Employee Compensation

April 2015 www.blr.com Issue 426

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ESOP may be short answer to complex questions

Question: How can an employer engage employees in the company's success, give themselves a competitive position in the battle for new and existing employees, and at the same time, facilitate the sale of the company to a group of trusted, motivated people?

Oh, and if it can be done in a way that doesn't place the company at a higher than necessary risk for violating Employee Retirement Income Security Act (ERISA), that would be even better.

Answer: Try an Employee Stock Ownership Plan (ESOP)!

The ESOP, the lesser-known cousin of qualified defined benefit and defined contribution plans, is a tool that has been in the arsenal of closely held companies for several decades now. The ESOP can meet the needs of employers and employees alike. It is subject to many of the same regulations that apply to other qualified plans, but it has some distinct advantages over other qualified plans for closely held companies whose owners are seeking to sell.

The ESOP came into existence as a means to transfer ownership of a company to its employees. The first ESOP was reportedly created for this purpose for a newspaper publisher. The publisher's owners were in their eighties, and they had long desired their employees to take over management when they retired.

However, the owners knew that the employees would be unable to raise the cash necessary to buy them out. And even if they could, there was little likelihood they would ever be able to pay off the loan. And the owners needed cash to retire.

So, instead of selling the company to acquire the needed cash, they created an ESOP to purchase the company stock from the owners. The plan took ownership and the shares could then be distributed to employees. The same basic idea is in use today.

A valuable tool for ownership transfers

Timothy L. Stewart, an employee benefits attorney (and a shareholder) at DeWitt Ross & Stevens, S.C. (www.dewittross.com), frequently works with clients who have or want ESOPs, and he appreciates these plans as a valuable vehicle for ownership transfers. They can also contribute to employee engagement, he says—something important for every kind of company.

And we're not just talking about very large companies—you may have heard that the Chrysler Corporation implemented an ESOP in 1979 as a way of avoiding a negative financial situation. In fact, Stewart says that companies with as few as 12 or 15 employees can effectively use an ESOP, and companies in nearly any industry have been known to.

"A small company can have an ESOP and use it successfully in succession planning and employee engagement," Stewart says. "However, like a large company, the small company must be profitable enough to drive the 'fair market value' high enough to make it worthwhile to the business owner to sell his or her stock.

"Similarly, the business must be profitable enough to substantiate the costs of an ESOP transaction and annual

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valuation. Finally, if the company is an S Corporation, there must be a sufficient number of employees to spread the stock around enough to pass the nondiscrimination rules that apply to S Corporation ESOPs.

"Historically, manufacturing companies were more apt to pursue the ESOP model because they had more hard assets, which made such companies more attractive to banks looking to lend money for an ESOP transaction (i.e., more collateral). However, with seller financing becoming more common, more sellers (i.e., the current business owners) are becoming aware of and excited by using an ESOP as a succession planning tool."

Encourages thinking like an owner

An important factor in the success of any company, and ESOP sponsors in particular, is employee engagement, says Stewart. "Employee engagement is important in any company, but ESOP companies have a special tool for truly connecting employees to the success of the business. That is, employees in ESOP companies can rightfully be called 'owners' of the company and therefore should think of the company's success from an *owner's* perspective, rather than an employee's perspective."

Some companies have a more open corporate culture than others, and a willingness to share information can be particularly important for companies that sponsor an ESOP. Financial information is one aspect about which some companies are more willing to share information with employee/owners than others are. Regardless, some level of sharing financial information is necessary, says Stewart.

Stewart continues, "It goes to answering this question: 'What tools do I have to increase employee engagement?' If you truly want employees to care about the success of the business and to understand its goals, you may decide that giving them *more* information about the business will result in *more* 'buy-in' by employees.

"The amount of information disclosed to employees will vary from ESOP company to ESOP company, but it seems to me that the most successful ESOP companies (at least of those that are owned 100 percent by an ESOP) eventually adopt something close to an 'open book' strategy."

What about investment diversification?

The thought of implementing a qualified plan that invests primarily in company stock may be a little unnerving in light of recent developments in the world of retirement plans. Even when succession planning is the core reason for the ESOP, it must still adhere to the rules set for it by the Department of Labor (DOL) and Internal Revenue Service.

One of today's chief concerns of lawmakers and others concerned with retirement plans is appropriate diversification of plan investments. The fall of some well-known companies revealed that, when employees invest too heavily in company stock, they put both their current income and their future retirements at serious risk.

So how can an ESOP help protect employees against overinvesting in company stock, when company stock is the main investment in the plan?

ERISA requires that ESOPs allow diversification of the accounts of employees who have reached the age of 55 and have participated in the plan for at least 10 years, according to the National Center for Employee Ownership (www.nceo.org). For the subsequent 5 years, they may diversify up to 25 percent of their ESOP stock into cash investments.

The ESOP must either distribute the cash to the participant (who could roll it over into an IRA), or offer at least three alternative investments within the ESOP (or another qualified plan like a 401(k)) in order to meet the diversification requirement. During the sixth year after the participant has reached age 55 with at least 10 years of participation, he or she must be allowed to diversify up to 50 percent of his or her account, including the amount diversified in the 5 previous years.

Most companies today are seeking ways to improve employee engagement. Stewart believes that while an ESOP is not right for every company, its contribution to employee engagement can be significant for some. "In terms of increasing engagement, it is all about culture and education," he says. "It seems to me that fostering increased engagement in an ESOP company is more about 100 little things than a few big things. The best ESOP companies use persistent reminders of what the goals of the company are and what that means to the ESOP participants."

Retirement plan fees: Take a closer look at the data

The retirement plan you sponsor comes along with some serious responsibilities. Among those is the duty to understand and evaluate fees paid on behalf of the plan. You may use benchmarking data to determine whether those fees are reasonable.

That's a good start, says Jonathan Baltes, CEO of QPSteno (www.qpsteno.com), an organization that is taking fee evaluation to a deeper level.

The firm started, he says, because of the recognition of one simple truth: Two covered service providers (who each must legally report to the plan the compensation they receive) may be charging the same fees, but one may have significantly more experience and spend significantly more time on your plan than the other.

It dawned on Baltes and his partner, Matthew Hunter, that covered service providers need a way to demonstrate their value to their retirement plan clients. And at the same time, plan fiduciaries could use the same information to evaluate 'reasonableness,' an important factor in meeting their fiduciary responsibilities.

"The fee disclosure rules under Sections 408(b)(2) and 404(a)(5) of

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ERISA were intended to make employers, trustees, plan sponsors and participants more aware of the fees being paid to covered service providers," Baltes says. "But what we've found is that most sponsors and trustees still don't understand a lot of it, and most participants—if they're spending any time at all looking at the disclosures— are still having a tough time wrapping their heads around what exactly they are being charged."

Is it apples to apples?

Yet plan costs are a big issue. Baltes says that while the existing benchmarking methods and tools are useful, they may not go far enough. "Typical benchmarking tools show the cost for a particular service, and the service provider's costs relative to what everybody else is charging. That's not necessarily bad. But what happens when the evaluation shows that a provider is more expensive than others? The only solution for the plan sponsor was to negotiate a lower fee or change providers."

That may not always be the best solution, considering that some providers just bring more to the table or are spending extra time serving the client than its peers are. "Remember," Baltes says, "the DOL is clear that the responsibility of the fiduciary is not to choose the cheapest provider. It's to choose the provider whose value most closely matches what you need. The fees need to be appropriate for the level of service being provided.

"Most advisors feel like they don't necessarily have the tools to be able to show the client all the work that goes into a plan outside the quarterly due diligence meetings and the annual reviews. One example would be clients with multiple locations. If a plan sponsor has locations in multiple states, there is a fair amount of travel involved. But when you benchmark the plan, that's not included as a factor that goes into the average fee.

"If you have 1,200 employees at one location, it's not the same as having 1,200 employees spread across 15 locations. It isn't a good comparison. Many covered service providers have a tough time showing their clients the value in the time and effort that goes into that activity."

Check the box vs. granular data

Baltes mentions one plan advisor whose data he ran through his system, and who came away with some information he didn't necessarily want to pass along to his client. "When I ran one of his plans through this type of analysis it showed that he was getting paid about $3,000 per hour on this particular client's plan." By anybody's measure, that hourly rate seems high. Yet under traditional benchmarking methodology, a red flag failed to pop up, Baltes says.

"In a popular reference book about average 401(k) fees, he didn't look that off the charts, although he was at the higher end of things. He was a CFP, but he didn't have qualified plan experience. That type of analysis doesn't pop up on some of the more base-level benchmarking strategies out there. There are companies and services that give you more information than you might get in this particular reference book, but it is still more of a 'check the box' situation: 'Yes, I'm providing fund due diligence' or 'No, I'm not.'

"If that particular client had gone through the data they would have seen that this advisor was not doing any fund due diligence, and they were not doing some of the other things you would expect on a decent size plan. When you can dig deeper, like we do, it can not only expose they're not doing that type of activity, but also that they're not really spending any time on the plan."

On the flip side, digging deeper into the data may also reveal that you're getting a bargain in spite of what the typical benchmarking shows. Baltes says, "I know that there are a lot of good people doing good work in this industry, and they have their clients' best interests at heart. There has been a tremendous amount of fee compression, for several reasons. But it is partly because we have not had the ability to go back to our clients and justify what they're paying against how much, for example, a General Electric plan is paying.

"Many plan sponsors talk about where their fees should be because of what the average fee is, but they fail to consider that the top 1 percent of plans hold 71 percent of all 401(k) assets. That skews the benchmark and it doesn't necessarily mean that a smaller plan is overpaying." Based on their expertise and ability, advisors should be paid a reasonable amount. It's just difficult to figure out what reasonable means without enough information.

Using deep data to enhance participant education

Data tracking can also help in targeting participant education, Baltes says. A system (like his) that can be accessed by the advisor, the third-party administrator, the recordkeeper, or other service providers who work on the plan can provide information to better inform participants and, at the same time, create efficiencies.

"Any covered service provider that touches the plan can track their time and activity through our service," says Baltes. "Their time and their method of engagement with participants is tracked, so the data includes whether they engage over the phone, or via email or another electronic means, or if it's done in person.

"They can enter whether the meeting is one-on-one or in a group setting, and what the topic is. For instance, is it an education meeting, a fund due diligence meeting, a fiduciary meeting? We can track this granular level of information across all participant engagements with the covered service providers."

Gathering such detailed information can benefit both the plan and the participants by giving them enough information to target specific educational topics and even mode of delivery. "What you want is to have actionable insights," says Baltes. "If you think about most reports that are generated by benchmarking data, they may show the number of hits to the service provider's website and the number of phone calls to the 800 number. It falls short from an actionable point of view.

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This Month's Statistics

	Latest Period	Current	Prior Report	A Year Ago	12 Month % Change
CPI-U	Jan/15	233.7	234.9	233.9	- 0.1%
CPI-W	Jan/15	228.3	229.9	230.0	- 0.8%
ECI EMPLOYMENT COST INDEX					
Total Compensation	4Q/14	122.2	121.7	119.4	2.3%
Wages and Salaries—Private Industry	4Q/14	121.6	121.2	119.0	2.2%
Wages and Salaries—Civilian Workers	4Q/14	121.2	120.7	118.7	2.1%
Benefits—Private Industry	4Q/14	126.2	125.7	123.0	2.6%
Average Weekly Gross Wages*	Jan/15	$703.04	$702.05	$683.40	2.9%

*seasonally adjusted

(Source: Bureau of Labor Statistics, Washington, D.C.)

All figures are national.

KEY TO STATISTICS

CPI-U: Consumer Price Index for all urban consumers; the newer index representative of the buying habits of about 87% of the total U.S. population. (1982–84=100).

CPI-W: Consumer Price Index for urban wage earners and clerical workers; the older index covering only about 32% of the U.S. urban population.

ECI: Measures change in compensation per hour worked, including wages, salaries, and employer costs of benefits. (6/89=100).

Average Weekly Gross Wages and Average Hourly Wages: Data relate to production workers in manufacturing and mining; construction workers; nonsupervisory workers in transportation, public utilities, and wholesale/retail trade; also finance, insurance, real estate, and other services. Accounts for approximately 80% of the total employees on private, nonfarm payrolls.

Retirement plan fees … *(continued from page 3)*

"As a plan sponsor, I don't know if I have one participant who is sitting there on their online account hitting refresh every 15 minutes, or if I have 20 percent of my employees who are scared about what's going on in the market and have significant questions about it or about Roth or about budgeting. We track that information so we're able to provide that insight back to the plan sponsor.

"Are we dealing with one participant who needs some education to get them comfortable with what's happening in the market? Or do we have a trend in participant questions that would lead us to want to engage the advisor to come in and do a lunch and learn type session on a specific topic? This is about efficiency of effort on the part of the covered service providers, as well as the actionable insight back to the plan."

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Issued monthly. Subscription price: $395 annually for complete service. Periodicals postage paid at Old Saybrook, CT 06475-9998 and additional offices. POSTMASTER: Send address changes to *Employee Compensation*, P.O. Box 5094 Brentwood, TN 37024-5094.