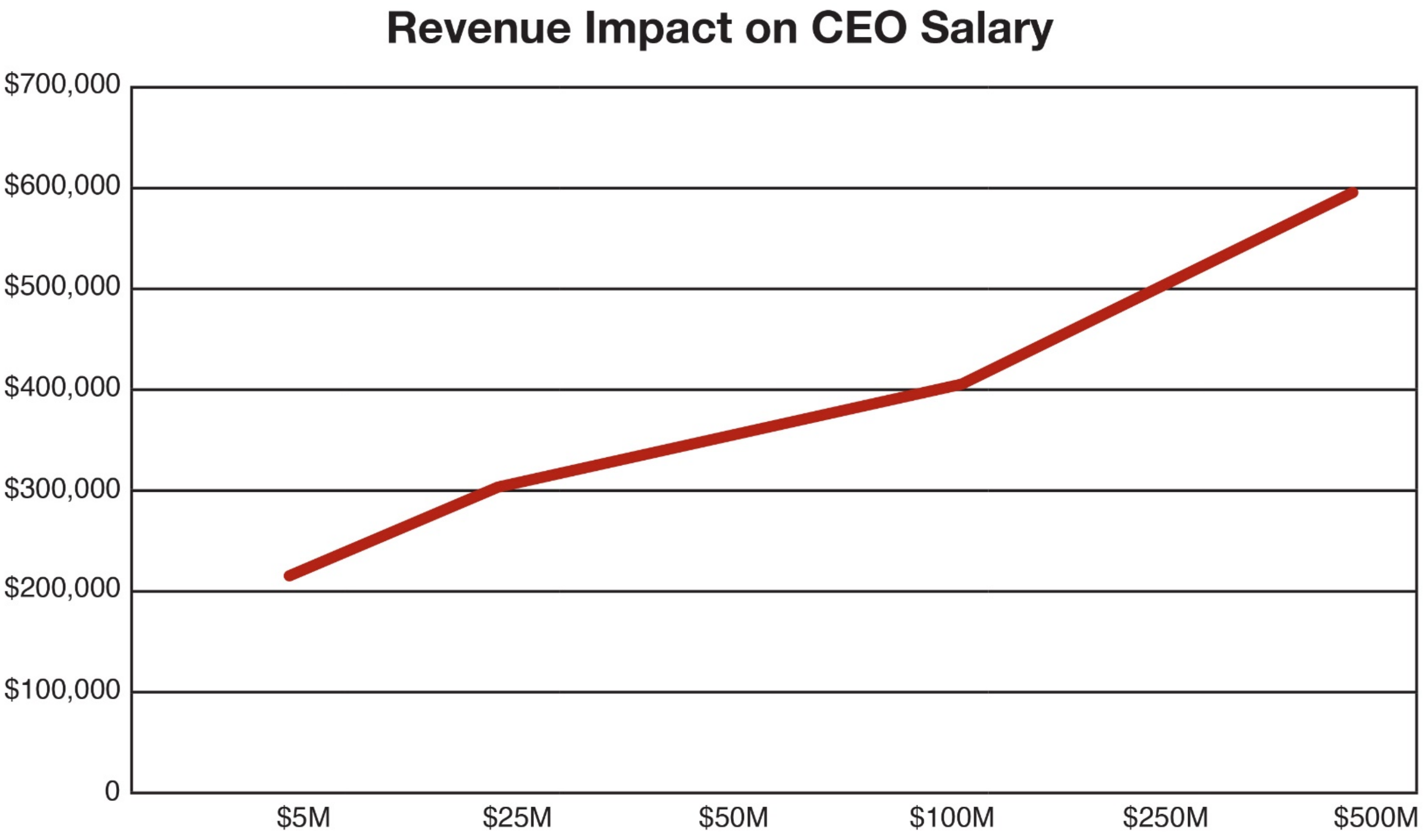
ROLE

INDUSTRY

VARIABLES THAT INFLUENCE EXECUTIVE COMP PAY LEVEL

COMPANY SIZE

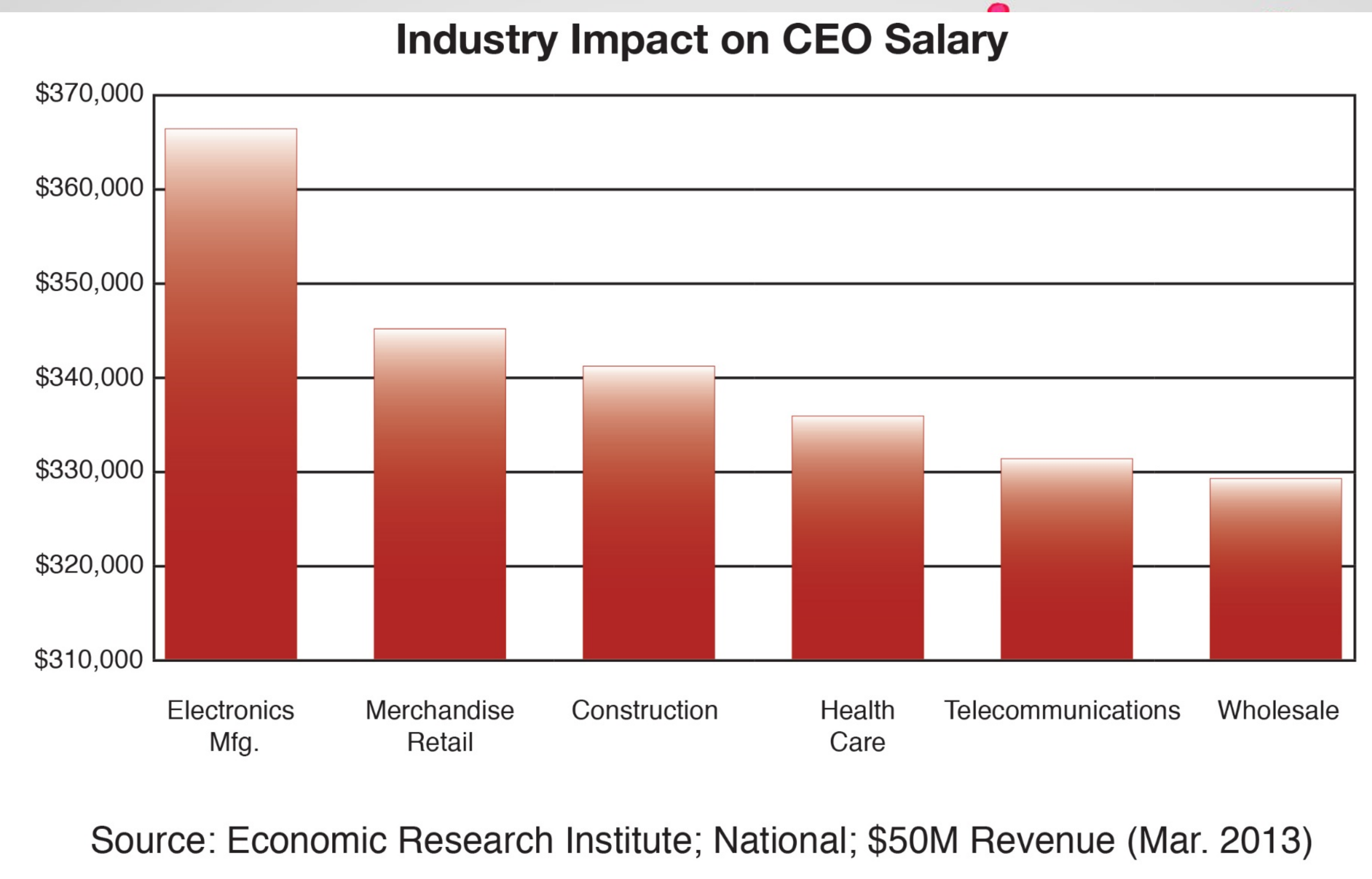
GEOGRAPHIC LOCATION

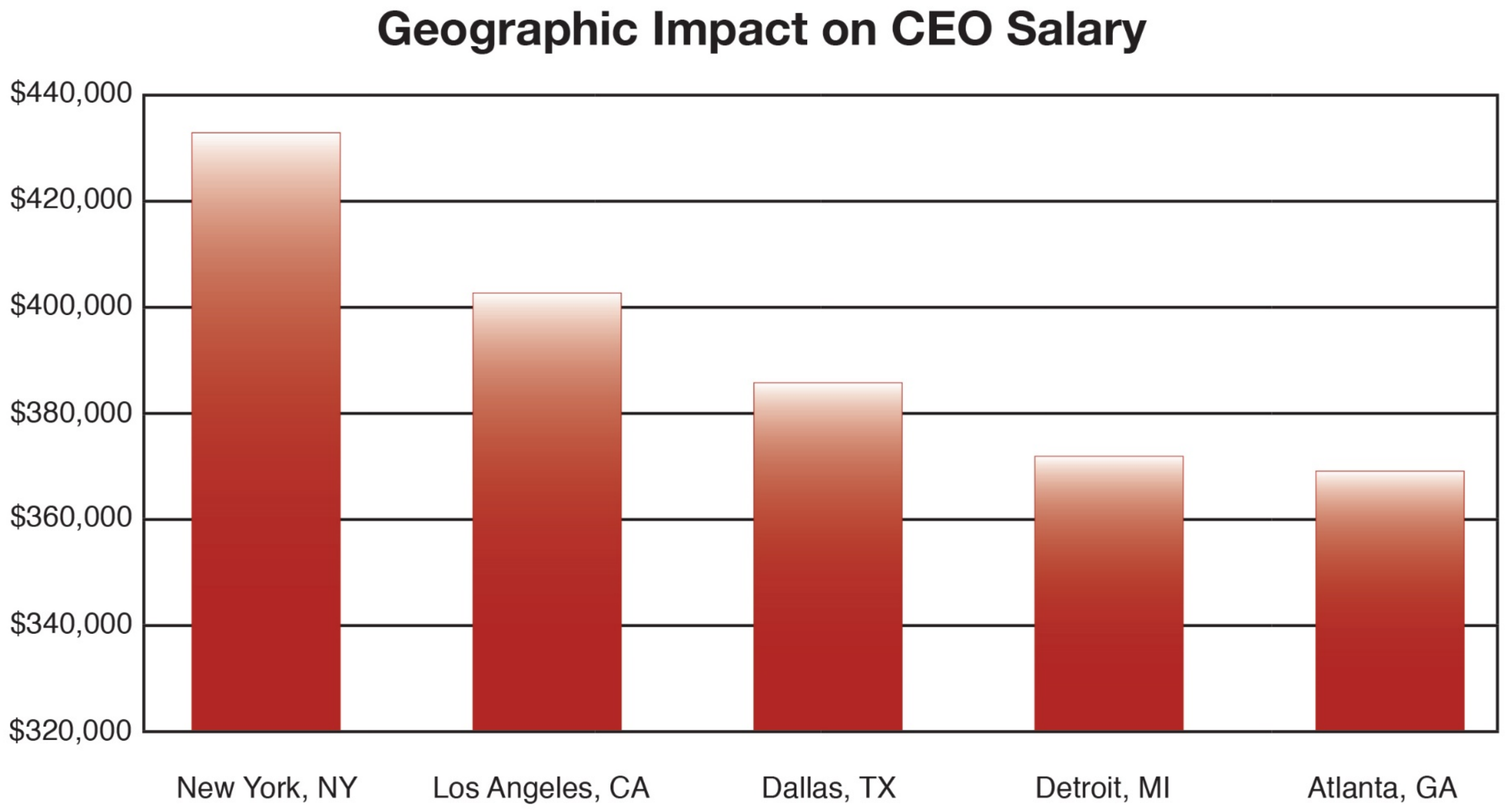


Source: Economic Research Institute; All Industry Data; National (Mar. 2013)

#EO2019

ESOP™


Industry Impact on CEO Salary
$370,000
$360,000
$350,000
$340,000
$330,000
$320,000
$310,000
Electronics Mfg.
Merchandise Retail
Construction
Health Care
Telecommunications
Wholesale
Source: Economic Research Institute; National; $50M Revenue (Mar. 2013)



Source: Economic Research Institute; National; $50M Revenue (Mar. 2013)

#EO2019

ESOP™

Succession Planning Considerations

- Consider the impact of your compensation strategy on succession planning
  - Impact of long-term vesting if desire short-term transition
  - Consider shifting long-term incentives toward successors
  - If successors will be from the outside or not yet identified internally, hold back some potential synthetic equity grants for a grant to key recruits
  - Consider a tiered program with increasing grants as employees move up a tier

Case Study

- Owners of a successful private company were ready for a liquidity event – no longer wanted to run business
  - Owners decided to sell to an ESOP
  - Owners wanted to ensure that management team was properly incentivized and goals of ESOP, company, and management were aligned

Outcome: Company adopted Incentive Stock Option Plan for key executives, plus ESOP:

1. 10 year ISOP implemented for top management team
2. Focuses management actions on long-term performance – not just short-term profits
3. All executives and broad base employees share in company growth through ESOP accounts
4. Management uses ESOP share price to help all employees understand how daily actions affect long-term value
5. After expiration of ISOP, a Stock Appreciation Rights Plan was implemented

Driving performance: (short-term incentives)

Guidelines to consider

- Decide what you want to achieve from your plan(s)
- Determine the appropriate relationship between organizational and department/individual performance
- Determine eligibility requirements and pertinent provisions
- Decide how payouts will be calculated and when they will be paid
- Decide what type of training and communications are needed to implement your program effectively

"Building a visionary company requires 1% inspiration and 99% alignment."
-Jim Collins and Jerry Porras, *Built to Last*

Retaining top performers: (long-term incentives)

- Attract, retain and build “ownership participation” among key executives
- Focus key executives on performance that will drive long-term profitable growth, enterprise value and shareholder return

Retaining top performers: (long-term incentives)

Incentive Stock Options

A plan that grants an executive the right to purchase a fixed number of shares of company common stock at a fixed price over a specified period of time.

Advantages:
1. Turns executives into "owners" with a bigger "piece of the pie"
2. Encourages retention
3. Flexible plan design

Disadvantages:
1. Must have money to exercise and pay taxes
2. Potential for tax leakage
3. May encourage risky behavior to drive up stock
4. Dilutes ESOP

Taxes on 1,000 shares at an exercise price of $10 per share

	Incentive Stock Options	**Other Tax Considerations**
Employee exercises when market value is $20 per share	No regular income tax paid (no employer deduction)	AMT issues
Employee sells at $30 per share after holding one year or more	($30 - $10)*1,000*23.8% = $4,760	If S Corp, "phantom" K-1 income
Total tax paid	**$4,760**	**TBD**

Retaining top performers: (long-term incentives)

Phantom Stock / SARs

Award mirrors the value (or increase in value) of equity-based plans without using real equity. Rather a promise to pay the equivalent cash value of the shares at some point in the future

Advantages:

1. Provides equity-like value
2. Avoids tax leakage associated with direct stock ownership

Disadvantages:

1. May be difficult to communicate to employees who would prefer an equity stake in the company
2. Dilutes ESOP

Ordinary income to recipient and deduction to employer at payment date

EMPLOYEE OWNED 2019

ESOP™

Retaining top performers: (long-term incentives)

Cash Based Performance Award

Incentive plans tied to performance of > 1 year and designed to pay out over multiple years. Can be linked to items such as improvement in share price, EBITDA, sales and quality

Advantages:
1. Flexible and simplistic
2. Links pay to performance
3. Does not directly dilute outstanding shares

Disadvantages:
1. Requires establishing accurate long-term goals
2. May be difficult to communicate to employees
3. Section 409(p) compliance issues

Ordinary income to recipient and deduction to employer at payment date

EMPLOYEE OWNED 2019

ESOP

Example of Tiered System

- Initial Phase (at or immediately following ESOP sale):
  - Tier only for top executives (e.g., 5 or 6 senior managers or key decision-makers), awarded based on achievement of certain key performance indicators (e.g., revenue or EBITDA goals)
- Second Phase:
  - Two tiers
    - Top executives – additional grants to achieve retention goals
    - Lower level key employees, but not all employees – award benefits using higher thresholds and give grants including both cash bonuses and incentive equity

Valuation Perspective

- Annual valuations should consider the impact to cash flow and/or equity dilution
- Vesting impacts
- Tax impacts
- Do the projections reflect the expected executive compensation
- Should historical compensation be normalized to reflect future compensation levels
- Equity based compensation is a claim on the equity of the company and in isolation is dilutive to the ESOP and other shareholders
- However, there are offsets to dilution – incentive to create additional value (growing the pie), attract and retain qualified executives, performance based

Valuation Treatment

- **Valuation of Phantom Stock**
  - Treated part of shares outstanding
  - Dilutive impact per share is equal to per share value

- **Cash Bonus Plans**
  - Typically included in projected cash flows and capture in Discounted Cash Flow analysis

- **Valuation of SARs and Options**
  - Black-Scholes option pricing model
  - Intrinsic value method

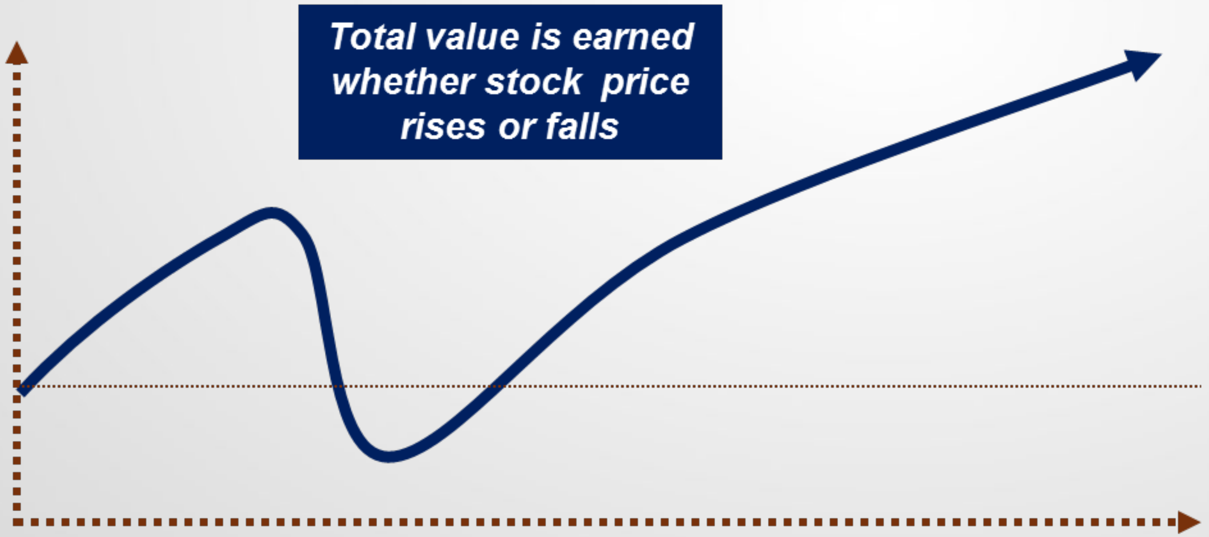
Valuation Impact ISO/SARs

- **Derivative Concept**
  - Stock Options and Stock Appreciation Rights
  - Right to buy shares at a pre-determined price or
  - Right to receive appreciation beyond a certain price
  - No "Intrinsic Value" unless the stock price increases
  - All value flows to the recipient

#EO2019

Valuation Impact Phantom Stock

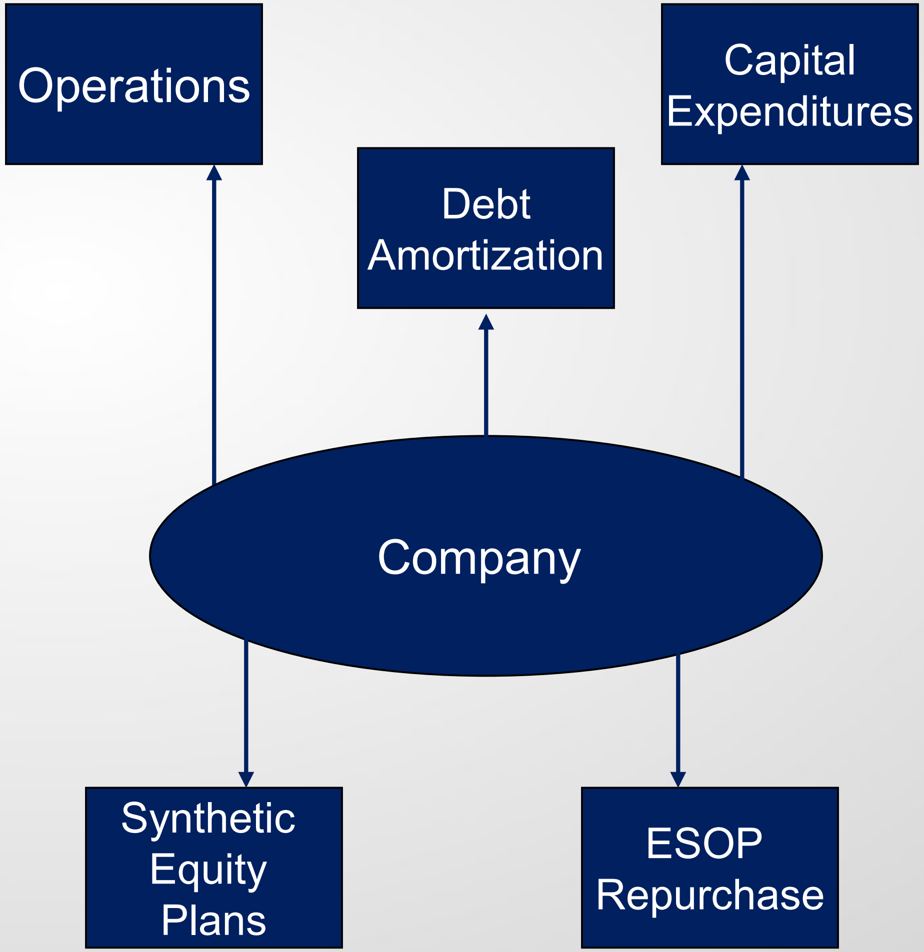
- **Direct Ownership Concept**
  - Common Stock and Phantom Stock
  - All value flows to recipient



#EO2019

Valuation Impact of Cash Flows

- The dilution from synthetic equity plans are incorporated into annual ESOP valuations
- Consideration also needs to be given to the cash impacts of exercising the synthetic equity
- 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



#EO2019

Example Performance Grant

- Example: Assume a majority or 100% S Corp.
  - **SARs Cap: 15% of equity** of the Company on a fully diluted basis. All grants issued at FMV
  - **Initial Grant: 5% Retention** – determined by compensation committee of the Board of Directors
  - **Annual Grant: Performance** – maximum 2% per annum by Compensation Committee of Board of Directors but only if company achieves/exceeds EBITDA target for the year
  - **Reload Pool: 5%** - once above SARs granted

Communicating Incentive Plans

- Assumptions:
  - Employees understand our bonus drivers
  - Executives understand LTIP awards

- Reality:
  - Program details are often misunderstood
  - Companies miss a chance to reinforce the link between employee efforts, key company goals and successful outcomes

Performance-Based Pay and 409(p)

- Certain compensation tools can enhance risk for section 409(p) violation.
- Section 409(p), if violated, can result in significant taxes and penalties imposed on the affected participant and on the corporation, as well as potential plan disqualification.
- Section 409(p) is an anti-abuse provision only applicable to S corporations.
- Under Section 409(p) no allocation of ESOP stock (or assets in lieu thereof) may accrue (directly or indirectly) to a disqualified person in a non-allocation year.
- A "non-allocation year" occurs if “disqualified persons" collectively have ownership interests of greater than 50% of the shares of an S corporation ESOP sponsor.
- Testing includes allocated and unallocated ESOP stock and "synthetic equity."

409(p) Compliance

- An individual is deemed to own ESOP shares allocated to his or her account, a pro rata portion of unallocated shares in the ESOP, and synthetic equity.
- Synthetic equity includes:
  - Stock options
  - Warrants
  - Restricted stock
  - Stock appreciation rights
  - Phantom stock
  - Right to future cash based on the value of stock
  - Other right to acquire stock or assets of related entity
  - Non-qualified deferred compensation

409(p) Compliance (cont.)

- Monitor 409(p) compliance daily.
- Always test for 409(p) potential violations when designing and before implementing performance-based pay programs.
- Use current cash compensation (pay increases and bonuses) rather than equity based compensation or deferred compensation programs.
- Identify current or potential disqualified persons.
- Consider utilizing plan design options to avoid a non-allocation year.
- Consider terminating S election and converting to a C corpora

QUESTIONS?

EMPLOYEE OWNED 2019

Cara Benningfield

Cara’s area of focus is employee stock ownership plans (ESOPs) in privately held companies. She structures and facilitates the creation of new ESOPs and works with existing ESOPs in matters ranging from acquisition structuring to repurchase planning and analysis. Cara’s experience with ESOPs also includes providing financing assistance, tax planning, ongoing plan administration, employee communication and structuring of executive incentive plans

cbenningfield@bkd.com

BKD

CPAs & Advisors

Frank “Chip” Brown

Chip’s past work experience includes providing valuation and transaction financial advisory services as a managing director for a national valuation firm where he served as the firm’s ESOP practice leader. These services included fairness opinions, solvency opinions, fair market valuations, and other financial advisory opinions to various parties, including ESOP fiduciaries. Chip has served as an expert witness in state and federal court on a variety of matters pertaining to valuation and economic damages. He is an active member of The ESOP Association and the National Center for Employee Ownership. He has authored numerous articles, book chapters, and presentations related to ESOPs. Chip has been with TI-TRUST since 2018.

chip.brown@ti-trust.com

TI-TRUST
TRUE INTEGRITY FIDUCIARY SERVICES

Mary Beth Gray

Mary Beth Gray practices in the areas of mergers and acquisitions (representing sellers and buyers), corporate finance, corporate governance, corporate restructuring, and executive compensation. Her practice has a special focus on business succession, including the sale of businesses to employee stock ownership plans (ESOPs) and other transactions involving ESOPs.

Mary Beth has extensive experience in mergers and acquisitions, and has represented buyers and sellers in more than 300 transactions involving both equity and assets. Mary Beth also regularly advises companies and shareholders with respect to both transactional and operational issues, including corporate governance, stock ownership, succession planning, equity and non-equity compensation, securities law issues, corporate finance, and corporate tax matters.

Mary Beth has represented companies and owners in many different industries and at many different stages of growth. She has advised both start-up companies and mature companies engaging in a variety of transactions. In her ESOP work, Mary Beth has represented companies, sellers, and ESOP trustees in all facets of ESOP creation and maintenance, including plan design, corporate governance, fiduciary matters, equity ownership, compensation issues, and tax matters.

mbgray@kleinbard.com

KLEINBARD LLC

Postscript

- Please fill out a session evaluation form and drop it off at the table outside of this room
- Your feedback on topics and presenters is important and will be used to develop subsequent TEA programs
- Remember to get your CPE sheet stamped before and after each session for CPE credit