Reprinted from “*Work Force: HR Trends and Tools for Business Results*”

EXECUTIVE TOPICS

COMPENSATION AND BENEFITS

Volume 10, Number 2 Spring 2001

Midsize Companies Compete for Human Capital With Non-Qualified Plans

By Terry R. O'Neill

Terry R. O'Neill is President and CEO of The O'Neill Company

Between the time I write these words and the time you read them, hundreds of top executives will have left key positions at small and midsize companies. In many cases, these will be people who were happy with their jobs, their organizations, and their salaries—but who were lured away by enterprises offering them more diversified benefits.

Today, many small to midsize companies focus on three key tools to recruit, reward, and retain talented employees: salary, stock options, and qualified pension plans. In general, these last two items remain highly-valued perks. Yet in the past year, when so many equities performed poorly, stock options lost some of their luster.

When a stock sinks under water—as it did for many companies last year—the retention value of stock options seriously diminishes. Indeed, if you have an experience like Jaap van der Meer, president of Alpnet, Inc., who watched the value of his own stock in this small corporation sink from over $14 million to under $715,000 in less than eleven months, your concern may not be whether to leave your organization, but when.

The upshot of declining stock values is that many key employees at small and midsize enterprises are now asking for more hard cash in addition to stock options. Faced with low stock prices and a concern that many of their key people will bolt, some companies are complying and paying out hefty bonuses and other cash rewards. But this retention strategy cannot remain viable indefinitely. As Merrill Lynch analyst Henry Blodget noted in ***The Wall Street Journal***, "Unfortunately, at some companies, it can lead to a vicious cycle where employees demand more cash. That causes earnings estimates to go down and puts further pressure on the stock price, which can lead to further demands on the company for cash."

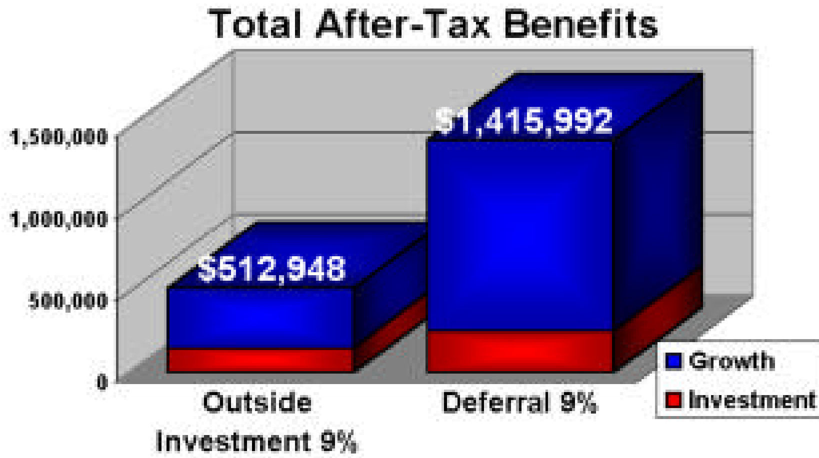
What about qualified pension plans, then? Are these doing much to help small and midsize companies get and keep highly-valued people? Unfortunately, the general answer is no, because federal regulations strictly limit the benefits that such plans can provide to highly-compensated employees.

There are two basic types of qualified plans, each with a limitation that particularly affects highly-paid people (in 2001, those whose compensation exceeds $170,000 annually):

- ***Defined benefit plans***, in which each month the employee receives a percentage of their final compensation once they retire. These plans are always employer-funded. ***Limitation:*** All participants must receive the same pre-set percentage of their final salaries, with a benefits cap based on the compensation limit ($170,000 in 2001). Thus a rank and file employee who retires might receive 80% of their final salary in retirement benefits, while a highly-paid vice president might receive less than 20% of their final salary.
- ***Defined contribution plans***, in which the employee

Continued on page 2

Graph 1



provides most or all of the funding (sometimes with a partial employer match and/or with discretionary profit-sharing contributions) by deferring a percentage of their salary; once they retire, they have considerable flexibility in taking cash distributions. ***Limitation:*** In a defined contribution plan, all employees are subject to the same annual contribution limit, which is set at 15% of their salaries. Furthermore, these plans are subject to the Sec. 401(k) annual cap (currently $10,500) on employee contributions, regardless of the level of compensation. Thus a CFO or CEO's contribution may be limited to 5% of their salary (or even less).

In companies of all sizes, the trend has clearly been toward defined contribution plans. Many enterprises that have sponsored defined benefit programs have recently switched to defined contribution plans, and of the companies that are setting up new plans, the overwhelming majority are choosing defined contribution programs.

There are sound financial reasons behind this trend, as Graph 1 demonstrates. This compares the results of putting $25,000 of deferred income a year into a defined contribution plan with taking that same $25,000 as income each year and investing it. Assuming for both arrangements a 9% annual return and ten years of contributions or investments, the defined contribution plan ultimately yields over $1.4 million, while the outside investment yields just over $500,000—a 176% difference.

Another cause of this trend is the benefits cap built into defined benefit plans. Graph 2 clearly illustrates this limitation. (This graph, based on several economic studies, employs financial professionals' rule of thumb that people need about 80% of their final salaries in annual income once they retire.) As this graph reveals, a retired senior manager whose final salary was $100,000 will receive only about 60% of that salary from their defined benefit plan and social security. A retired vice president whose final salary was $300,000 would receive only about 34% of their final salary from these resources. In either case, the difference would need to be made up from some other income stream.

Practicing Benefits Diversification

Long-term investors often stress the importance of diversified investments—which, they argue, keeps people from being at the mercy of a volatile market. Yet many small and midsize enterprises often neglect to follow this essential principle in offering recruitment and retention incentives to key people. By making stock options their primary perk, these companies discourage diversification, and in some cases unwittingly increase the financial risk of the people they value the most.

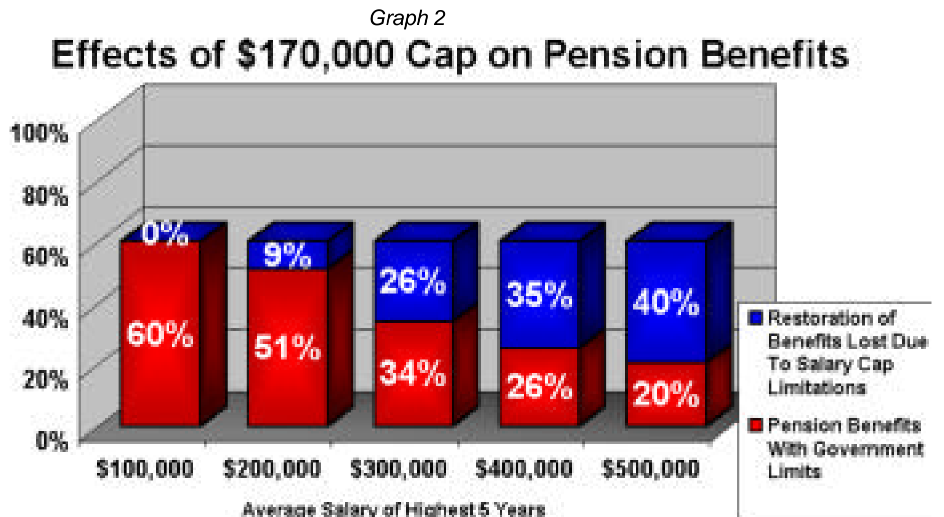
One cost-effective way to establish greater diversity—and to create a more effective balance of benefits for highly-valued employees—is to provide substantial additional retirement income through a non-qualified plan, or NQP.

NQPs can be particularly attractive to top executives, because they can make up most or all of the huge potential difference between their final salaries and their post-retirement income from social security and qualified pension plans. For example, a 47-year-old executive earning $300,000 today may make well over $700,000 on retirement at age 65, yet receive an annual pension of under $65,000 and social security benefits of less than $25,000—a net income reduction of almost 87%. An NQP can be designed to make up most of all of this $610,000 shortfall.

Non-qualified plans come in the same two variations as qualified plans: ***defined benefit plans*** (more often known as ***Supplemental Executive Retirement Plans***, or ***SERPs***), and ***defined contribution plans*** (often called ***deferral plans***). These operate very much like their qualified plan counterparts, but with some crucial differences: your company has the freedom to choose which employees will participate, as well as what benefits will be provided to each

Continued on page 3

Graph 2



participant. Indeed, in general these plans have few limitations and much flexibility.

Another benefit of NQPs is that they avoid the ERISA reporting requirements and discrimination testing of qualified plans, making them relatively easy to administer. One other plus is that a non-qualified plan does not—and cannot—move with an employee. Furthermore, since non-qualified plans can be designed in almost any way you choose, you can create a program in which an employee's benefits are contingent on a specific number of years of service, or on the success and growth of the company, or on almost any other reasonable criterion you select. (This is partly what makes an NQP such a potentially powerful retention tool: you can design a plan so that the longer the key person stays with the organization, the more future benefits they forfeit by leaving.)

Thus, in the 21st century, many small and midsize companies are following in the footsteps of Fortune 1000 corporations and turning to non-qualified plans as cost-effective tools for recruiting, retaining, and restoring benefits to highly-valued human capital.

The Small Print on Non-Qualified Plans

Like any other benefit, an NQP needs to be properly designed, implemented, monitored, and financed if it is to create the most value to both employers and key employees. Furthermore, once your company decides to offer NQPs to some or all of its most valued people, it is essential that it consider these important issues:

First, the terms of any non-qualified plan should be stated clearly, in writing. It can be tempting to recruit people by making verbal promises, with an understanding that the terms will get written down (or the blanks filled in) later. ***Resist this temptation***, however, because it's all too easy for the blanks to stay blank, and for the promises to stay unwritten, for years. All too often, this neglect—whether deliberate or benign—results in lawsuits over what was actually promised or agreed to.

A promise of a benefit normally creates a legally binding agreement, so treat it as one. Engage a capable attorney who specializes in (or is very familiar with) NQPs, and have them prepare a formal, detailed, fully-quantified description of any non-qualified plan that you offer to anyone (including yourself). This document should specify:

- when plan benefits will begin to be paid (e.g., on retirement at age 65 or older)
- how much those benefits will be (e.g., in dollars, in percentage of final salary, etc.)
- how often those benefits will be paid

NB: If your company has already agreed to provide benefits through an NQP to one or more key employees, but has not yet prepared such a formal description, have such a plan document drawn up as soon as possible.

Second, if your company is privately-owned, and largely or entirely run by one person, you'll need to create a business continuation plan for when its patriarch or matriarch leaves the company. In the absence of such a plan, when this person dies or retires, the company may simply be dissolved—at which point all future non-qualified benefits for all key employees would disappear.

Another important consideration: by law, NQP benefits ***must*** be paid out of either operating income or borrowed funds. This means that, once a promise to pay a benefit through an NQP has been made, it becomes a liability to the company—just like rent, salaries, or any other operating expenditure—and the future beneficiary becomes one of its creditors.
This liability—like any liability—needs to be carefully planned and accounted for. However, by law you cannot ***formally*** establish a fund to pay NQP benefits, because recipients must be subject to the same risk of forfeiture as all other creditors.

One common way to handle this is to financially quantify what your total after-tax

Continued on page 4

NQP liabilities will be, year by year, for all plan participants. Then set up a sinking fund—one not tied to NQP benefits in any way—from which the company will draw money for general operating expenses. However, the fund should be designed so that it yields roughly the amount needed to pay all NQP liabilities each year. All NQP benefits will then be paid out of the general operating account.

Where NQPs Meet COLI

Large and midsize companies use a wide range of options for building assets in these sinking funds—corporate-owned life insurance (COLI), managed portfolios (mutual funds), corporate annuities, real estate, tax-exempt bonds, zero coupon bonds, unregistered company stock, preferred stock, and so on. However, the most popular—and, to my mind, most cost-effective—option today is COLI. In a recent survey of large companies offering non-qualified plans, 85% used COLI as the informal financing vehicle supporting these plans. Managed portfolios—another good choice, in my opinion—ranked second.

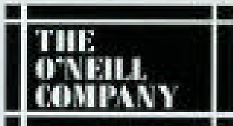
To use COLI most cost-effectively, a small or midsize company can buy a properly-designed high-cash-value life insurance policy on the key employees enrolled in its non-qualified plan. However, for maximum benefit and cost-effectiveness, these policies (and their costs) should be pooled. Many large companies take this pooling a step further, and write life insurance not only on their key people, but on a larger group of employees as well. This maximizes these companies' potential benefits from their COLI investments, and provides a number of tax advantages as well.

The company owns each policy, pays the premiums, and designates itself as the beneficiary. Each policy should of course be carefully designed and managed to yield the optimum benefits and payout to the corporation.

Whatever informal financing vehicle you choose for your own company, however, you will be joining the ever-swelling ranks of small and midsize enterprises that are looking beyond stock options and qualified pension plans to recruit, keep, and reward the human capital who are critical to their success.

"Take away my factories, my plants; take away my railroads, my ships, my transportation; take away my money; strip me of all these, but leave me with my men and in two or three years, I will have them all again."

-Andrew Carnegie



23221 South Pointe Drive, Suite 103
Laguna Hills, CA 92653
Phone: (949) 586-8001
Fax: (949) 454-6543
E-mail: troneill@ix.netcom.com
Web Site: http://www.genam.com/oneill

Our mission at *Beyond Strategy* is to maximize our readers' financial empowerment. While we always endeavor to be 100% accurate, we are not responsible for any inadvertent inaccuracies that may appear.

Terry R. O'Neill is a registered representative of and offers securities through Walnut Street Securities, Inc. (WSS), Member NASD, SIPC. The O'Neill Company is not a subsidiary or an affiliate of WSS. Securities activities are supervised from a WSS office at 4100 Newport Place Drive, Suite 840, Newport Beach, CA 92660 (949) 474-7060.

Copyright 1999 by The O'Neill Company