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Equity-Based Plans vs. Nonqualified Executive Benefit Plans

Can They Co-Exist?

Background

In the year 2007, Nolan Financial presented an Educational/Marketing seminar to an executive compensation membership group in the Northeast. Nolan emphasized the merits of implementing nonqualified executive benefit plans *in addition to* stock/option plans, which at that time served as the primary retention and attraction vehicles for senior executives. This presentation took place *before* the onslaught of one of the most devastating recessions since the Great Depression.

Although employers were contending with the negative impact of FAS 123(R),[1] requiring expensing of stock option grants, their *alternate* solutions were to either revert to restricted stock grants or create phantom stock plans. With stock markets attaining new heights in that pre-recession period, Nolan found it difficult to convince senior HR officers of the advantages of diversifying executive benefits into nonqualified plans offering investment choices other than company stock. Having learned from the sobering experience of the recession, employers now have an opportunity to reassess their executive benefits strategies and consider nonqualified plan alternatives more seriously.

A Fresh Look

Nolan believes it is an opportune time to revisit the utilization of both nonqualified executive benefit plans and stock/option plans in the design of a comprehensive executive benefit strategy. With the economy in the early stages of recovery, many employers are grappling with underwater stock options and the undesirable prospect of stockholder dilution if new stock options, or re-priced options, are granted. In addition, many companies are reluctant to seek shareholder approval for additional grants of options in light of public sensitivity to excessive compensation practices. To make matters worse, underwater stock options are affecting executive morale impacting employers' ability to retain talented executives.

As stronger companies ramp up their operations in anticipation of economic recovery, senior executives have compelling reasons to seek new executive positions with competitor firms. In effect, executives holding worthless stock options no longer have any "golden handcuffs" holding them back to their current employers. In the absence of alternate nonqualified plans—which also serve as effective retention vehicles—executives are unconstrained in their motivations to seek new positions with other companies.

In the context of highly compensated executives, the negative impact of *"Reverse Discrimination"* also plays an important theme covered in prior issues of *Nolan Financial Reports.* Reverse discrimination impacts senior executives and is attributable to IRS restrictions on *qualified* plans, which limit their effectiveness in serving as retention vehicles and in providing adequate retirement income for senior executives. It is not uncommon for a lower compensated employee to earn 60% to 70% of their Final Average Earnings from their qualified retirement plans and

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[1] FAS 123(R) relates to "share-based payments" including stock options, restricted stock, stock appreciation rights, performance shares, employee stock purchase plans, etc. Under FAS 123(R) companies are required to recognize the fair value of stock option grants as a compensation expense in their financial statements.

Social Security while the Highly Compensated executive can only earn 25% to 30% of their Final Average Earnings due to the limits imposed by the Federal Government on Qualified Plans and Social Security.

In contrast, nonqualified plans may offer substantial benefits helping to not only ameliorate the impact of reverse discrimination, but also serve as important retention vehicles. With this background, it seems appropriate to once again review the advantages and disadvantages of stock/option plans in comparison with nonqualified executive benefit plans.

Stock Options are grants given by a company to a select group of executives, which serve as a retention device and give executives the opportunity to earn additional compensation. Stock options are the most popular form of equity-based compensation. The option to buy company stock is set at an established price called the *grant price*. The grant price is generally the published price of the stock on the date of grant issuance. Stock options are granted for a specific period of time during which they can be exercised and usually have a vesting schedule attached to them. The executive's potential profit is the difference between expected appreciation in the stock on the date of exercise and the grant price. The executive recognizes this appreciation as income when the stock option is exercised.

Advantages / Disadvantages of Stock Options

The key advantage of stock options for executives is that they are afforded the opportunity to benefit from the potential appreciation in the company's stock price. For employers the key advantages are that they are able to align the interests of the executives with those of the company and also have an effective retention vehicle in place.

The disadvantage for executives is having a significant portion of their compensation package tied to their employer's stock performance. Due to the vagaries of the stock market the future benefit amount remains highly unpredictable and could potentially become zero if the options go underwater. Another disadvantage is that many companies require their executives to retain a significant amount of their company stock and report such holdings to the stockholders in the annual proxy statement. This adds the additional burden on executives of not being able to exercise their options for anticipated expenses when needed, and not being able to take advantage of a run up in the company's stock price.

Nonqualified Executive Benefit Plans fall under two broad categories. They could be entirely employer funded such as a Supplemental Executive Retirement Plan (SERP) or a salary reduction plan such as a Nonqualified Deferred Compensation (NQDC) Plan.

A SERP is similar to a pension plan and it usually defines an employer's obligation to provide a specified retirement income or in the case of a defined contribution SERP, a specific annual contribution usually as a percent of compensation. SERPS supplement an executive's qualified retirement benefit, thereby reducing the impact of reverse discrimination defined earlier. In order to fund the future SERP benefit liability, most employers utilize mutual funds or corporate–owned life insurance (COLI).

A salary reduction, or NQDC Plan, allows the executive to accumulate money tax deferred based primarily on voluntary deferrals of compensation made by the executive. The employer implements an NQDC plan that allows senior executives to defer income on a pre-tax basis as a percentage of their base, bonus and, at times, stock-based income. NQDC plans may be set up as *'Mirror'* 401(k) plans, essentially replicating the employer's qualified 401(k) plan. Hence, these plans allow the executive to defer additional compensation, once the deferral limits of the qualified 401(k) plan are exhausted. In addition, the *'Mirror'* 401(k) plan also provides an employer match similar to the 401(k) plan provisions. NQDC plans may also be informally funded by the employer using mutual funds or COLI. Generally employers fund NQDC plans using the executive's own deferral of compensation. COLI is widely utilized as a funding mechanism due to tax and accounting advantages, and its use in nonqualified plans was recently affirmed in the COLI Best Practices provisions of the Pension Protection Act of 2006.

Advantages / Disadvantages of Nonqualified Plans
Nonqualified executive benefit plans offer very unique and attractive advantages. Executive and employer contributions accumulate on a tax-deferred basis under a SERP or NQDC plan. Nonqualified plans offer a wider variety of investment alternatives to executives for greater investment diversification. Participants have the opportunity to elect multiple investment choices in equities, fixed income, and money markets among others. From the employer's perspective, a nonqualified plan benefit is fully tax-deductible when it is paid out to the executive. Furthermore, if the employer chooses to informally fund the executive's benefit liability with COLI, the employer retains full control over the policy cash values and may be able to recover most, if not all, of its administrative costs through the insurance policy's death benefit proceeds.

The disadvantage to the employer is that a tax deduction for the executive's deferred compensation is available only when benefit is paid out to the Executive. The disadvantage to a participating executive—which has greater relevance in the case of a deferred compensation plan—is that while there may be some protection from the employer's change of heart or change of control, there is no protection of the benefits from company bankruptcy. The participant is treated as a general creditor. However, through careful plan design incorporating multiple security provisions, it is feasible to allay participant concerns regarding their benefit security. Similarly, employers can mitigate their funding concerns by utilizing highly rated insurance companies and by using variable products offering separate account protection.

In designing a comprehensive and competitive executive compensation and benefits strategy, employers must carefully consider the merits of both nonqualified executive benefit plans and stock/option plans. By integrating complementary plans, employers can create a robust and diversified package appealing to senior executives.

As employers embark on a *redesign* of their executive compensation and benefits strategy, certain important elements of the overall strategy must be weighed:

- **Cost Recovery** – Does the plan offer any element of cost recovery? If the plan is informally funded with COLI, at the participant's death the employer may recover most, if not all, of the underlying expense. This is not feasible with stock or option grants.
- **Employer Control** – To what extent does the employer retain control over benefit distribution? Once the stock or options vest, the exercise of these options or the sale of stock rests with the executive. Executives can control—within certain guidelines—when the exercise will occur. With nonqualified plans, the employer has greater control over any distributions through the design of the plan.
- **Plan Design Flexibility** – Can the employer be selective in choosing the eligible executives for the plan? It depends. When dealing with equity plans, there is little, if any, opportunity for selective discrimination. Plans are set and most often have received shareholder approval. However, Nonqualified plans have the distinct advantage of creating within the plan design the flexibility of participant selection, as well as the flexibility of offering different levels of benefits under the plan based on seniority.
- **Investment Diversification** – What is the level of investment diversifciation under the plan? Within the stock or option plans, there is none. The distribution is paid in stock or the cash equivalent of any appreciation of the option. Within nonqualified executive benefit plans, the investment diversification is driven by the underlying investments or sub-accounts that the employer offers to participants. Usually these investment choices are similar to the investments found in the employer's 401(k) plan. Nonqualified plans offer much needed investment diversifiction not available under stock or option plans.
- **Death Benefit** – If the plan is informally funded, does the funding vehicle offering any death benefit? There is no death benefit available to the employer with the distribution of options or stock for recouping costs. However, if a nonqualified executive benefit plan is informally funded with COLI—as opposed to mutual funds—the employer may recoup most, if not all, of its cost of providing this benefit. In addition, with some

nonqualified plan designs it is also feasible to allocate a portion of COLI death benefit to a participating executive's beneficiary.

- **Timing of Distributions** – Does the plan give the employer the ability to control the distribution timing preferences? Usually within option plans, there are certain well-defined option exercise periods. These are usually governed by not only the vesting of the option but also by the distribution windows that the employers must create to avoid any SEC and insider trading violations. Within nonqualified plans, employers place the broader provisions relating to distributions along with vesting schedules, and within those parameters executives select the timing and form of their distributions.
- **Significant tax and accounting considerations** – What is the tax and accounting impact of the plan and the informal funding vehicle? The tax and accounting issues vary significantly, hence an employer must consider the advantages and disadvantages of each plan, as well as the impact on the executives. *Nolan Financial does not give tax or legal advice and readers are strongly encouraged to seek qualified tax or legal counsel for advice.*

  From an accounting perspective, both stock/option plans as well as nonqualified executive benefit plans require the employer to expense the benefit on the employer's books. However, with a nonqualified plan the employer can mitigate the benefit expense by deploying an effective informal funding strategy utilizing COLI.

  From a taxation perspective, the executive is taxed at the time the option is exercised and the employer takes the deduction at that time. With nonqualified plans, the executive is taxed when the benefit is paid out and the employer takes the tax deduction at that time. Nonqualified plans give the executive better control over when to receive distributions from the plan and possibly take advantage of a lower income tax bracket.

Summary

The recession of 2007- 09 left a damaging and lasting impact on stock/option plans affecting both employers and executives. If a lesson was to be learned from this debacle, it was simply that executive compensation and benefit plans must offer greater diversification of risk. In this regard, nonqualified executive benefit plans serve as increasingly viable and complementary alternatives to existing stock/option plans. Instead of viewing these plan alternatives as mutually exclusive arrangements, perhaps the more fitting question to ask is—*can these plans co-exist and benefit both the employer and the executive?*

In our experience we have found that they *can* and *should* co-exist. Both types of plans have unique attributes and benefits. The design of a comprehensive executive compensation and benefit strategy is feasible only with complementary plans that offer a balance of reward and benefit security. While stock/option plans align the interests of executives through equity ownership, nonqualified plans help to diversify their benefits under a completely different value proposition. Nonqualified executive benefit plans allow executives to address the reverse discrimination issue, avail a greater selection of investment choices, and ultimately derive a higher level of retirement income—in addition to benefits they receive under the employer's stock/option plans.

If you have any questions or concerns about how your company may be impacted or would like additional information, please contact:

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