Overview of Stock-Based Executive Compensation Plans for ESOP Sponsor Companies

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This discussion provides an overview of stock-based executive compensation plans for ESOP sponsor companies. More specifically, this discussion provides (1) a basis for installing stock-based executive compensation plans at ESOP sponsor companies, (2) an introduction to the types of stock-based incentives that are commonly used by ESOP sponsor companies, and (3) an overview of the best practices for implementing a stock-based executive compensation plan for ESOP sponsor companies.

The Role of the ESOP Trustee

The employee stock ownership plan (ESOP) trustee may be asked to review the sponsor company board's proposed executive compensation plan. Corporate governance issues can be compounded for internal ESOP trustees who are also the beneficiaries of the proposed executive compensation plan.

ESOP sponsor companies that have institutional trustees may find it advantageous to ask the ESOP trustee to review the proposed executive compensation plan.

The ESOP trustee, whether internal or institutional, may find it beneficial to engage a compensation consultant to advise on the matter. Ultimately, the ESOP trustee should be aware of his or her responsibility to:

1. represent the ESOP's interest as a shareholder and
2. act solely in the interests of ESOP participants and beneficiaries.

The trustee should consider whether the design of the executive compensation plan creates a "win-win" situation for key executives and for ESOP participants.

An effective sponsor company executive compensation plan should:

1. have measurable goals that contribute to the value of sponsor company stock (i.e., share price growth will offset executive compensation plan dilution),
2. provide aggregate compensation to key executives that is both reasonable and competitive, and
3. promote the long-term retention of sponsor company key executives.

Basis for the Sponsor Company Compensation Plan

The primary purpose of stock-based executive compensation plans is to align the economic interests of management with those of shareholders. Stock-based executive compensation plans benefit the subject sponsor company by helping to motivate, recruit, and retain executives.

However, the decision to implement a stock-based executive compensation plan comes at a cost—equity-based compensation is dilutive to current equity holders.

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For the executive compensation plan decision makers, the acceptable level of dilution should be estimated based on the expected increase in company value resulting from the efforts of a more incentivized management team.

Stock-based compensation is a prevalent issue for private companies that are competing for talent with public companies, and specifically, for ESOP sponsor companies. ESOP sponsor companies are often hesitant to issue equity to non-ESOP shareholders (i.e., company management).

In terms of attracting talent, a recent compensation survey of corporate financial executives indicated that 89 percent of public company respondents receive some form of stock-based incentive compensation, whereas only 35 percent of private company respondents receive stock-based incentive compensation.[1]

The greater sophistication, complexity, and liquidity of public companies are a few reasons for the disparity in the public company and private company use of stock-based incentives.

In this regard, one benefit that ESOP sponsor companies have over traditional private companies for implementing stock-based compensation plans is that ESOPs are already required to have an established share price from their annual valuation.

Stock-based executive compensation plans can be custom tailored to fit the goals and needs of most ESOP sponsor companies. Effective plans position executives to think like investors—promoting decision making that favors long-term growth.

Types of Compensation Plans

The following list presents some of the common types of stock-based incentive plans offered by ESOP sponsor companies:

- Incentive stock options (ISOs)
- Nonqualified stock options (NSOs)
- Restricted stock
- Phantom stock
- Stock appreciation rights (SARs)

An executive compensation plan may include one or more of the stock-based incentive plans listed above. There are differences in the regulations, payout, accounting, and tax treatment for each of the stock-based incentive plans. Some of the important aspects of each type of plan are discussed below.

Stock Options

ISOs and NSOs are the two primary types of stock options offered for executive compensation purposes.

A few of the common terms relating to stock options are as follows:

- Exercise (or strike) price: The price at which the option holder may purchase the stock
- Spread: The difference between the exercise price and the fair market value of the stock
- Exercise period: The period that an option holder has to exercise his or her option prior to its expiration
- Vesting: The requirement that must be met for the option holder to have the right to exercise the option

Stock options are often issued with exercise prices equal to the current fair market value of the ESOP sponsor company stock (this is referred to as "at-the-money"). If the sponsor company stock appreciates in value, the option is considered to be "in-the-money," and the option holder benefits from exercising the option.

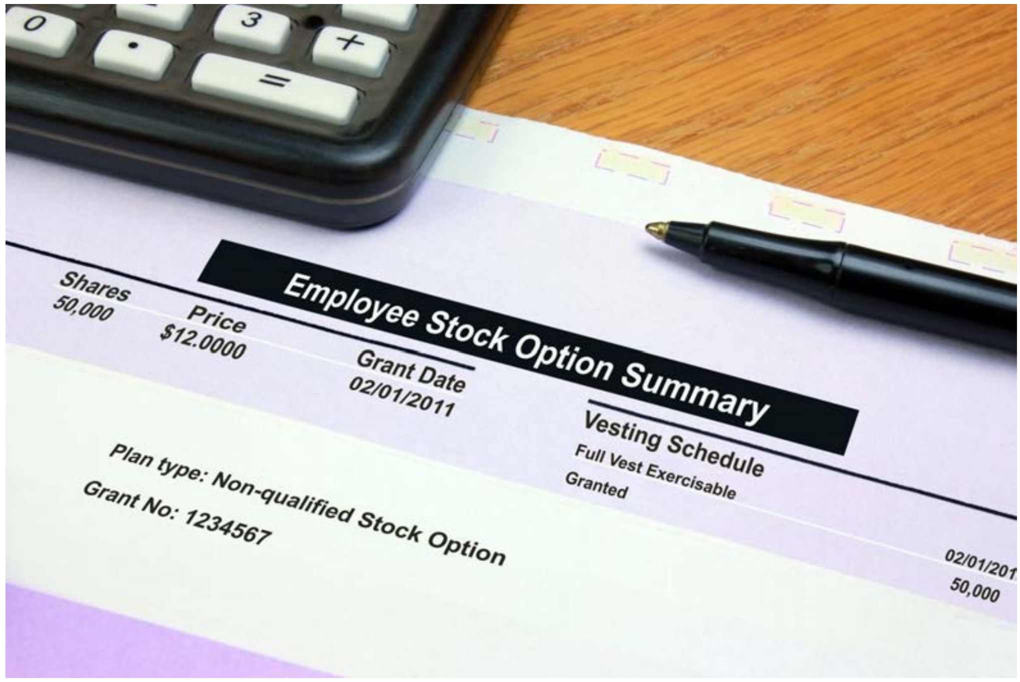
When a stock option is exercised, the employee exchanges the option and pays the amount of cash required to exercise the option for a share of ESOP sponsor company stock.

The ESOP sponsor company may impose certain restrictions on the acquired shares. For example, the sponsor company may restrict the transferability of the acquired shares by imposing a right of first refusal.

Stock options that are granted with exercise prices greater than or equal to the fair market value of the sponsor company stock are not subject to Internal Revenue Code Section 409A.

Section 409A was enacted January 1, 2005, and applies to nonqualified deferred compensation plans. A detailed examination of Section 409A is beyond the scope of this discussion.

Incentive Stock Options



The primary advantage of ISOs is favorable tax treatment for the employee. Gains from an ISO are deferred until the date that the shares are sold and are then taxed at the capital gains tax rate. ISOs are not tax deductible for the sponsor company. ISOs are subject to a number of requirements that are set forth in Section 422.

Income generated from the spread on an ISO is considered a preference item for estimating the employee's alternative minimum tax (AMT). Depending on the employee's tax situation, the ISO may result in an AMT payment when the ISO is exercised.

Nonqualified Stock Options

NSOs are not required to meet any specific tax law requirements and, thus, have greater structuring flexibility than ISOs. Additionally, unlike ISOs, NSOs may be issued to nonemployees.

Employees are taxed at ordinary income tax rates on the spread when the NSO is exercised, and the sponsor company may expense the same amount, lowering its taxable income. Income from an NSO is not considered a preference item for purposes of the AMT.

Restricted Stock

Under a restricted stock plan, an employee is granted shares or allowed to purchase shares at or below fair market value. The shares are generally subject to a substantial risk of forfeiture and transfer restrictions that lapse when certain criteria are met.

These criteria are often based on, but are not limited to, the employee remaining with the company for a specified number of years.

The restricted stock plan will generally specify the types of shareholder rights and privileges (i.e., dividends, voting rights, etc.) that individuals may receive as participants in the restricted stock plan.

For tax purposes, unless a Section 83(b) election is made, the employee pays taxes at ordinary income tax rates when the gain or loss on restricted stock is realized.

Employees may make a Section 83(b) election when they are granted restricted stock. If this election is made, the employee pays ordinary income tax on the bargain element from the restricted stock grant in the taxable year of the grant. Any future change in the value of the shares is then taxed as a capital gain or loss, not as ordinary income.

Making the Section 83(b) election is not without risk. For example, income taxes paid as part of the Section 83(b) election are not refundable to the employee should the restrictions fail to lapse.

The ESOP sponsor company is allowed to take a tax deduction for the amount that the employee is taxed at ordinary income tax rates. Restricted stock is generally exempt from Section 409A.

Synthetic Equity

Two common types of synthetic equity are phantom stock and SARs. These plans allow executives to receive an award based on an increase in the value of sponsor company stock without requiring an actual ownership interest transfer. Synthetic equity plans have a high level of structure flexibility and may be settled in cash or in stock.

Synthetic equity plans are often favorable for S corporation ESOPs. This is because, if they are settled in cash, they do not dilute the ESOP's equity interest in the sponsor company for income tax purposes.

Synthetic equity plans are taxed at ordinary income tax rates for the employee and are tax-deductible for the sponsor company.

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Phantom Stock

Under a phantom stock plan, hypothetical shares of the ESOP sponsor company's stock are allocated to the employee's account. When the vesting requirements are met, the phantom shares in the account may be converted to cash or stock, or a combination of both.

Taxation occurs when distributions are made from the phantom stock account to the ESOP participant.

Phantom stock plans are generally treated as nonqualified deferred compensation plans subject to Section 409A.

Stock Appreciation Rights

In contrast to phantom stock plans, distributions to an employee's account in a SAR plan are based only on the appreciation in the value per share between the grant date and the date of distribution. A SAR plan may allow an employee to choose the timing of distributions from his or her account.

SARs that are granted at fair market value are exempt from Section 409A.

Implementing a Stock-Based Executive Compensation Plan in an ESOP Sponsor Company

The remainder of this discussion focuses on the best practices and potential pitfalls to avoid when structuring and implementing a stock-based executive compensation plan at an ESOP sponsor company.

Conflicts of Interest

The determination of executive compensation is typically the responsibility of the board of directors or a compensation committee selected by the board.

Stock-based compensation plans are a component of the overall executive compensation scheme, and therefore, executive compensation best practices are applicable to stock-based compensation plans. The stock-based compensation plan should be considered in the context of the overall executive compensation scheme.

For ESOP sponsor companies, it is important to consider potential conflicts of interest of board members, particularly members of management that serve on the board, to eliminate self-dealing (or the appearance of self-dealing).

It is generally advisable to have independent members of the ESOP sponsor company board of directors be responsible for establishing the terms and level of executive compensation. It may also be helpful to involve a compensation consultant.

The executive compensation of ESOP sponsor companies is subject to scrutiny by the Internal Revenue Service (Service) and the Department of Labor (DOL). It is also subject to the Employee Retirement Income Securities Act (ERISA) fiduciary requirements.

Relevant Judicial Decisions

There have also been instances where the ESOP or a sponsor company employee has challenged the level of executive compensation.

Two relevant court cases where the reasonableness of the level of executive compensation was challenged are discussed below.

Delta Star, Inc. v. Patton

In *Delta Star, Inc. v. Patton*,[2] Delta Star, Inc., and the Delta Star ESOP sued Andrew W. Patton, the former president of Delta Star, on claims of breach of fiduciary duty.

The Delta Star ESOP was established in 1989 when it acquired a majority interest (98.63 percent) of the Delta Star common stock.

The ESOP trustees consisted of Patton and two other executives. The three trustees were also the only members of the Delta Star board of directors with Patton serving as the chairman and president of Delta Star. Under Patton's direction, the board of directors adopted a Benefit Restoration Plan and a Supplemental Executive Retirement Plan.

From 1989 to 1993, Patton's base salary increased from $201,400 to $301,320, and over this period, Patton received bonuses totaling $2.7 million.

On the other hand, Delta Star's performance suffered over this time frame, with revenue decreasing from over $41 million in 1989 to $27 million in 1994.

The District Court found that:

1. Patton unilaterally established his own compensation without the approval of the board of directors and the ESOP trustees and

2. he actively concealed his compensation from the other board members and trustees.

The District Court found that Patton's compensation was unreasonably high, especially given the financial performance of Delta Star.

The District Court concluded that Patton:

1. breached his fiduciary duty to the ESOP by paying himself an excessive base salary, excess bonuses, and other excessive fringe benefits;
2. failed to recognize the conflict of interest that existed between his duty of loyalty to the ESOP participants and his own financial gain; and
3. violated ERISA statutes prohibiting self-dealing by voting the shares held by the ESOP in favor of his retention as a member of the board of directors, enabling him to pay himself excessive compensation and benefits.

As a result, the District Court ordered Patton to repay more than $3.3 million to Delta Star.

Eckelkamp v. Beste

In Eckelkamp v. Beste,[3] the Sixth Circuit affirmed the District Court grant of summary judgment, rejecting the claim by plaintiffs that key executive compensation was excessive.

Gary Eckelkamp, an employee of Melton Machine and Control Company (Melton) and two former employees, Bradley Hoemann and Ronald Kampmann, brought this action against Melton, its ESOP, and four Melton officers, alleging breach of fiduciary duty claims under ERISA.

In 1986, the ESOP purchased Melton from the founder for $1.4 million. At that time, Melton was transitioning from manufacturing for the bicycle and furniture industries to manufacturing for the automotive industry.

This change brought increased sales, with Melton achieving annual sales of more than $20 million by 2000. From 1985 to 2000, the average annual rate of return on Melton stock was approximately 20 percent.

The average Melton employee earned in excess of $100,000 in direct cash compensation each year, approximately 125 percent greater than the median market rate for similar positions in other companies.

In addition, the average employee with at least one year of service at Melton had ESOP and deferred compensation account totals of approximately $350,000.

The plaintiffs alleged that the defendants violated their fiduciary duties by:

1. overcompensating themselves and
2. failing to obtain accurate annual valuations of Melton stock.

The defendants were responsible for setting employee salaries, including their own. And, the defendants acknowledged that they were compensated at least 56 percent above the median rate for similar positions in comparable companies.

The plaintiffs relied on an expert report that concluded:

1. that the defendants were overcompensated and
2. that annual appraisals consistently undervalued the sponsor company.

The District Court rejected the expert report conclusions, finding that the expert failed to take into account that all Melton employees were paid considerably more than market rates.

In addition, the District Court found that the expert based his analysis on comparisons to executive compensation at companies that were not sufficiently comparable to Melton. For example, none of the "comparable" companies used for comparison had achieved a similar historical revenue growth rate, and some "comparable" companies in the analysis were not even profitable.

In addition, the expert failed to visit the Melton facility, interview its employees, or research the job duties of executives at the comparison companies to ensure that their jobs were actually comparable to those of the defendants.

The expert also did not consider the fact that much of the Melton key executive compensation was paid in the form of bonuses contingent on the performance of the company.

In both of these court cases, the defendants did not make provisions for conflicts of interest in establishing the level of executive compensation. The judicial decisions ultimately differed based on the financial performance of the ESOP sponsor company.

The ESOP sponsor companies could have protected themselves against lawsuits had they followed best practices by:

1. having independent members of the board of directors responsible for setting executive compensation and/or
2. enlisting the services of a compensation consultant to assist in determining reasonable compensation.

Reasonableness of Executive Compensation

There are two primary analyses used to assess the reasonableness of executive compensation:

1. A multifactor analysis
2. The independent investor test

The Internal Revenue Service Job Aid for Valuation Professionals[4] lists 12 factors to be considered by the Service in determining the reasonableness of executive compensation. These 12 factors are as follows:

1. The employee's qualifications
2. The nature, extent, and scope of the employee's duties
3. The employee's background and experience
4. The employee's knowledge of the business
5. The size and complexity of the business
6. The time devoted by the employee to the business
7. The economic conditions generally and locally
8. The character and amount of responsibility of the employee
9. Whether or not the compensation is predetermined based on activities to be performed or not determined until the end of the tax year
10. Amounts paid to the employee in prior years
11. The salary policy of the taxpayer as to all employees
12. The amounts paid by similar size businesses in the same area to equally qualified employees for similar services

Judicial decisions have also provided multifactor outlines for determining reasonable executive compensation.

These relevant judicial decisions include *Mayson Manufacturing v. Commissioner*,[5] which was tried in the Sixth Circuit in 1949 and provides nine factors to be considered for determining reasonable compensation, and *Elliotts, Inc. v. Commissioner*,[6] which was tried in the Ninth Circuit in 1983 and provides five factors to be considered for determining reasonable compensation.

Conversely, in *Exacto Spring Corp. v. Commissioner*,[7] the Seventh Circuit favored an "independent investor" test over the multifactor tests. The independent investor test is based on a stock's return on investment (ROI).

The conclusion was that an investment generating a reasonable ROI would result in a satisfied shareholder that would not object to the level of executive compensation.

Determining the Vesting Schedule

As stated previously, the primary goal of stock-based executive compensation plans is to align the economic interests of key executives with shareholders. The board of directors can accomplish this goal by setting a vesting schedule for the plan.

Generally, units under stock option, restricted stock, phantom stock, and SAR plans are scheduled to vest based on time, performance, or a combination of the two.

Time-based vesting requirements can be used to attract and retain key executives, and the typical vesting period is a ratable schedule of three to five years. In performance-based vesting, specific goals are set in the executive compensation plan documents, and shares vest as performance targets are met.

Performance goals can be based on any measurable criteria. Common performance measures include financial metrics such as earnings before interest, taxes, depreciation, and amortization; cash flow; or stock price targets; or other company, department, or individual goals and objectives.

Sponsor Company Employer Stock Valuation

The addition of any form of stock-based compensation will have a dilutive effect on current equity holders.

The valuation analyst should receive copies of executive compensation plan documents in order to understand how the plan works and ensure that the economic factors of the plan are appropriately reflected in the valuation analysis, whether the analysis is a valuation update for ESOP administrative purposes or as part of a proposed transaction.

A proposed stock-based executive compensation plan that is part of a transaction may affect the share price that a trustee is willing to accept on behalf of ESOP participants.

In any case, the key decision makers should consult with a valuation analyst or a compensation expert in order to understand the valuation effects of adopting a stock-based executive compensation plan.

Valuation analysts often use established econometric or theoretical option pricing models, such as the Black-Scholes model, to estimate the dilution from the stock-based compensation plan. It is common to see a single adjustment to total equity for the amount of the executive compensation plan.

However, there are other methods that may be used to account for the dilution from stock-based compensation plans.

Repurchase Obligation

The potential cash outlays of the stock-based executive compensation plan should be considered when establishing the structure of the plan.

For ESOP sponsor companies, it is appropriate to consider the cash outlays for the executive compensation plan in conjunction with the ESOP repurchase obligation.

S Corporation Considerations

ESOP sponsor companies that are also S corporations should consider the allocation rules in Section 409(p) when allocating equity-based compensation benefits.

In Section 409(p) testing, stock-based compensation is treated as outstanding, deemed-owned shares and may trigger an improper allocation during a nonallocation year by or to a disqualified person.

The rules for Section 409(p) testing are somewhat complex and are outside of the scope of this discussion.

Conclusion

This discussion provided an overview of the benefits and potential pitfalls of stock-based compensation and introduced the various types of stock-based incentives used by ESOP sponsor companies.

An executive compensation plan that is structured appropriately can drive growth of the ESOP sponsor company by (1) incentivizing key executives and (2) aligning the goals of management and shareholders.

Notes:

1. Thomas Thompson and Ken Cameron, *Financial Executive Compensation Survey 2016*, (Morristown, NJ: Financial Executive Research Foundation, 2016).
2. Delta Star, Inc. v. Patton, 76 F.Supp.2d 617 (W.D. Pa. 1999).
3. Eckelkamp v. Beste, 315 F.3d 863 (8th Cir. 2002).
4. "Reasonable Compensation: Job Aid for IRS Valuation Professionals," Internal Revenue Service (October 29, 2014).
5. Mayson Mfg. Co. v. Commissioner, 178 F.2d 115 (6th Cir.1949).
6. Elliotts, Inc. v. Commissioner, 716 F.2d 1241 (9th Cir. 1983).
7. Exacto Spring Corp. v. Commissioner, 196 F.3d 833 (7th Cir.1999).

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