

CLIENT ALERT

ESOP COMMUNICATION DURING ECONOMIC HARD TIMES

Written by: Guest author Mike Shay, Principal of Praxis Consulting Group, Inc., with input from Praxis Principals Alex Moss and Ted Freeman.

It is important to remember that there is no such thing as a lack of communication within an organization. There is only a lack of **effective, factual** communication because communication gaps within an organization are filled by rumor and gossip which quickly take on the gravitas of fact. Furthermore, rumor and gossip will almost always be fear-inspired and driven, and this is especially true in times of high stress like the current deep economic downturn. Recognizing these challenges, the objectives of your ESOP communications during difficult economic times should be:



1. Replace concerns driven by fear-based myth, rumor and gossip with a measure of confidence that the organization is headed in the right direction, and have that confidence grounded in the current facts as leaders are able to discern them.
2. Inspire confidence in the competence of organizational leaders. It is important that the organization have a high level of trust in the competence of its leaders, especially in uncertain times.
3. Give hope to the organization that there are fact-driven, credible plans in place to deal with current difficulties and grow the organization early in the recovery phase of the current downturn.
4. Identify the Key Organizational Performance Indicators (KPIs) on which employees should focus their individual and collective attention.
5. Establish strong mental links between the quality of employee efforts and decisions and the rate of organizational improvement.
6. Prioritize efforts to have maximum affect on critical improvement.
7. Continually reinforce the fact that moving the KPIs in the right direction, and at the maximum rate possible, is the only route to long-term job security and maximizing increases in annual stock value.

These seven outcomes are the critical filters through which all ESOP communication should pass.

► Replacing concerns with confidence.

The economic situation creates uncertainty about our companies and how individual employees will be affected. Uncertainty leads to anxiety, and anxiety can often lead to unproductive or fear-based behavior. This is a particularly important time to share business information across your organization - and frequently. How is your business performing, what is happening with key customers, what opportunities are on the horizon, and most importantly, how can employee owners help, especially in terms of day-to-day job performance? Although you may not be able to answer all questions, answer what you can. This level of sharing creates trust. However, it can also create anxiety when the news is not good. But withholding bad or challenging information is generally a recipe both for distrust and also for people to make assumptions about what you are not telling them, and those assumptions are very often much worse than reality. Even if the picture of the future is not yet clear, people will know that you are keeping them apprised as best you can, and they will trust both good news and difficult news more readily when it is available. Having trust and confidence in the communication of leaders is a critical competitive advantage

ESOP Communication During Hard Times

in creating and/or sustaining a highly responsive organization.

► **Inspiring confidence in the competence of leaders and inspiring hope by having plans in place that will lead to organizational success.** Lack of trust in the competence of leaders (much less a full blown crisis of leadership) during hard times will result in chart-busting levels of anxiety among the workforce. In communications to the organization, ESOP leaders need to demonstrate a high level of understanding of the internal and external factors that affect the financial performance of the ESOP. These leaders also need to communicate that this understanding is translated into a highly credible plan of action that will result in organizational success. This communication must be grounded in a fact-driven message that states, “We understand what is going on, we understand how the business is being affected, we know what to do, plans are in place and we are going in the right direction.” The workforce needs to feel that the organization has direction and focus, and is well led.

Downturns, like economic booms, create winners and losers. Remind your employee owners of the basics: not every company will respond well to challenges, and those that respond better are more likely to retain customers and jobs and position themselves for recovery when the economy does turn around.

The key question: how can we position our firm to take advantage of this and respond more effectively? You may not have the finest year in terms of earnings and stock price, but it’s often the case that the groundwork laid during the downturn positions successful firms to accelerate much more quickly and to compete even more

effectively when the business cycle shifts again.

Your external environment. How are your competitors responding? What customers are they failing to serve? Which of your customers are cutting their own capacity and may in fact need more from your company to support them? How can we reach out to existing and potential customers to strengthen ties (sometimes even at the risk of short-term profitability)? How can we use this time as an opportunity to build stronger relationships for the future?

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Inside your company. In what ways are your processes optimized to deliver value to customers and take best advantage of employee efforts, and where are the opportunities for improvement? From the employee owners’ perspective: if we need to reach out to customers in new ways to help them weather the storm, what does this mean for our internal processes, and what might we need to do differently to enable a different level of customer service?

These are all routine questions with which management is already wrestling. The point is to share this thinking with employee owners, that challenging times require a different level of responsiveness to customers and potential customers. Often, employee owners may tend to focus on the past – the missed opportunities, the mistakes and the negative results. Of course learning from the past is critical, but mainly as a guide to learning for the future. Focus on the horizon, and specifically what people can do to respond.

► **Identify the KPIs, enable the establishment of links between effort and organizational performance, and empower the workforce through information to prioritize their resources for maximizing improvement.** ESOP leaders need to communicate the critical metrics that mean the difference between organizational success (employment stability, growth, increases in stock values) and organizational failure (repeated and ongoing job loss, violation of covenants, decreases in stock value). KPIs need to be limited in number, balanced and measured, and communicated frequently, even daily where possible. A clear example of a balanced set of KPIs might be: customer claims (external quality), rework (internal quality), productivity, safety, inventory and sales. Employee owners should be able to tell at the start of the workday how yesterday’s activities affected the KPIs and what level of performance is required today to maintain the requisite rate of improvement for the week, month, quarter and/or year to date. Employee owners should be encouraged to think through how the organizational resources they control can best be utilized to maximize their contribution to organizational improvement based on the frequently communicated KPIs (as opposed to maximizing individual or departmental improvement).

In hard times, the organization needs to maximize the resources it has available to drive improvement, and employee owners are an often underutilized resource. Employee owners also need to feel that they have the ability to affect their current condition and their future, that they have some measure of control over whether or not their organization is successful. They want to feel challenged and that they have a reasonable chance, with sustained effort, to successfully meet the challenge.

► **Linking improvement to long term job security and stock value.** The basic ownership culture building blocks continue to

apply in this economic environment. We know that:

- Engaging employee owners in problem-solving leads to better, faster solutions.
- Achieving this potential performance boost from employee ownership is not automatic - it requires focused and continual leadership effort. To be effective, employee owners need:
 - ◊ routine access to appropriate financial and other business information to track performance at the job and overall company levels;
 - ◊ systems and structures through which they can offer appropriate input into improving operations, and training in

the skills to participate productively; and

- ◊ leaders who will balance encouraging a significant level of input into improving performance while maintaining performance accountability at the individual, team and overall company levels.

We also know that people need meaningful incentives tied to their performance.

Our experience in severe downturns suggests that the incentive of keeping one's job and benefits becomes paramount during these times, more so than cash bonuses (which may not be real at this time), and more so than recovering long-term

share value. Your emphasis should be on extending the focus and aligning the goals. Yes, job security is paramount - now. But the things we need to do to build job security are the same things we need to do to drive profitability, all of which will enable us to return to paying bonuses and other benefits while building share value over the long run.

Praxis believes that engaged owners do better work. Mike, Alex and Ted are recognized leaders in advising employee-owned clients in leveraging shared ownership to improve organizational performance. Mike and Ted serve on The ESOP Association's Ownership Culture Advisory Committee and Alex currently serves on TEA's Board of Directors. www.praxiscg.com

REQUIRED MINIMUM DISTRIBUTIONS WAIVED FOR 2009...OR ARE THEY?

Written by: Tina M. Fisher, CPC - Senior ESOP Consultant

The Worker, Retiree and Employer Recovery Act of 2008, or WREERA, provides a temporary waiver of the minimum distribution rules for calendar year 2009. Once a participant reaches his "required beginning date" (defined as age 70 ½ for participants who own more than 5%, or the later of age 70 ½ or separation from service for those participants who own 5% or less), the minimum distribution rules under IRC Section 401(a)(9) would normally require a plan to begin making minimal annual distributions to participants. The first minimum distribution can be distributed as late as April 1 of the next calendar year, so WREERA also waives first minimum distributions due by April 1, 2010. The waiver applies to qualified defined contribution plans (i.e., ESOPs, 401(k) plans and profit sharing plans), 403(a) plans, 403(b) plans, governmental 457 plans and IRAs).

While WREERA does relieve plans from

being required to make any minimum distributions in 2009, the waiver is by no means a mandatory provision. As a result, plan sponsors must decide how their plan will comply with these provisions. WREERA also does not include any language regarding notice requirements to participants and no IRS guidance on this issue has been provided to date. In the absence of any notice provisions, it would still be advisable to provide some form of communication to participants regarding the change in law. And depending on how the employer chooses to handle minimum distributions during 2009, this information could be included within the distribution/election form. Following are four plan design options as well as suggestions for participant communications for each option:

Option 1: Continue to make scheduled distributions of 2009 minimum distributions allowing participants the option to waive the distribution. Under this ap-

proach, the plan's default provision is to continue making minimum distributions in 2009 but allow the participant the option of electing out of the minimum distribution. Affected participants are notified that the employer has decided to continue making minimum distributions during 2009, but that the participant has the option of waiving the distribution. A distribution form would be included providing the amount of the distribution available, an election to waive the distribution and withholding options for the distribution.

Option 2: Waive distribution of scheduled 2009 minimum distributions allowing participants the option to receive the distribution. Under this approach, the plan's default provision is to suspend minimum distributions for 2009, but allow the participant the option of receiving a minimum distribution. Affected participants are notified that the employer has decided to stop making minimum distributions

Required Minimum Distributions Waived for 2009...Or Are They?

during 2009 in accordance with the change in law, but that the participant has the option of receiving the distribution. A distribution form would be included providing the amount of the distribution available, an election to receive the distribution, and withholding options for the distribution.

Option 3: Continue minimum distributions as in previous years, with no election to waive. This option eliminates the need for the employer to change the plan's minimum distribution procedures. Notices to participants can occur as in previous years.

Option 4: Stop minimum distributions completely. As provided in WRERA, employers could choose to completely skip minimum distributions during 2009, and allow no elections by participants to receive. Participant communications would advise the participant of the law change, and inform them that no minimum distributions will be provided during 2009.

Communications provided under any of the four options above should also include information on the tax consequences of receiving a minimum distribution during 2009. WRERA amended the Code's distribution provisions to provide that a distribution which would have been a minimum distribution for 2009 but is not because of the WRERA waiver provision, and now because it is not a minimum distribution could be an eligible rollover distribution, shall not be considered an eligible rollover distribution for purposes of 1) the direct rollover rules, 2) the 20% withholding requirement or 3) the special tax

notice for eligible rollover distributions required under IRC Section 402(f).

Therefore, the plan will not offer the direct rollover option on this distribution, must apply the 10% withholding rate to the distribution rather than 20% withholding (although the participant has the option of having a smaller percentage withheld as in prior years), and does not have to provide the 402(f) notice to the participant (although it may need to provide this notice if the minimum distribution is part of a larger distribution).

Example 1: Participant is over age 70½ and terminated. Participant elects to take a lump sum distribution of his account balance in 2009 in the form of a rollover to an IRA. His account balance is \$10,000. Normally, \$250 would be a minimum distribution which he could not roll over and \$9,750 would be an eligible rollover distribution. In 2009, the employer would still cut a check to the IRA for \$9,750 and a check to the participant for \$250 (at the 10% or less withholding rate). IRS Notice 2009-9 which was written to provide guidance to financial institutions regarding the reporting of required minimum distributions during 2009, also comments that the participant "might" be able to rollover the portion attributable to the minimum distribution (in this example, \$250). In that case, employers would still cut the check to the participant and the participant would have 60 days to complete an indirect rollover of the entire \$250. However, we recommend that the participant consult with their tax advisor to confirm that this amount would be eligible for an indirect rollover.

Introducing

SES Advisors is pleased to welcome Karen Hurley to our ESOP Administration team as Senior Plan Administrator. Karen will provide professional ESOP Administration and consulting services as well as assist in the marketing of SES' ESOP administration services. Karen has a BBA in accounting from Niagara University and five years of ESOP recordkeeping experience. She is located in Charlottesville, VA and can be reached at khurley@sesadvisors.com.

Example 2: Same facts as Example 1, except the participant does not elect a rollover, but elects to have cash paid directly to him. 20% is withheld on the \$9,750 and the \$250 is subject to the 10% withholding rate.

Example 3: Participant is not eligible for any distribution in 2009 other than what would normally be a required minimum distribution. This amount is still not considered an eligible rollover distribution during 2009 and is subject to the 10% withholding rate.

Generally, plans will need to be amended by the last day of the first plan year beginning on or after January 1, 2011. However, the required timing of plan amendments will depend upon the existing language within the plan and the option chosen by the employer.

If your plan has any participants that have met their required beginning date and are eligible to receive a minimum distribution, your Plan Administrator will work directly with you and assist in selecting the option best for you.

If you have any questions please contact Tina at tfisher@sesadvisors.com

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