

## REASONABLE KEY EXECUTIVE COMPENSATION IN MAJORITY ESOP-OWNED EMPLOYER CORPORATIONS

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*This discussion provides (1) an overview of factors that financial advisers typically consider in the determination of reasonable executive compensation for ESOP majority-owned employer corporations. This discussion also provides a review of certain ESOP-related court cases that focus on the determination of reasonable executive compensation.*

### INTRODUCTION

Recent corporate scandals and controversies regarding total compensation for key executives have resulted in a significant increase in the focus on corporate governance and on key executive compensation for public companies, closely held companies, and nonprofit entities.

For public companies, certain external controls exist that are designed to limit key executive compensation to a reasonable level. These safeguards include the oversight of the board compensation committee and reporting requirements of the Securities and Exchange Commission (SEC).<sup>1</sup>

Although closely held ESOP sponsor companies are not subject to SEC reporting requirements, executive compensation at ESOP sponsor companies is subject to (1) scrutiny by the Internal Revenue Service (the “Service”) and the Department of Labor (DOL) and (2) ERISA fiduciary requirements. However, in many ESOP companies, certain key executives also serve as ESOP trustees or as fiduciaries of the ERISA-protected retirement plan. This creates the appearance of a conflict of interest.

In these instances, it is generally advisable to have independent members of the sponsor company board of directors retain an independent compensation consultant to review executive compensation. This independent review would provide protection for the ESOP trustee if the executive compensation was challenged by ESOP participants, the Service, or the DOL.

Without direct oversight by some independent body, such as an independent committee of the board of directors, a key executive serving as the ESOP trustee could unilaterally determine his or her salary increases and bonuses. The key executive’s salary and bonus may be excessive, possibly resulting in self-dealing and the failure

to act in the best interests of the sponsor company and its shareholders.

Key executives who also serve as ESOP trustees are susceptible to fiduciary liability claims if they pay themselves excessive compensation. This is because excessive compensation for key executives:

1. limits the cash flow available for the employer corporation to make the amount of ESOP contributions necessary to service the ESOP stock acquisition debt and
2. limits the cash flow available to provide for a fair return on the ESOP’s investment in the employer corporation’s common stock.

Therefore, financial advisers retained to estimate the value of employer corporation stock in majority employee-owned corporations must analyze the reasonableness of key executive compensation.

This discussion provides an overview of the typical factors considered by financial advisers in the determination of reasonable executive compensation. This discussion also presents a review of two ESOP court cases regarding the reasonableness of executive compensation, including the factors considered by the courts in the determination of the reasonableness of key executive compensation.

### REASONABLE KEY EXECUTIVE COMPENSATION

Executive compensation is reasonable only if the amount paid would ordinarily be paid for similar services by similar organizations under similar circumstances. In determining the reasonableness of executive compensation, all items of compensation must be considered—including, for example, salary and bonuses, deferred compensation, premiums for

liability or other insurance coverage, severance payments, and all fringe benefits.

A majority of the statutory authority, Service guidance, and judicial precedent for analyzing reasonable compensation have been developed for federal income tax purposes. An overview of these factors is presented below. Financial advisers generally apply many of these factors in the determination of reasonable executive compensation for majority ESOP-owned employer corporations.

### Statutory Authority

Internal Revenue Code Section 162(a)(1) permits a corporation to deduct “a reasonable allowance for salaries or other compensation for professional services actually rendered.”

Under Treasury Regulations Section 1.162-7(a), the corporation can take a deduction for compensation only if the payments were reasonable in amount, and the payments were for services actually rendered.

### Service Guidance

The Service has recently increased its audit efforts with regard to executive compensation by challenging (1) unreasonably high executive compensation for closely held C corporations resulting in the avoidance of income taxes, and (2) unreasonably low executive compensation by S corporations resulting in the avoidance of payroll-related taxes.

The Service’s *Audit Manual* lists 12 factors to be considered by a Service examination agent in determining the reasonableness of a key executive’s compensation.

These factors include the following:

1. the nature of the employee’s duties
2. the employee’s background and experience
3. the employee’s knowledge of the business
4. the size of the business
5. the employee’s contribution to the profit making
6. the time devoted by the employee to the business
7. the economic conditions in general and locally
8. the character and amount of responsibility of the employee
9. the time of year when compensation is determined
10. the relationship of shareholder-officer’s compensation to stock holdings
11. whether alleged compensation is in reality, in whole or in part, payment for a business or assets acquired

12. the amount paid by similar size businesses in the same area to equally qualified employees for similar services

### Relevant Judicial Decisions

Various judicial decisions have outlined somewhat different lists of factors to consider when analyzing reasonable executive compensation. For example, in *Mayson Manufacturing Company v. Commissioner*,<sup>2</sup> the Court of Appeals identified nine factors that should be considered with respect to reasonableness of executive compensation. These factors included the following:

1. the employee’s qualifications
2. the nature, extent, and scope of the employee’s work
3. the size and complexities of the business
4. a comparison of salaries paid with the company’s gross income and net income
5. the prevailing general economic conditions
6. comparison of salaries with distributions to stockholders
7. the prevailing rates of compensation for comparable positions in comparable companies
8. the salary policy of the corporation for all employees
9. in the case of small corporations with a limited number of officers, the amount of compensation paid to the particular employee in previous years

Over the years, various courts have referenced many of these criteria when analyzing executive compensation. In *Elliot’s, Inc. v. Commissioner*,<sup>3</sup> the Court of Appeals stated that for analytical purposes, the factors to be considered in analyzing reasonable executive compensation could be divided into the following five general categories:

1. Role in the Company—some considerations include the position held by the employee, functions performed by the employee (including any multiple roles such as president and chief financial officer), the number of hours worked, duties performed, and the employee’s relevant education and experience.
2. External Comparison—requires a comparison of the employee’s salary with those paid by similar companies for similar services.
3. Character and Condition of the Company—requires the consideration of factors such as the company’s size based on statistics such as sales, net income, and total asset value; historical growth; the company’s performance compared to its peers; the complexities of the business; and general economic conditions.

4. Conflicts of Interest—requires the consideration of whether some relationship exists between the corporation and its employee which might permit the company to disguise nondeductible distributions of income as salary expenditures—for example, where the employee is the corporation’s controlling shareholder.
  5. Internal Consistency—requires the consideration of whether the compensation plan of the corporation has been reasonable and consistently applied across management employees over time.
3. the factors considered by the courts to arrive at those conclusions.

### Delta Star, Inc. v. Patton<sup>6</sup>

In this District Court decision involving the issue of reasonableness of executive compensation, Delta Star, Inc. (Delta Star) and the Delta Star ESOP sued Andrew W. Patton (Patton), the former president of Delta Star, on claims of breach of fiduciary duty.

Delta Star was created as a spin-off from H.K. Porter Company in 1989. As part of the transaction, the ESOP acquired substantially all (98.63 percent) of the Delta Star common stock.

Three individuals served as members of the ESOP board of trustees—Patton and two other Delta Star executives. The ESOP board of trustees voted the Delta Star ESOP stock, and the members of the ESOP board of trustees elected themselves to serve on the board of directors of Delta Star. The board of directors then appointed Patton as chairman and president of Delta Star. Although the sponsor company legal counsel advised Patton to have one or more outside directors serve on the Delta Star board, Patton rejected that advice.

In 1989, at the time Delta Star became a separate entity, Patton’s base salary was \$201,400. Patton’s base salary increased over the next five years to \$301,320. Patton also received bonuses between 1989 and 1993 totaling over \$2.7 million. In addition, he received other compensation, including several country club memberships and the option to purchase luxury automobiles at the end of leases at below-market prices.

Under Patton’s direction, the board of directors adopted a Benefit Restoration Plan and a Supplemental Executive Retirement Plan. Under these plans, and as a result of his excess compensation, Patton was to receive unusually large additional proceeds.

Over the 1989 to 1994 time frame, as Patton’s compensation increased dramatically, Delta Star sales decreased from \$41.6 million to \$28 million. In addition, the company reported an operating loss in 1994.

In reviewing the facts of the case, the court found that (1) Patton unilaterally established his own compensation without the approval of the other two members of the company’s board of directors and the ESOP’s board of trustees, and (2) he actively concealed these amounts from the other members of the board of directors and board of trustees.

In addition, Patton determined his compensation without approval from an independent committee of the board of directors or the use of an outside compensation consultant. Based on a comparison of Patton’s compensation with compensation paid by similar companies in the industry

The Seventh Circuit, in *Exacto Spring Corp. v. Commissioner*,<sup>4</sup> heavily criticized the multi-factor tests listed above as generating unpredictable results. Instead, the Court of Appeals applied an “independent investor” test.

The independent investor test considers the return on investment indicated by the increase in value of the corporation’s stock along with dividends paid during the time periods in question. If a reasonable return is indicated based on the increase in value and dividends paid, an “independent” investor would be satisfied with the return on investment and would not object to the key executive compensation.

Therefore, the higher the rate of return (adjusted for risk) that a key executive can generate, the greater the compensation he or she can generally command. The *Exacto* case demonstrates that it is important to consider the rate of return actually achieved by investors compared to expected return when analyzing key executive compensation.

In certain subsequent judicial decisions (such as *Haffner’s Service Stations, Inc. v. Commissioner*<sup>5</sup>), the courts have continued to apply the multi-factor analysis to determine reasonable compensation. Financial advisers typically consider both the multi-factor analysis and the independent investor test when analyzing the reasonableness of key executive compensation.

## ESOP-OWNED EMPLOYER CORPORATION REASONABLE KEY EXECUTIVE COMPENSATION COURT CASES

There have been two recent court cases involving the determination of reasonable key executive compensation in ESOP-owned employer corporations. The two cases below present:

1. an example of a case in which key executive compensation was determined to be excessive,
2. an example of a case in which key executive compensation was determined to be reasonable, and

for similar services, the District Court found that Patton's compensation was unreasonably high, especially considering the financial performance of the company.

Patton was an ESOP fiduciary in this case. This is because he served as a member of the ESOP board of trustees. The District Court concluded that Patton breached his fiduciary duty to the ESOP by paying himself an excessive base salary, excessive bonuses, and authorizing other excessive fringe benefits. The District Court ruled that Patton failed to recognize the conflict of interest that existed between his duty of loyalty to the ESOP participants and his own personal financial gain.

The District Court also ruled that Patton violated ERISA statutes prohibiting self-dealing<sup>7</sup> by voting the shares held by the Delta Star ESOP in favor of his retention as a member of the Delta Star board, thereby enabling him to pay himself excessive compensation and retirement benefits. As a result, Patton was ordered by the District Court to repay more than \$3.3 million to the sponsor company.

*“. . . it is generally advisable to have independent members of the sponsor company board of directors retain an independent compensation consultant to review executive compensation.”*

### *Eckelkamp v. Beste*<sup>8</sup>

In this case, the Sixth Circuit affirmed the District Court grant of summary judgment, rejecting the claim by plaintiffs that key executive compensation was excessive.

Gary Eckelkamp, an employee of Melton Machine and Control Company (Melton) and two former employees, Bradley Hoemann and Ronald Kampmann, brought this action against Melton, its ESOP, and four Melton officers, alleging breach of fiduciary duty claims under ERISA.

In 1986, the ESOP purchased Melton from the founder for \$1.4 million. At that time, Melton was transitioning from manufacturing for the bicycle and furniture industries to manufacturing for the automotive industry. This change brought increased sales, and Melton achieved annual sales of more than \$20 million by 2000. From 1985 to 2000, the average annual rate of return on Melton stock was approximately 20 percent.

The average Melton employee earned in excess of \$100,000 in direct cash compensation each year—125 percent over the median market rate for similar positions in other companies. In addition, the average employee with at least one year of service at Melton had ESOP and deferred compensation account totals valued at approximately \$350,000.

The plaintiffs alleged that the defendants had violated their fiduciary duties (1) by overcompensating themselves and (2) by failing to obtain accurate annual valuations of Melton stock. The defendants were responsible for setting employee salaries, including their own. And, the defen-

dants acknowledged that they were compensated at least 56 percent above the median rate for similar positions in comparable companies.

The plaintiffs relied on an expert report that concluded (1) that the defendants were overcompensated and (2) that annual appraisals consistently undervalued the sponsor company. The District Court rejected the expert report conclusions, finding that the expert failed to take into account that all employees at Melton were paid considerably more than market rates.

In addition, the District Court found that the expert based his analysis on comparisons to executive compensation at companies that were not comparable to Melton. None of the companies used for comparison had achieved Melton's 20 percent annual rate of growth, and some “comparable” companies were not even profitable.

In addition, the expert did not visit the Melton facility, interview its employees, or research the job duties of executives at the comparison companies to ensure that their jobs were actually comparable to those of the defendants. The expert also did not consider the fact that

much of the Melton key executive compensation was paid in the form of bonuses contingent on the performance of the company.

## SUMMARY AND CONCLUSION

Certain external controls exist to limit key executive compensation to a reasonable level for public corporations. Although closely held ESOP sponsor companies are not subject to SEC reporting requirements, executive compensation at ESOP sponsor companies is subject to (1) scrutiny by the Service and the DOL and (2) ERISA fiduciary requirements.

However, in many ESOP sponsor companies, key executives typically also serve as ESOP trustees. This creates the appearance of a conflict of interest. In these instances, it is generally advisable to have independent members of the sponsor company board of directors retain an independent compensation consultant to review executive compensation.

This independent review would provide protection for the ESOP trustee if the executive compensation was challenged by ESOP participants, the Service, or the DOL. Without this additional independent oversight, a key executive serving as the ESOP trustee could unilaterally pay himself or herself excessive compensation, limiting profit and cash flow available to provide for a fair return on the

ESOP's investment in the employer corporation's common stock.

As a result, financial advisers retained to estimate the value of stock in majority employee-owned employer corporations should independently analyze the reasonableness of key executive compensation.

This discussion provided an overview of factors that financial advisers typically consider in the determination of reasonable key executive compensation for majority ESOP-owned employer corporations, including the multi-factor analysis and the independent investor test.

In addition, this discussion presented a review of certain ESOP-related court cases that focused on the determination of reasonable key executive compensation. The *Delta Star* and *Eckelkamp* cases presented in this discussion highlight the factors considered by courts in the determination of reasonable key executive compensation in ESOP-owned employer corporations.

In both of these cases, the courts considered many of the factors listed in the multi-factor tests presented in this discussion and a version of the independent investor test to determine reasonable key executive compensation.

#### Notes:

1. In 2006, the SEC approved new executive compensation disclosure standards that require companies to provide a more complete tabular and narrative disclosure of compensation elements in their filings for the principal executive officer, the principal financial officer, and the three highest paid executive officers and directors. The objective is to give investors a clear understanding of the components of executive pay and the basis for determining whether the compensation is reasonable.
2. *Mayson Mfg. Co. v. Commissioner*, 178 F.2d 115 (6th Cir. 1949).
3. *Elliotts, Inc. v. Commissioner*, 716 F.2d 1241 (9th Cir. 1983).
4. *Exacto Spring Corp. v. Commissioner*, 196 F.3d 833 (7th Cir. 1999).
5. *Haffner's Service Stations, Inc. v. Commissioner*, 326 F.3d 1 (1st Cir. 2003).
6. *Delta Star, Inc. v. Patton*, 76 F.Supp.2d 617 (W.D. Pa. 1999).
7. These provisions of ERISA provide that a fiduciary with respect to the ERISA plan (1) shall not deal with the assets of the plan in his own interest or for his own account and (2) shall not in his individual or in any other capacity act in any transaction involving the plan on behalf of a party (or representing a party) whose interests are adverse to the interests of the plan or the interests of its participants or beneficiaries.
8. *Eckelkamp v. Beste*, 315 F.3d 863 (8th Cir. 2002).

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## GOODIN V. INNOVATIVE TECHNICAL SOLUTIONS

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The District Court also recognized that the Plan's ITS stock was acquired by contributions to the 401(k) component, not the ESOP component. The ESOP component of the Plan could only be funded by:

1. ITS cash contributions or
2. loans leveraged against ITS stock.

The record before the Court did not reflect that:

1. ITS ever made any profit contributions to the ESOP component of the Plan or
2. any leveraged loans ever existed.

Fourth and finally, if the ITS stock was to be held in the ESOP portion, the defendants would not be permitted to eliminate the put option feature (at least as it applied to exempt loans to leveraged ESOPs) under the Internal Revenue Code and applicable Treasury Regulations.

Given this fact, the District Court determined that the ESOP and the 401(k) components are distinct and separate. The District Court concluded that the "ESOP Exception" does not apply to ITS stock held in the 401(k) component of the Plan.

Therefore, the District Court concluded that the put option was an optional form of benefit under the 1998 Plan, the elimination of which is prohibited by the ERISA Anti-Cutback Provision.

## SUMMARY AND CONCLUSION

This discussion provided a review of the *Goodin v. Innovative Technical Solutions* case. In this case, the District Court determined that the ITS termination of the Plan participants' right to receive put options for in-kind distributions was a violation of the ERISA anti-cutback provision, which is not statutorily exempted by the "ESOP Exception."

Employer corporation managements, ESOP administrative committees, and ESOP trustees should consider the implications of the *ITS* judicial decision in the event that their employer corporation attempts to eliminate employee benefits.

#### Note:

1. *Goodin v. Innovative Technical Solutions*, 489 F.Supp.2d 1157 (D.C. Haw. 2007).

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