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Strategically Designed Nonqualified Executive Benefit Plans

Aligning Performance, Motivation and Reward with Employer Goals & Objectives

Introduction

Nonqualified Executive Benefit plans have proliferated primarily due to the limitations of qualified benefit plans in delivering comprehensive benefits to senior executives. In order to provide supplemental benefits to senior executives, most nonqualified plans are designed to emulate the purpose and character of *qualified* plans. For example, due to the annual elective deferral limitations of 401(k) retirement plans—presently $16,500 in 2010—a nonqualified *'Mirror'* 401(k) plan is implemented with design features and provisions almost identical to the actual 401(k) plan. Although the nonqualified plans providing supplemental benefits do serve a useful purpose, the plan designs have generally not kept up with the demands of a competitive workplace and the overriding objective of any organization—creating value.

The elements of performance, motivation and reward have been sorely neglected in most nonqualified plans, resulting in plans that merely offer basic benefits or entitlements. In the case of nonqualified deferred compensation plans (NQDC), executives are traditionally afforded the opportunity to electively defer additional compensation along with employer match. The ability for the executive to derive the benefit of the employer match is automatic without any element of performance, motivation or reward. Similarly, a nonqualified supplemental executive retirement plan (SERP) offers employer-paid benefits in the form of a pension arrangement. Again, this type of a traditional SERP offers a benefit that is almost an entitlement, recognizing only an executive's length of service with the organization. Traditional SERPs also lack elements of performance, motivation and reward.

In this edition of Nolan Financial Reports (NFR), we will look at *how* it is possible for employers to design elective deferral or supplemental benefit nonqualified plans more creatively. By focusing on the plan design, employers can bring a higher level of excitement and purpose among its group of senior executives to drive profitability and growth.

Elective Deferred Compensation Plans

Due to government limitations imposed on qualified 401(k) plans, highly compensated executives are severely limited in their ability to defer compensation in the *same* proportional percentage of income as lower compensated employees. This *'reverse discrimination'* phenomenon can be remedied only by the implementation of NQDC plans. In order to make the NQDC plan a seamless extension of the qualified 401(k) plan, the NQDC plan typically retains key provisions of the 401(k) plan. As such, a senior executive can defer higher amounts of compensation that exceed the 401(k) plan limits, and also earn employer match on the excess deferrals.

However, such a traditional NQDC plan design does not address several critical areas:

- **Competitive Advantage:** Although employers offering nonqualified plans are perceived to be more desirable by executives, in a competitive environment nonqualified plans have become a *de facto* offering

with most employers. In this regard, there is little to distinguish one NQDC plan from another, as most of these plans offer elective deferral opportunities with similar features.
- **Motivation:** Participation of senior executives in NQDC plans is driven in large part by the availability or absence of an employer match. The only other motivation for executives to defer compensation is the need to avoid immediate taxation. However, NQDC plans do not offer much else by way of motivation.
- **Performance:** The element of performance is generally missing from NQDC plans. Executive participation and the ability to earn an employer match are not conditional. Executives may earn an employer match simply by deferring compensation into the NQDC plan.
- **Reward:** NQDC plans do not offer the prospect of any reward based on superior performance. By merely achieving the vesting schedule, executives receive 100% of the employer contributions.
- **Value Creation:** There is no provision in most NQDC plans that drives the executive to create value for the organization by focusing on profitability and growth.

Proposed Design Alternatives for NQDC Plans
By introducing elements of performance, motivation and reward, an employer can transform a simple NQDC plan into a strategic tool for the organization. How can this be accomplished?

Almost unlimited variations of plan designs are possible that employers may customize to their own needs. However, despite the many permutations feasible for any NQDC plan, it should have two essential components:

1. **Basic benefits:** Traditional benefits offered under most NQDC plans fall under this category. Executive participation would be driven by eligibility, compensation level, the desire to avoid immediate taxation and the ability to earn employer match. Typically the employer match would be subject to a vesting schedule.

2. **Performance-based benefits:** The second and more important component of the plan offers performance driven benefits, resulting in a higher payout if organizational goals and objectives are met. In this regard, employers have the flexibility to link additional benefits to the attainment of individual goals as well as organizational goals.

   - Plan provisions would specify additional employer contributions if performance-based goals are met annually.
   - In order to increase the impact of additional employer contributions, a vesting schedule may be utilized and all employer contributions may be linked to a Performance Unit plan.
   - The Performance Unit plan would award executives with units of value, based on the attainment of annual targets, driving executives to increase enterprise value.
   - Employers would have to determine which drivers would maximize results and how those would be linked in the NQDC plan to incentivize key executives.

This type of a strategically designed plan would help employers enhance the usefulness of a traditional NQDC plan. The basic features of the plan would help to ***meet*** the competitive practices of other employers. In addition, the performance-based component would help to ***exceed*** the benefits offered by other employers. By linking employer contributions to a vesting schedule and valuations based on Performance Unit achievement, executives will be motivated to increase corporate profitability and growth over the long term. Employers must, however, undertake the due diligence to design the NQDC plan carefully so that it offers a good fit with their unique corporate philosophy.

Supplemental Executive Retirement Plans
In addition to elective deferred compensation plans, SERPs funded entirely with employer contributions serve as an important and integral piece of any compensation and benefits package. The intent of most SERPs is to restore pension benefits that would otherwise be lost due to government limits imposed on qualified pension plans. Although SERPs provide valuable benefits to key executives, as drivers of corporate growth and profitability SERPs add little value to the employer.

In a conventional plan design, a SERP credits a stated percentage of final average compensation annually, resulting in higher benefits based on years of service alone. There is no element of performance required in traditional SERP designs. As compensation practices have come under scrutiny, employers have a greater duty to redesign plans that offer benefits that are better aligned with corporate goals and objectives.

Proposed Design Alternatives for SERP Plans

SERPs are generally designed to recognize the long-term service of key executives. SERPs assume that by providing long-term service to the employer, an executive participates in the growth of the employer. However, there are no metrics or measurement standards applied. In addition, the benefit to the executive is based on a prescribed formula with no impact on the payout, except due to changes in some actuarial and interest rate assumptions. Whether the organization experiences any growth during the executive's tenure is not even a consideration and the executive's performance has no impact on the SERP benefit. So, how can employers redesign their SERPs to drive profitability and growth instead of offering a rich benefit to executives with no measurable impact?

As is the case with *any* nonqualified plan, employers have wide latitude in their ability to design a SERP with provisions linked directly to their desired objectives. Since SERPs are funded with employer contributions, plan provisions may be designed to offer multi-tiered benefits based on certain conditions. As an example, an employer may implement a SERP with two tiers—one providing a basic benefit, the other providing a performance-driven benefit linked to stated goals. Similarly, another SERP design could have three tiers—one providing a basic benefit, the second tier providing benefits linked to individual goals and the third tier providing benefits linked to corporate goals. By incorporating various elements of performance, an inert SERP can be transformed into a dynamic program.

A performance-oriented SERP should also have two essential components:

1. **Baseline benefits:** The baseline benefits offered under the SERP would be similar to those offered in a conventional SERP. This portion of the SERP benefit would be driven by a formula with an element of guarantee. Participants in the SERP would thus be assured of receiving the maximum baseline benefits if they remain employed with the employer to retirement age. Employers would determine what percentage of an executive's final average compensation should be targeted as the maximum baseline benefit.

2. **Excess benefits:** Performance-driven benefits may be offered as excess benefits in the SERP. Excess benefits may be incorporated via additional tiers linked to the attainment of individual and corporate goals.

    - Tier 1: Plan provisions would specify additional employer contributions if *individual* performance-based goals are met annually. Individual goals would be set by the employer annually, or certain metrics may be specified that could be used on a consistent basis annually. If annual goals were met, employer contributions would go into Tier 1 component of the SERP account.
    - Tier 2: Plan provisions would specify additional employer contributions if *corporate* performance-based goals are met annually. Corporate goals may include revenue targets, profitability, and market share expansion, among others. If annual goals were met, employer contributions would go into Tier 2 component of the SERP account.
    - Employer contributions would be made *only* to those tiers for which annual goals are met.
    - Employers would have to carefully design the performance goals, both at the individual level and at the corporate level. Performance targets should be measurable and relevant to the employer's line of business. The goals should be geared towards driving corporate growth and profitability.

As SERPs are funded entirely with employer contributions, a vesting schedule is usually applied to the SERP benefit. In order to provide a higher level of motivation, employers have the flexibility to implement two vesting schedules—a stringent vesting schedule applicable to baseline benefits and a more generous vesting schedule applicable to excess benefits. However, actuarial and interest rate assumptions may be applied in a uniform manner to both baseline and excess benefits.

Employer Considerations

Employers that currently do not have an NQDC or SERP in place have an excellent opportunity to implement plans that are not only competitive, but also have the potential for delivering superior benefits. Talented executives should have the opportunity to derive higher benefits based on their contributions to the employer. Furthermore, performance-oriented executives would find performance-based nonqualified plans more appealing than conventional nonqualified plans.

Employers that currently have an NQDC or SERP in place should reassess the goals and objectives of their nonqualified benefits strategy. Participation levels, executive turnover and direct feedback from executives can easily indicate if existing nonqualified plans are perceived as a valuable benefits or not. Especially in the case of SERPs, employers have the duty to assess organizational performance against the performance of individual participants in the plan. If the current nonqualified plans are not proving effective in attracting, retaining and motivating key executives, it's time for the organization to redraw their nonqualified plan strategy. Publicly-listed employers face even greater pressures due to a backlash by shareholders against excessive compensation practices. By redesigning existing SERPs and NQDC plans, management can assure shareholders of an effective compensation and benefits strategy that is properly aligned with corporate goals and objectives.

In addition to assessing the value proposition of any nonqualified executive benefits strategy, employers must ensure that all legal requirements are current. If funding is utilized, the financial impact of the funding vehicle can be significant. As such, employers must review funding considerations along with the overall nonqualified plan strategy.

Summary

Nonqualified plans offer employers the flexibility and the tools to integrally align the interests of senior executives with those of the organization. By incorporating a performance-based incentive component into nonqualified plans, employers can more effectively attract, retain and reward key executives. An overall increase in enterprise value would not only offset higher payouts to executives, but also help to reduce the financial impact of nonqualified 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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