The Swerdlin Quarterly

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Swerdlin & Company
Actuaries ■ Pension Consultants

Lobbying in Washington for ESOPs

In today's world, "employee ownership" is an important component of the compensation package. Companies may now be taking a second look at offering company stock in their benefits program. ESOPs are a retirement plan of choice if the goal is to link employee and employer performance. With company stock, employers and employees can receive substantial tax and retirement savings.

Robert, Bowden, Inc., An ESOP Client

The ESOP Association, a national, non-profit association dedicated to employee ownership, plays a strong advocacy role in communities and cities across the country, and in our nation's capitol. This advocacy role of The ESOP Association is to interact continuously with elected officials to prove that pro-active positions for employee ownership and ESOP laws will improve America's economy in a way that is fair to all wage earners.

This year lobbying efforts take on a greater importance due to the Enron situation. As you know, Enron employees suffered losses from the company stock held in their 401(k) plan.

Recently, representatives from Swerdlin & Company attending The ESOP Association national conference in Washington DC had an opportunity to visit with legislators. Michael Miller, Dee Robbins, Lee Swerdlin, and Joanne Swerdlin met and discussed ESOPs and the future of ESOPs with:

- Senator Zell Miller of Georgia,
- Senator Richard Shelby of Alabama,
- An aide to Senator Max Cleland of Georgia,
- An aide to Senator Thad Cochran of Mississippi,
- An aide to Senator Fred Thompson of Tennessee, and
- An aide to Senator Bill Frist of Tennessee

For more information on The ESOP Association, visit their website at http://the-esop-emplowner.org or call (202) 293-2971.■

Dorn's Corner

I hope you are enjoying your summer. As I write this, I am looking out at the Gulf of Mexico on Memorial Day. Our editor, Carol Friend, is a tough taskmaster and forces me to work on holidays!

Last quarter I mentioned that four of us from Swerdlin & Company were to attend the "Great Game of Business" gathering in St. Louis. The "Great Game" is about "open book management" and much more. This concept ties in with our Year of Communication (2002) and our Year of Continuous Improvement (2001). It also dovetails with the theme of this Swerdlin Quarterly edition, employee ownership.

How does all this tie together? An Employee Stock Ownership Plan (ESOP) allows employees to share ownership in their company. In order to realize the greatest advantages of employee ownership, employees must learn to think and act as owners. This requires a significant shift in the company culture. The "Great Game of Business" provides the procedures and mechanism for employee owners to know how their job affects the total performance of the company. It also establishes systems to encourage and reward employees for actions which enhance the company's performance and long-term growth. The reward system includes short-term rewards such as bonuses, while long-term rewards are often reflected in the value of the employee's stock.

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FAQ?

Q What is an ESOP?

A An Employee Stock Ownership Plan (ESOP) is an employee benefit plan enabling employees to own stock in their company.

Q Why would my company want an ESOP?

A The three most commmon reasons for companies to establish an ESOP are:

∑ To buy the stock of a retiring owner in a closely held company.

∑ To provide an extra employee benefit or incentive plan.

∑ To provide a means of corporate finance.

Q What is a leveraged ESOP?

A A leveraged ESOP is an ESOP that borrows money from a bank or other qualified lender, and the company usually guarantees the loan. If the lender prefers, the company may borrow directly and make a loan back to the ESOP. Other financing arragements are also available.

Q Why would I want a leveraged ESOP?

A The borrowed funds in a leveraged ESOP are generally used for expansion, capital improvements or to buy out the stock of a retiring owner.■

Dorn's Corner

(Continued from page 1)

The beginning of the Great Game of Business is an appraisal process. This four step process leads to a "critical number" or "critical issue" to focus on for the year.

1. Determine employee attitudes and beliefs by means of surveys.
2. Determine opinions of key management personnel.
3. Analyze the company's financial trends for the last three to five years.
4. Compare the company's results with those typical in your industry.

We are initiating this process at Swerdlin & Company this summer and we'll keep you posted. In the meantime, I wish you all a wonderful summer!

Plan Design and the Long-Term Success of Employee Stock Ownership Plans

Introduction

In the process of installing an ESOP, business owners sometimes overlook the need for careful plan design. There is often much focus on the sponsor company valuation and the ESOP stock acquisition financing. However, less attention is paid to the decisions that will help make the ESOP a success. In fact, Swerdlin & Company is often called upon to fix problems resulting from using of an "off the shelf" plan.

This article discusses early ESOP plan design as a way to link shareholder, company and employee needs and concerns. Many options are available for the different ESOP plan decisions need to be made. Some of the major areas for consideration in the planning process include:

1. plan participation,
2. contributions to the plan,
3. distributions from the plan, and
4. the impact on company culture.

Plan Participation

Although any qualified retirement plan must cover employees in a nondiscriminatory manner. However, this does not mean that everyone must benefit equally.

Most typically, plans are established (1) for current employees to enter the plan at its inception and (2) for new employees to wait one year. However, consideration should be given to the design of any other existing qualified plans. Whenever possible, coordination among plans should be considered for (1) consistency and (2) ease of understanding.

An additional consideration in establishing plan participation requirements relates to (1) the number of participants and (2) total eligible compensation. Since annual IRS deduction and contribution limitations are based upon eligible compensation, participant demographics should be analyzed to be sure the payroll base supports the plan contributions and deductions. If loan payments are projected to exceed IRS contribution limitations, the terms of the ESOP loan may need to be changed.

Contributions

The typical method for allocating contributions among participants is to give each eligible employee a pro-rata portion of the contribution based on his or her compensation. However, the definition of compensation for plan purposes can give the company flexibility to make the plan work best for its particular situation. For example, "Form 1099" income to employees can be included or excluded in the definition.

In addition, commissions paid to sales people can be included or excluded. Contribution alternatives are available as long as the definition does not discriminate in favor of highly compensated employees.

An eligible participant is not only (1) someone who has met the entry requirements but is also (2) someone eligible to receive a contribution. ESOPs usually require participants to (1) work 1,000 hours during the plan year and (2) to be employed on the last day of the year. Plan sponsors use these rules to encourage service to the company in order to receive benefits from the plan.

Keep in mind the amount of shares available for contributions each year. If the ESOP is leveraged (i.e., financed), then a fixed number of shares are available for allocation to participants. Non-leveraged ESOPs have more discretion since shares are generally contributed from the company and allocated similarly to a profit sharing plan.

Forfeitures are another way participants are eligible to receive shares. Timing is discussed below. For now, however, it is important to consider whether nonvested terminated participants should have their shares redeemed by the company or recirculated to other participants.

Finally, dividends or S corporation distributions increase account balances. Whether they are from a C corporation or an S corporation and whether they are attributed to allocated or unallocated shares has an effect. They may be used to pay a loan more quickly or they can be passed through to participants and distributed or reinvested. These plan decisions are important prior to finalizing administrative policy and document provisions.

Distributions

Planning for distributions from the ESOP is a critical planning item. Eventually, all plan participants will leave the plan, whether through retirement, death, disability or termination. The plan sponsor must plan carefully for this "repurchase liability".

The first consideration is the vesting schedule to use. If there is another plan in the company, vesting could be the same as in the existing plan, or a new timetable established. The rules state that if ESOP allocations are not tied to deferrals, then (1) a maximum 5-year cliff schedule (0 percent vested until 5 years of service and 100 percent vested afterwards) or (2) a 7-year graded schedule (0 percent vested during years 1-3 and an additional 20 percent vested per year during years 4-7) may be used. If ESOP allocations are used for a company match to 401(k) deferrals, then the maximum vesting drops to either (1) a 3-year cliff or (2) 6-year graded schedule.

Most company executives want the ESOP to work in favor of the long-term employees, those whose careers are tied to the company. A 5-year cliff vesting schedule works well for these firms, since the nonvested portion of a departing employee accounts may be reallocated to the accounts of all remaining plan participants. Alternatively, these forfeited balances could be redeemed by the company and contributed to the plan in future years or they could be used as an executive compensation tool.

In some ESOP companies, the opportunity for wealth building through reallocation can be significant. For example, a restaurant franchisee will generally experience high turnover. As many as 2500 Forms W-2 for 750 employee positions may be typical in any year. The amount of reallocation can be quite large, as well as the long-term employee benefit.

Timing is another important consideration. In designing the plan, the plan sponsor may impose a break-in-service rule. This rule says a participant is not eligible to request or receive a distribution until 5 years have passed since last credited with 500 hours of service. This is a way for management to deal with potential drain on company cash flows because of the repurchase obligation inherent in all ESOPs.

The break-in-service rule does not apply in the event of diversification (currently age 55 with 10 years of plan participation), retirement, or death. In these cases, participants must be paid out even if the ESOP is leveraged and the loan has not been fully amortized.

A final alternative related to distributions is that participants can be paid in a lump sum and/or installments. For example, a plan may be drafted to restrict participant distributions until 5 years after termination and then providing installment payments over 5 years. Effectively, a participant is not completely paid out until 10 years after termination. Companies concerned about cash flow should definitely consider how much money would be necessary in any year. The most lenient distribution policy will be one in which participants are paid immediately upon termination based upon the most recent stock valuation.

Planning is critical. Repurchase liability studies can help you plan for distributions based upon:

1. entry, eligibility and distribution options,
2. demographic assumptions such as hiring, terminating and retiring,
3. contribution and forfeiture allocation assumptions; and
4. corporate assumptions such as stock growth.

These plan design factors can affect who shares in stock contributions. For example, a group of key employees who are all about the same age may retire about the same time. With long service and healthy stock appreciation, the company may be required to distribute sizeable account balances.

Repurchase liability studies can help determine the present values of funding needs to match cash positions. Companies can prepare for cash needs through various funding tools with options inside the trust (if contributions and deductions are not at maximum levels) or outside the trust. If repurchase liability studies are not performed early and funding established, plan sponsors can find themselves in a financial crisis. Also keep in mind, distributions are an obligation and plan sponsors must be ready with the cash.

Since repurchase liability studies can help determine present value of future distribution funding, plan sponsors can take the necessary steps to provide for the funding of these obligations.

A Note Related to Company Culture

We have already discussed the design of the ESOP impacting future cash flow, as well as employee retention. No matter the reason for an ESOP, its existence creates the opportunity for enhancement of the culture of the company. If the plan is designed in a way to make it easy for management to communicate to all of the employees, it will be better understood. If the plan is understandable, the employees are more likely to buy into it.

Employees who buy in to the concept of the ESOP are more apt to contribute more to the company. This does not mean opening the books, but it does mean teaching employees about being an owner. Ownership understanding and culture is built by teaching about income statements and about teamwork. Closely held companies are only required to have their stock valued annually, but the efforts should be made year-round.

Conclusion

I have touched on some of the plan design considerations when establishing an ESOP. There are technical complications related to each plan design decision. However, the point is that in ESOP installations, the company needs a team of professionals who understand an ESOP and its nuances. That team needs to spend time on the important plan design areas.

Michael S. Miller, CEBS is the director of consulting services at Swerdlin & Company in Atlanta. They administer all types of qualified and nonqualified retirement benefits with an emphasis on ESOPs. Michael can be reached at (770) 396-6601 or at mmiller@swerdlin.net.

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What's Happenin'

Welcome to Mary Butina who joins one of our Defined Contribution teams as a Pension Consultant. Mary brings with her 20 years of experience in our industry.

Congratulations to Kim Hall and Christy Crossway who both celebrated 5 years with Swerdlin.

On March 16, we participated for the third year in the Bowling for Big Brothers/Big Sisters. We are proud to have raised close to $1,800, while having lots of fun!

Kudos to Amy Murphy who raised almost $260 while participating in the March of Dimes Walk, and to Jodi Burket, who ran in the "Race for the Cure" and raised approximately $150.

On May 31, we celebrated our fourth annual Fun Day at Dave and Busters. We closed the office and spent a day of fun participating in team activities.■

Our Client of the Quarter

We are pleased to present Robert Bowden, Inc. (RBI) as our client of the quarter. We have been providing recordkeeping and administrative services for their 401(k) plan over the last several years. This year we assisted RBI in establishing an ESOP as an enhancement to their retirement program. The culture within the RBI community was a perfect fit for an ESOP.

RBI began operations on June 27, 1983, with five employees, one delivery truck, and a 25,000 square foot warehouse in Marietta, Georgia.

By March 1985, the Company employed 35 dedicated people, including an outside sales force of 6 serving the Metro Atlanta area. The Company had begun manufacturing its own windows and millwork in an additional warehouse in the Marietta Industrial Park.

During 1986, the Company consolidated all its operations into one location near Kennesaw Mountain. Presently, this facility is 180,000 square feet on 14 acres. A second branch was added in Duluth, Georgia in February 1994, and a third branch opened on May 10, 2000 in McDonough, Georgia.

Today, RBI employs 280 people and serves a broad area from South Atlanta to Dalton, Georgia. The Company maintains 5,000 product items such as doors, mouldings, roofing, windows, hardware, treated lumber, and siding. BI also offers an array of services such as lock, screen, hardware, and shelving installations.

Approximately 45% of the Marietta facility is dedicated to manufacturing wood double-hung windows, steel door units, and custom architectural millwork. They also fabricate interior and exterior door units to meet the individual needs and specifications of their customers.

The Company maintains a fleet of 45 radio-dispatched vehicles equipped with GPS, which logs over 1,000,000 safe miles per year.

The Company attributes its success to the RBI employees who dedicate themselves to serving the customer and delivering quality materials on an efficient and courteous basis.

Robert Bowden, Inc. was named Dealer of the Year in 1992 by Pro Sales Magazine. This is a national award was presented by Hanley Wood, Inc., publishers of many industry publications. RBI's active involvement in its industry and community are evident by the numerous plaques seen in their offices.

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Robert Bowden, Inc. continues to offer its customers reliable service, quality products, and a unique way of doing business.

featuring

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Vision Statement:

We strive for financial strength for our clients, our employees and our company by caring to be the best. We are committed to being the leading pension consulting firm in our market. We achieve this through cooperative teamwork, community building and continuous learning and development.

Mission Statement:

We focus primarily on design and administration of qualified retirement plans. Our mission is to develop relationships with our clients, our employees and our community so that all parties grow and develop financially and otherwise.