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Change Is In The Air

A Focused Approach to Executive Retention in 2011

Introduction

Executive retention is a consideration that is always prominent in the minds of employers regardless of the prevailing economic environment. On this very topic there was a striking article in *The Wall Street Journal* written by Elizabeth Craig, John R. Kimberly and Peter Cheese that caught our attention. It was entitled *"How to Keep Your Best Executives"*. Given the importance of executive retention, it is not surprising there have been numerous articles written on this very topic and the need for a company's leadership team to focus on this issue. The ultimate objective is that employers must develop a strong plan for retention of their key executives who are deemed critical to their ongoing success and future growth.

However, for the last 18 to 24 months, Corporate America has not focused on this issue as the U.S. has struggled to extract itself from the terrible recession that began in 2007, and still faces sluggish recovery prospects. Like many of our readers, we sense the mounting concern on the issue of executive retention that is being expressed in various media from professional journals to experts on TV. The sense of urgency for this important mandate is almost universal as support is sought from CEOs and Boards to address the issue of executive retention.

While the rhetoric is certainly vigorous, the corporate decision makers are still somewhat reluctant to put together a concerted effort to adequately address this issue. We believe that 2011 will be a seminal year for executives seeking alternative opportunities and the migration of executive talent will begin to accelerate. Employers that do not take their retention programs seriously will be challenged by last minute knee-jerk decisions in an effort to retain executives who may choose to resign.

Anyone who may have encountered this type of sudden departure of an executive will realize that it is not a comfortable situation to be in, both from the standpoint of the executive who resigns, or from the standpoint of the CEO or head of Human Resources who loses the key executive.

For the resigning executive, the decision to depart has social and psychological implications, and generally a last minute counter-offer from the employer to retain the executive would be seen as ineffective whether it involves additional compensation, promotion, or both. Furthermore, the resigning executive will recognize that accepting such an offer to stay on with the current employer may entail different dynamics going forward that would only strain the relationship with the company leadership. In such a scenario, the most likely outcome would be a rejection of the counter-offer by the departing executive.

For the CEO and the leadership team, a last-minute counter-offer will be perceived as a failing attempt to retain a valuable executive and end with the recognition that they were ineffective in their ability to keep the executive from going to a competitor. Once the executive departs, a whole new dynamic will begin as the current employer decides how best to respond to the departed executive and his/her new employer. More importantly, the current employer has to take immediate steps to assess their remaining executive talent and address what they should be doing to prevent any further erosion of talent.

The Solution

In *The Wall Street Journal* Article mentioned above, the authors state that getting serious about retention "means giving executives opportunities to take on greater responsibility, broaden their skills and cultivate a network of relationships with their peers"(1). We do not disagree with that statement; however, we feel that in addition to the enhanced *qualitative* aspects of a position, a performance-oriented *quantitative* component truly provides the "golden handcuffs" needed for executive retention. In other words, to retain a key executive the employer needs to provide the executive with an opportunity to earn supplemental compensation that recognizes the executive's contributions today, and also provides an opportunity to build supplemental retirement income for tomorrow. These supplemental benefits may be offered via Nonqualified Executive Benefit Plans or nonqualified plans.

While nothing will ever replace good management and leadership as an integral part of retention, the compensation and benefits package that an employer offers to an executive certainly plays a key role in these efforts. Restrictive features of qualified retirement plans have added greatly to the appeal of nonqualified plans, such as Nonqualified Deferred Compensation (NQDC) plans. The qualified plans offered by most employers are now limited to defined contribution style plans, such as 401(k) plans and profit sharing plans. The more desirable defined benefit plans that provide for a percentage of prior income at retirement are no longer the standard, and in fact, are becoming increasingly rare. This shift to defined contribution plans requires the executive to take a more active role in managing and funding his or her retirement.

The introduction of the *American Jobs Creation Act of 2004* and the *Pension Protection Act of 2006* has shifted greater attention on the development and design of nonqualified plans. We believe that a NQDC plan, especially with an employer match, offers companies the most flexible opportunities in executive retention planning. As a result of recent legislative updates, NQDC plans have a very solid future in the executive benefits arena and, we believe, are a necessary component to help in the retention of high caliber executive talent. Other types of nonqualified plans may be utilized as well for executive retention, such as Supplemental Executive Retirement Plans (SERPs).

Executive Retention

Nonqualified plans offer the flexibility to accommodate diverse retention needs of employers. A typical nonqualified plan has three components:

- An agreement between the corporation and the executive,
- A high quality funding vehicle utilized by the employer, and
- A nonqualified administration system that can properly administer intricate plan designs.

These three components allow management to design and build a supplemental benefits plan that precisely meets the needs of both parties for retention purposes. As an example, the Board may contractually agree with a talented executive the terms of a nonqualified plan that provides a supplemental benefit of $50,000 a year for ten years commencing at retirement, if the executive stays with the employer for another ten years. In the event of death prior to retirement, the plan may offer the same $50,000 benefit to the family for ten years. Unlike the typical "golden handcuffs" arrangement, this plan, commonly called a SERP, provides for salary continuation if the executive dies, or a supplemental retirement income if the executive lives up to retirement.

[1] Elizabeth Craig, John R. Kimberly and Peter Cheese "How to Keep Your Best Executives" WSJ.com October 26, 2009

Design

Nonqualified plans are typically custom-designed to attract, retain, and reward executives through an agreement entered into between the executive and the corporation. These agreements are specifically tailored to meet the needs of the corporation and executive. Nonqualified plans do carry a higher risk for the participants in their capacity as general creditors, but they can be protected from the company's "change of heart" or "change in control" with some protective measures. However, participants cannot be protected from the employer's bankruptcy. For this reason, these plans are generally limited to the top 10% of the employee population of a company. This is typically the group that the organization is most interested in retaining. It is expected that at this level in an organization, participating executives are much more aware of the financial soundness of their company and thus can enter into these types of plans with a greater sense of comfort and knowledge of their company's position.

Plan design is the most critical component. The majority of our time with clients is spent on this subject. If designed properly, this will drive the proper funding and administration and, most importantly, create the attraction and retention device that was sought by the company in the first place. These plans require the assistance and guidance of highly specialized executive benefits consulting firms, if they are to meet corporate goals and expectations.

Funding Flexibility

Nolan Financial's Administration System is designed to handle a myriad of different informal funding methods. These methods include unfunded plans as well as those funded with mutual funds, COLI or a combination of COLI and mutual funds. In addition, if the corporate client has tax loss carry forwards, an institutional mutual fund platform may be the more appropriate solution.

In the event that the executive fails to meet the terms and conditions of the NQDC or SERP agreement, or under other circumstances, the corporation has the complete freedom to access the policy cash values via policy withdrawals and/or loans. If structured properly, there is little or no tax consequence to the company and no penalty for early withdrawal. The employer may also surrender the policies at any time.

Utilizing COLI within a Grantor Trust, otherwise known as a Rabbi Trust, affords the participating executive not only the protection available from any "change of heart" or "change in control", but also gives him or her comfort that the assets needed to pay his or her NQDC or SERP benefits will be there and are being managed.

Ease of Administration

Nonqualified plans require no IRS approval, no top-heavy discrimination testing and no tax filings and can be utilized with any or all eligible and participating executives without violating the non-discrimination provisions of ERISA. These plans may be changed or restructured as the needs of the parties may change, simply by mutual consent of the parties. In addition, they have no limitations on contributions, no age restrictions, and no penalties for early withdrawal. While there are some restrictions under IRC Section 409A, such as the changing of in-service distribution dates, with proper guidance, plan administrators can easily work around these restrictions.

Taxation

Executive Taxation - Because the executive enjoys no economic benefit until benefits are actually received or not subject to forfeiture, the executive is not taxed during the accumulation period. The company is also required to forgo its tax deduction until the actual benefits are paid out to the executive.

Corporate Taxation - An attractive feature for CFOs is that the accumulated assets within the plan are carried as assets of the corporation on its balance sheet. In the event of the death of the executive, the corporation receives substantial life insurance death benefit proceeds tax-free, subject only to possible alternative minimum tax (AMT) considerations.

Summary

A well-designed and well-implemented nonqualified plan is truly the "Right Instrument" to meet a company's executive "attraction and retention" needs, as enunciated in the article quoted above. A customized nonqualified plan can truly distinguish a company from its competitors and help to create an effective retention vehicle.

We expect that the attraction and retention of key management personnel will always be among the top five concerns of CEOs. We also know that there are now nonqualified plan solutions available to address the financial security and retirement concerns of top executives.

Nolan Financial has successfully designed and implemented nonqualified plans for all types of organizations, including for-profit and non-profit. We can help you organization do the same. If you have any questions or interest in regards to designing, funding or administering a nonqualified plan, please contact:

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