ESI Enterprise Services, Inc.

Beyond the Number$

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Associations weigh in on DOL proposal to define ESOP appraisers as fiduciaries.

by Sandy Paavola and Kris Cooper

The DOL's proposed regulation issued on October 22nd mandates that valuators of ESOP stock become ESOP fiduciaries. These potential regulations directly contradict current law and guidelines which state that a valuation firm needs to be independent.

Within the ESOP community, both TEA (The ESOP Association) and NCEO (National Center for Employee Ownership), have expressed their dissatisfaction with this new DOL proposal.

TEA's position is that these regulations, if finalized, will significantly increase the costs of establishing and maintaining an ESOP because valuation firms will have to purchase fiduciary insurance. They also state that the fiduciary exposure will increase the cost of transactions, thus hindering an ESOP company's desire to acquire another company, or to expand, or to be acquired.

According to TEA, many valuation firms may opt to drop their ESOP practice due to exposure to lawsuits - many trial lawyers who look for lawsuits against ESOP public companies will now have better monetary opportunities with lawsuits against private ESOP companies. Further, TEA states the DOL proposal is not needed and that its real purpose seems to be to stifle creation and operation of private company ESOPs.

The Board of Directors TEA is doing what it can to stop or significantly change the DOL proposal.

NCEO has also denounced the proposal, indicating that there are other alternatives to achieve the end result the DOL is seeking. They believe that the DOL's changes could have a serious and detrimental impact on the number and quality of ESOPs, which in turn would adversely affect retirement security in the U.S.

While the proposed DOL regulations are out for comment and the end result is uncertain, as many ESOP professionals believe, it is likely that ESI would incur significantly higher costs to cover its fiduciary exposure, which in turn would increase fees. We are monitoring the situation, have submitted written comment to the DOL against the proposal, as written, and will be certain to follow this proposal closely.

Please visit ESI's website at www.esi-enterprise.com for additional information on this proposed DOL regulation.■

Congressional update.

January 5, 2011 marked the start of the 112th Congress, which begins with major changes – a new Republican House majority and a much slimmer Democrat majority in the Senate – and the promise of heated discussions on topics including: jobs, the deficit, and health care reform.

Once the attempt to repeal the "Affordable Care Act" enacted last year fails (while the House has enough votes to repeal the bill, it will fail in the Democratic controlled Senate), there will be more focus on the economy and jobs. President Obama said after the release of several deficit commission reports late last year, a "robust dialogue" on how to tame the deficit will be center stage this year.

With the late 2010 extension of the "Bush era" tax cuts through 2012 and the next election cycle that we are already in (both Democrats and Republicans are positioning themselves for 2012), many in Congress do not anticipate sweeping deficit-reducing legislation to be enacted in 2011, and probably not in 2012. While small changes to the tax code may occur, it is anticipated that large scale tax reform will only be contemplated as Congressional attention is aimed at taxes, deficits, and jobs.

If you have any questions about Congressional activities regarding ESOP legislation, please contact ESI's Sandy Paavola. ■

Q&A

This question and answer section is intended to provide answers to some of your most frequently asked questions.

Q: We're a mature ESOP and we don't have enough shares for our new hires. Can we target shares from former employees for new employees?

A: Technically, yes, this can be done. Below is how this process would generally work.

(1) The company would amend the plan document to change the formula for allocating discretionary contributions in a manner that would give preferences to newer employees. The allocation formula would typically be based on reverse service points (which can be accomplished in a number of ways).

(2) ESOP distributions would be made in stock, with a put to the company (immediate or during specified put periods).

(3) The company would make a discretionary contribution of these shares to the plan.

(4) These shares would be allocated according to the new allocation formula (reverse service points).

(5) As a result, newer employees participating in the ESOP would receive more of the shares allocated.

(6) Test the allocations for nondiscrimination; this allocation formula does not meet the IRS approved safe harbor criteria. As this allocation formula favors new employees (most of whom are generally not highly compensated), the plan will usually pass this additional test without issue. ■

"Success does not consist in never making blunders, but in never making the same one a second time."

Josh Billings

The other kind of performance award.

Adapted from NCEO online.

There is a lot of buzz in the equity world these days about "performance awards," a term of art, not law, that usually means that either an equity award (typically restricted stock or a stock option) is vested, or sometimes granted, only if certain performance targets are met. But there is another kind of performance award that may work well for closely-held companies that want to tie employees to some kind of mid- to long-term performance, but not stock value per se. This kind of award would be based on the company meeting a certain critical number or numbers (revenue, profits, new customers, or whatever else drives business success) over some period of years. If the company meets those targets, then some pool of cash is set aside to award to eligible employees based on a predetermined formula.

For instance, a company might grant 'Sue' 100 performance units in 2011. The unit will be worth 10% of a pool of funds that will be set aside in 2014 based on if the company's revenue grows by at least 20% over that time. If it does, then 5% of the growth in excess of the target will go into the performance award pool, and 'Sue' would get 10% of it. Awards based on future targets could be granted every year or any other time period.

The thinking behind this concept is that employees may find it easier to focus on a number like this than the more abstract concept of share value. The payoff is more certain than many stock plans in closely held companies where plan rules often require a liquidity event to sell shares (albeit these plans could be written to provide for internal liquidity). Such a plan can augment other retirement programs such as an ESOP. Also, some owners may not be comfortable with sharing more equity or may have constraints on how much equity they can offer. Making these awards based on longer-term goals, meanwhile, encourages people to stick around and focus on whatever the company thinks drives the business. ■