

Should We Segregate Terminated Participant Accounts? Let's Debate!



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Agenda

- Segregation: Definition and Mechanics
- Ayers Saint Gross, Inc. ESOP
- Debate 1: Active vs. Terminated Participant
- Debate 2: Board of Directors vs. CFO
- ASG's Approach
- Striking the Right Balance
- Questions

- **Segregation: Definition and Mechanics**
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What is Segregation?

Segregation (sometimes called **conversion** or **reshuffling**) is the reinvestment of ESOP shares from a terminated ESOP participant, using cash or another investment.

i.e., replacing ESOP stock with cash / other investments for terminated participants

Example

ESOP has 2 participants: Romeo (active) and Juliet (terminated).

- Romeo's ESOP account has \$3,000 in cash (no shares).
- Juliet's ESOP account has \$2,000 in stock (100 shares with a fair market value of \$20 per share).

Company may reshuffle accounts so that Romeo is invested to the extent possible in company stock and Juliet is invested to the extent possible in cash. After segregation:

- Romeo's account has \$2,000 in stock and \$1,000 cash (still \$3,000 total)
- Juliet's account has \$2,000 in cash (no shares).
- Juliet's account remains invested in cash until she is eligible for a distribution.

Is Segregation Permissible?

Segregation is permitted only if:

- The plan provides for it (originally or by amendment);
- The participant has terminated employment for any reason; and
- It is done in a non-discriminatory manner.

Is Segregation Permissible?

YES!

- Participants do not have a right to a particular investment, or mix of investments, even in an ESOP, so long as the manner and amount of reinvestments is described, including the date of valuation.

(But....)

- Reshuffling is a permissible tool, but does not have unlimited flexibility.

Is Segregation Permissible?

- The plan must describe the circumstances when segregation will take place – administrator or fiduciary cannot use discretion to determine which participant accounts will be segregated.
- Segregation must be implemented in a non-discriminatory manner.
- Once an account is segregated, it may also be unsegregated, unless the participant satisfies the requirements for account diversification (over age 55 and 10 years in the plan) and has elected diversification.

Does Segregation Change Distribution Rules?

- NO, distribution rules do not change unless the Company chooses to change them as well.
- Account of a terminated participant can be re-invested in cash or other assets, and held in the plan until the participant is entitled to take a distribution of the account balance under the normal plan rules.
- Segregated account can be invested in the same investments as other non-stock investments in the ESOP.
- Investment of other assets needs to be prudent, but does not need to mirror the return on the stock.

Investment of Segregated Accounts

How will segregated accounts be invested?

- Trustee directed
- Participant directed (must provide at least 3 investment options)
- Within ESOP
- Transfer to 401(k) Plan

Must be invested prudently (risk and return)

Different concerns depending on how invested

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Ayers Saint Gross – a case study

Ayers Saint Gross is an employee-owned design firm with expertise in architecture, planning, landscape architecture, space analytics, interiors, and graphic design.



Firm Facts

FOUNDED

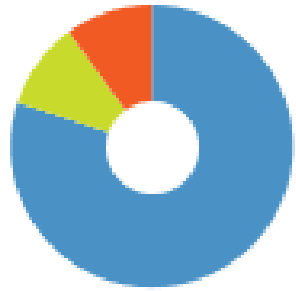
1912

STAFF

180

PROFESSIONAL STAFF
MEMBERS

PROJECTS



100%

of our work is for mission
driven clients

80%

is for
higher
education

10%

is for
cultural
institutions

10%

is for K-12
and private
sector

DISCIPLINES

Architecture

Landscape Architecture

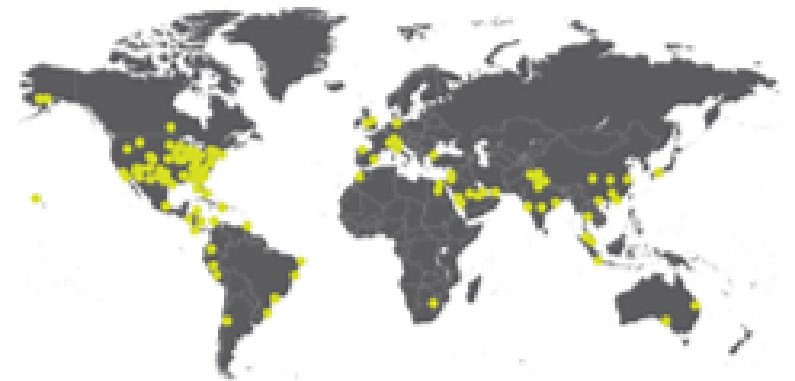
Graphic Design

Interiors

Planning

Space Analytics

INTERNATIONAL REACH

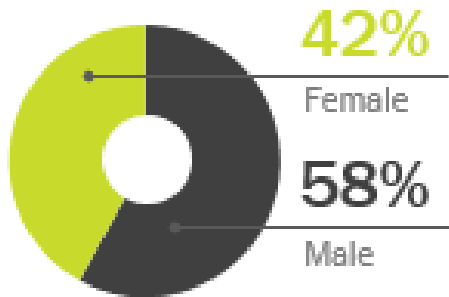


Leadership at Ayers Saint Gross

ASSOCIATE

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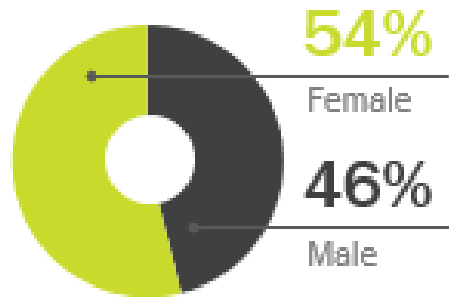
GENDER



SENIOR ASSOCIATE

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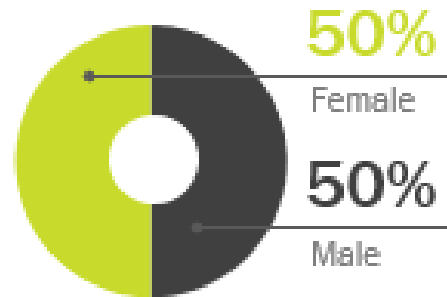
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ASSOCIATE PRINCIPAL

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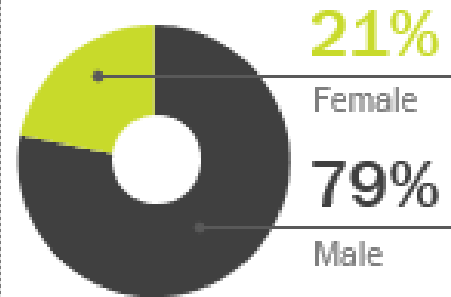
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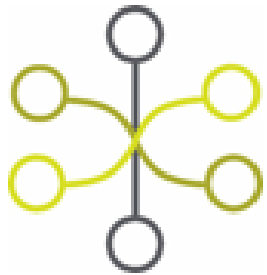
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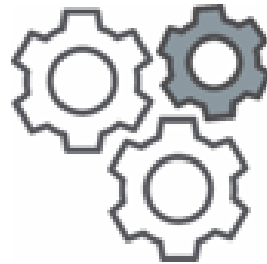
Our culture and values



INTEGRATED DESIGN
PRACTICE



COMMUNICATIONS



OPERATIONS



PEOPLE & CULTURE



PROACTIVE BUSINESS
DEVELOPMENT

Business Planning

- Employee-ownership ushered in a new era, 2013 as an S-Corp ESOP
- Three-year outlook: Strategic Plan
- One-year outlook: Business Plan
- Practice group overview
- Business development strategy
- Major investments and revenue goals
- Opportunities for growth and competitive advantage



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An Active Participant's Perspective

FOR segregation

- It's not fair for terminated participants to hold on to shares and realize gains from my hard work
 - Increases in per share value
 - Plus dividends / S distributions
- If we segregate, more shares will be recycled to me sooner, and I will get a higher ESOP benefit

AGAINST segregation

- But, then again, someday I will retire. How will I feel then?

A Terminated Participant's Perspective

AGAINST segregation

- My distribution will be lower if my account is segregated, assuming share value growth continues
- It's not fair to pay me out based solely on the share value right after termination:
 - I've been with the company a long time – my contributions won't be fully realized for a few years after I leave
 - There could be a short-term dip in share value; therefore I'd prefer installment payouts based on multiple values

FOR segregation

- If share value declines, my distribution will be higher if my account is segregated
- Segregating my account results in a more diversified investment and protects me from the risk of my company's stock price falling

Illustrating the Impact on Individual Participants

ABC company is considering implementing segregation, and wants to quantify the relative impact on individual participants

Key Assumptions

- 250 Employees
- 10% employee turnover annually
- Share price grows about 10% per year
- 2 scenarios modeled:
 - **No Segregation (Status Quo)** – Accounts are paid in 5 annual installments, beginning in the year following retirement. Distributions for other terminations are subject to an additional 5-year wait.
 - **Segregation** – Accounts are segregated in a lump sum in the year following termination.

Projected Account Balance + Distributions Received As of 12/31/2028



Illustrating the Impact on Individual Participants

In this example:

- The active participants accumulate **29% higher balances** with segregation, regardless of compensation level
- The terminated participant receives **52% less** with segregation

Comparing the potential effect on individual participants can be one helpful input when the Company is trying to decide whether to segregate.

This is just one example. The results are heavily dependent on the facts and circumstances and modeling assumptions.

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The Board of Directors Perspective

FOR segregation

- We want active participants to hold most of the shares in the ESOP, as a performance incentive
- We want to cap the value of the stock account at the date of termination
- However, we want to keep the delays and installments in our distribution policy
 - Don't want to pay out in an immediate lump sum

AGAINST segregation

- We're not thrilled about taking on the fiduciary responsibility for investing these accounts
- Segregation might make the plan administration more complicated, and might necessitate discrimination testing

The CFO's Perspective

AGAINST segregation

- If we segregate, we accelerate the turnover of shares, and our repurchase obligations will be higher
- Furthermore, if we segregate in a lump sum:
 - Cash requirements could vary widely from year to year
 - We limit our planning horizon to come up with the cash

FOR segregation

- I like the idea of “pre-funding” the repurchase obligation before it’s due if we have extra cash on hand
- If we can design segregation “to the extent of available cash”, I’m in

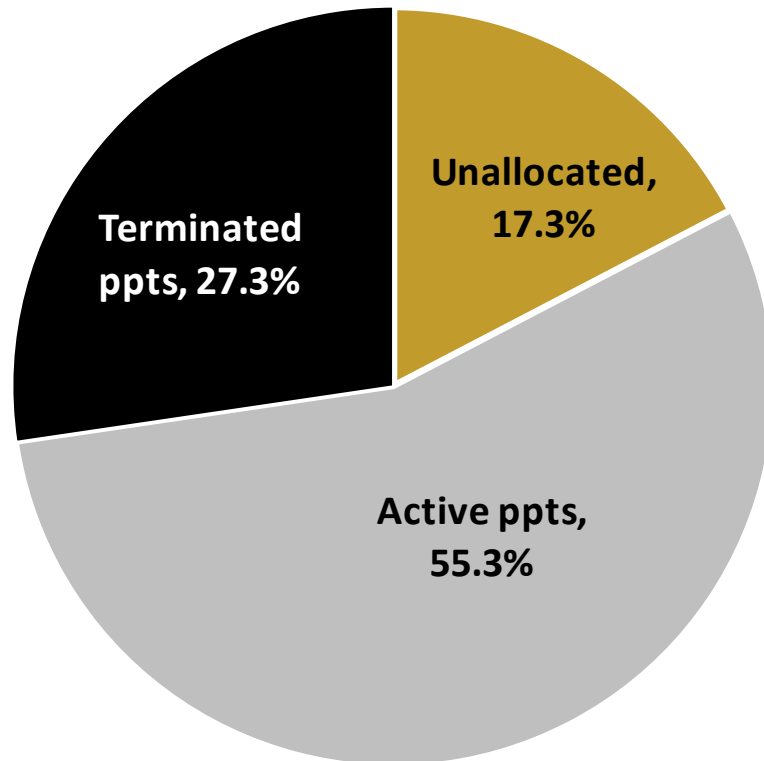
Illustrating the Overall Impact

ABC company would also like to understand the overall impact of segregation, specifically on:

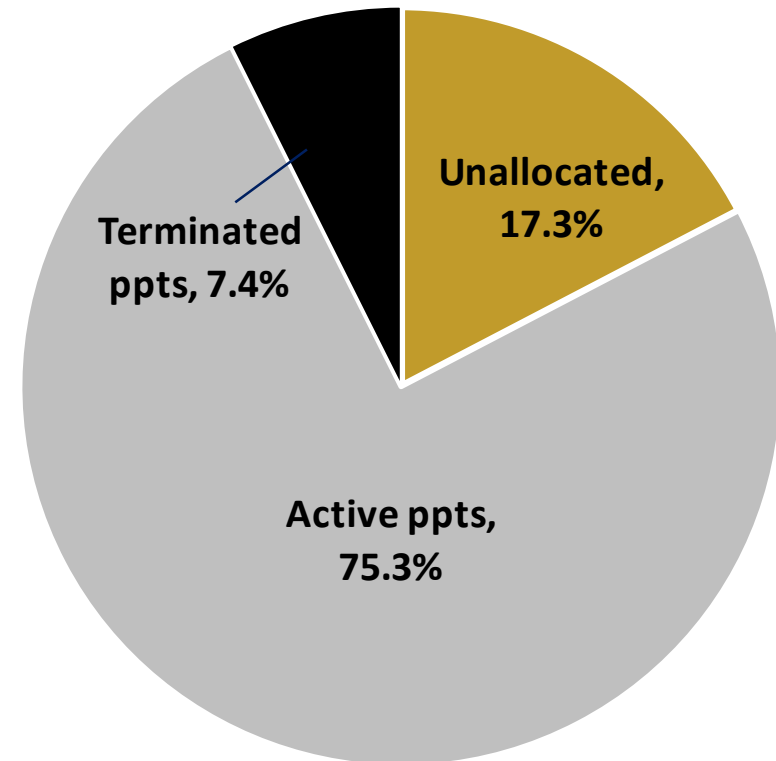
- “Ownership mix” between active and terminated participants
- Corporate cash balances
- Share value
- ESOP benefit level

Projected 2028 ESOP Share Allocation

No Segregation:



Segregation:



Projected 10-Year Financial Impact

| | No | |
|---|--------------------|--------------------|
| | <u>Segregation</u> | <u>Segregation</u> |
| 10-year Repurchase Obligation | \$8.0 | \$16.0 |
| 2028 Corporate Cash Balance | \$28.0 | \$20.0 |
| 2028 Per Share Value | \$39.43 | \$33.48 |
| Average ESOP Benefit Level as % Payroll | 13.6% | 18.1% |

\$ in Millions, except Per Share Values

Illustrating the Overall 10-Year Impact

In this example, if accounts are segregated:

- Terminated participants hold a much smaller piece of the pie (7.4% vs. 27.3%)
- The company will have \$8 million less cash on the balance sheet in 2028; however, the company will still accumulate \$20 million in cash
- Share value will be somewhat lower, affecting the ESOP shareholder as well as any outside shareholders or synthetic equity recipients
- However, the ESOP benefit level will average 18.1% vs. 13.6% of payroll

We highly recommend analyzing the financial impact before making any change to your ESOP plan provisions, to make sure the change is affordable and doesn't create unexpected consequences.

This is just one example. The results are heavily dependent on the facts and circumstances and modeling assumptions.

Illustrating the Overall 10-Year Impact

Before making the decision to segregate, we highly recommend:

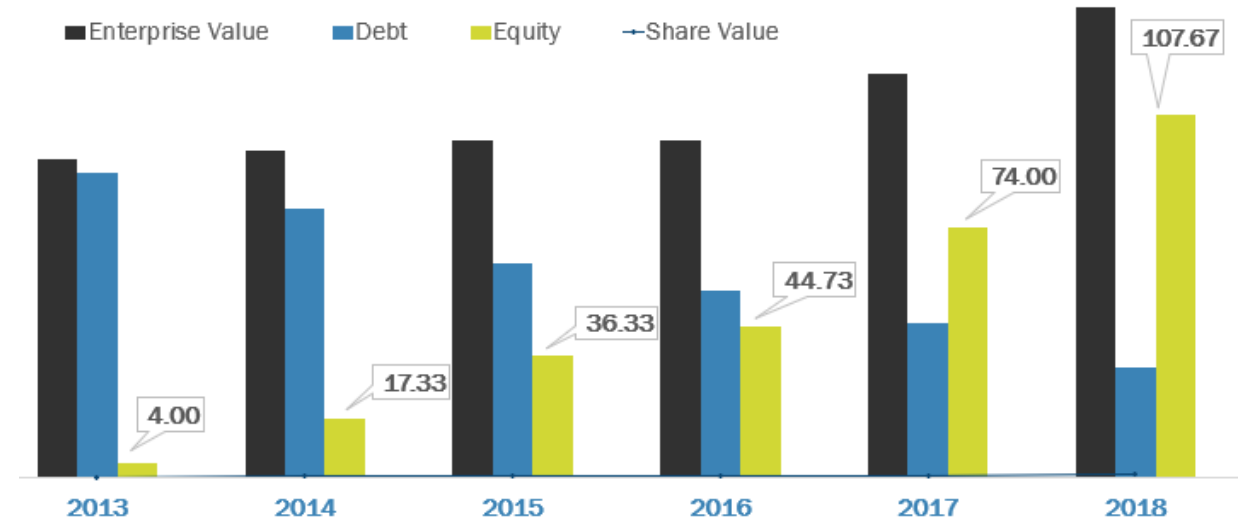
- Analyzing the financial impact and affordability of this change
- Discussing the change with your ESOP advisors, including your ESOP attorney, record-keeper, and financial advisor to understand all of the implications

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Circumstances leading to segregation

- We are a 6 year old leveraged ESOP, with a younger population

- As we have paid down the debt, we have experienced a significant increase in share price each year



- We have adequate cash on hand

- Our Board has held the philosophy that we should benefit current, rather than former employees

Annual review

- We annually evaluate whether the segregation is the right approach
 - We analyze our cash position
 - We take into account our share value
 - In partnership with our Trustee, we perform a Sustainability Analysis looking forward 10-20 years
 - As our ESOP matures, we re-examine our ownership mix and benefit levels
 - We review our strategy and recommendations with the Board

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Summary of Factors to Consider

- Cash flow
- Other uses for cash
- Valuation projections
- Benefit levels
- Cultural factors for stock ownership
- Repurchase obligation projections
- Have and have-not problem
- Depending on conclusion from above, at termination or later?

Other Alternatives

We've talked a lot about segregating in an immediate lump sum. There are other ways to do it!

- Can segregate after a delay, or over multiple installments
- Can segregate only to the extent participants do not elect distributions when eligible to do so
- Can segregate “to the extent of cash in the trust”
 - Be careful, as participants develop expectations, and will react negatively if segregation is abandoned during a period of declining share price

Other Alternatives

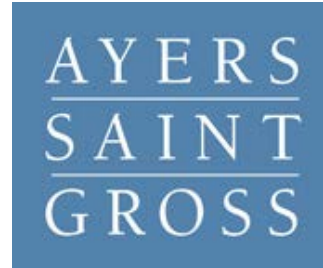
Other ways to provide a higher benefit to new participants:

- Increase the ESOP contribution level
- Remember that funding with dividends / S distributions generally does not provide a benefit, as they are allocated on share balance
 - The exception is that dividends/S distributions paid on unallocated shares are typically allocated in the same manner as contributions
- If you are redeeming repurchased shares, consider recycling or recontributing some or all of the shares

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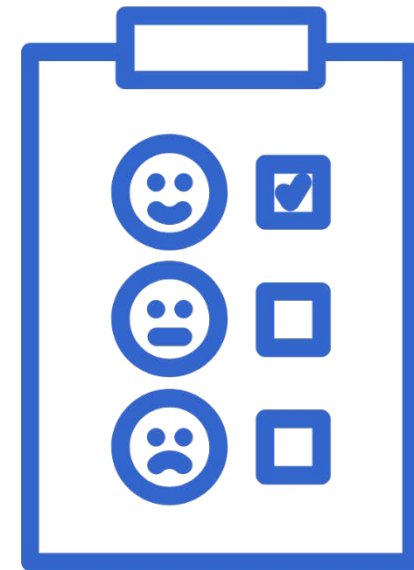
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