DOWNTOWN
BUSINESS ADVISORS, LLC

EMPLOYEE INCENTIVE PLANNING

- *Before they can sell or exit their businesses with financial security, most owners need to grow their companies' cash flow and transferable value significantly. Without management leading the charge, this is a most difficult task in today's economy.*
- *Few sophisticated buyers will seriously consider acquiring a company that lacks a capable management team that remains with the business after the owner exits.*
- *A sizeable percentage of businesses are sold to key employees—up to 40% according to a recent survey of 700 written exit plans created by advisors belonging to the BEI Network of Exit Planning Advisors.*
- *Transferring a business to children is especially risky in the absence of key employees who will remain with the new ownership.*

Each of these observations highlights an owner's need for motivated employees to grow business value and to stay with your company after you leave. This White Paper describes how to do that.

The beauty of a well-designed key employee incentive program is that as your employees meet their incentive-defined goals, you attain your Exit Planning goal of making your company more valuable and more marketable. And, of course, you are able to exit! If there was ever a case of "win-win" for both employer and employee, it is key employee incentive planning.

The first task in key employee incentive planning is to identify exactly who your key employees are. Most of your employees do not fit into the "key" category. Instead, they are attracted to your company and motivated by the usual items: a pleasant work environment, a stimulating job, good wages and benefits, and job security.

Key employees who tend to be in management, on the other hand, act and think more like you do. They want more challenges and opportunities. They want to prosper and grow as the company does. In short, they behave like owners. You may have key positions in your organizational chart. Make certain the persons filling those slots are key employees.

With these guidelines in mind, let's look at how to motivate this small, yet vitally important, group.

CHARACTERISTICS OF AN INCENTIVE PLAN

A well-crafted incentive plan is one that does more than make both owner and employee feel good.

In fact, five criteria are present in a well-designed plan:

The plan provides substantial financial awards to key employees. A potential bonus equal to at least 25 percent of annual compensation is, in our experience, necessary to motivate an employee to modify performance.

Performance standards are specific. There must be determinable performance standards such as certain company net income or revenue levels. Specific examples are examined below.

Performance standards are tied directly to increases in the company's value. As the key employee achieves measurable objective standards, the net income of the company increases. Put another way, unless the company's net income increases, the key employee does not receive a bonus.

Part of the bonus is deferred and subject to vesting. This characteristic of incentive plans is commonly referred to as "golden handcuffs." If the employee severs his employment before he is "fully vested," he forfeits at least part of the deferred compensation.

The plan is communicated in writing to key employees. In order to be successful, key employees must understand exactly how the plan works. The plan must:

- Be simple,
- Be easy to read,
- Be communicated face-to-face to employees with advisors present to answer any questions and
- Contain a summary for easy reference.

Having identified the elements that make a successful plan, you (as an owner) and your advisors must determine whether a stock-based plan or a cash-based plan (or some combination thereof) will best motivate your employees and cause them to stay with your company.

EQUITY-BASED PLANS

Providing the opportunity for stock ownership is one of the most powerful motivating – and retaining – factors a closely-held business can offer to a key employee.

Stock ownership motivates key employees for a number of reasons. The most common include:

- Stock ties key employees to the company by making them part of the company;
- The plan can require employees to pay for ownership, thus investing themselves, quite literally, in the company. Requiring employees to pay for stock demonstrates their dedication and commitment to the company; and
- Stock ownership provides strong incentive for increasing the value of the company and, therefore, increasing the key employee's benefit.

These are great reasons to transfer stock. We would be remiss, however, if we left unmentioned some of the "not-so-great" reasons that motivate owners to give stock to employees.

It is not uncommon for owners to reward an employee with a small percentage of stock perhaps because the employee was instrumental in a start up or is integral to one facet of the company. Unfortunately, these owners fail to appreciate that even the smallest percentage of stock carries with it significant rights.

Shareholders enjoy more than the right to a share of the growth of the company. They enjoy the right to access company books and records, the right to be informed about the financial condition of the company (including your salary and "perks") and often, a right to be consulted and given the opportunity to vote on major company decisions. Keep in mind one possible "major corporate decision" is a future sale of the corporation. You should be fully aware of the voting percentage requirements imposed by law, by your company's articles or bylaws before unwittingly tying your hands.

As ownership changes the outlook of the employee receiving the stock (usually for the better), it can change the outlook of her co-workers who now perceive her status to have changed. Co-workers may demand ownership as well or may quit. In attempting to reward a key employee, you may inadvertently antagonize other competent, potentially key, employees.

If you believe that stock is the appropriate incentive for your key employees, you then must determine if the time is right to make that award. A decision regarding timeliness is based on the presence of four conditions:

1. Your key employee(s) has been with your company for a sufficient time (usually several years) and is a "proven commodity."
2. The key employee(s) would be more motivated by stock than cash.
3. You are prepared to award the employee(s) a meaningful amount of stock. (Should you be unprepared to commit a significant amount of stock ownership to an employee, a stock-based incentive is not appropriate.)
4. You are willing to bring the employee into the company's confidence, to provide that employee with access to all information regarding the company (including your total compensation) and to allow the employee to participate in major decisions concerning the company.

In addition to determining when to award stock, you and your advisors must consider the following:

- *How does the incentive plan affect participants in other existing plans?*
- *Can non-participating employees participate in the future?*
- *What type of stock (voting or non-voting) will be awarded?*
- *What amount of stock will be awarded both at the outset and in the future?*
- *What valuation formula will you use when awarding and re-acquiring stock*
- *When will payments be made?*
- *What agreement is in place to buy back the stock should the employee leave the company?*
- *What performance standard must be attained before the key employee has the right to a stock bonus or purchase?*

Assuming that you have determined that a well-designed, stock-based incentive plan will motivate your employees and achieve your exit objectives, how do you implement it?

ISSUING STOCK

Stock can be issued to an employee either through a "non-qualified stock bonus" or by allowing him to purchase the stock at either its fair market value or at a discounted price.
Non-Qualified Stock Bonus

With the non-qualified stock bonus, the employee receives, at no cost, stock from the company. The fair market value of the stock is determined and the value of that stock is taxable to the employee as ordinary income in the year he receives it. The company receives an income tax deduction for the value of the stock bonus to the employee.

Thus, if you decide to have the company issue 100 shares to a key employee, and each share of stock is worth $500, the employee's taxable income increases by $50,000 and the corporation deducts $50,000. Alternatively, you can install a restricted stock bonus plan which, for example, grants the employee $25,000 worth of stock in the first year and ties the stock to a five-year vesting schedule. In this way, the employee receives all the economic benefits of owning the full amount of stock up front, (subject only to vesting requirements). If the employee leaves the company prior to full "vesting," he or she forfeits part or all of the value.

Finally, the employee has the option to include the full value of the stock awarded to him in his income, as compensation, in the first year and thus pay tax only on that amount. Owners often use this type of a restricted plan if the key employee is not using his own money to pay for the stock. These plans have significant technical requirements and several design twists so we recommend that you work with experienced advisors to set up the plan that is right for you and your employees.

Stock Purchase

Purchasing stock with a cash bonus is another way key employees can acquire stock from the corporation or from other key employees (including you). If the stock is purchased at less than fair market value, the employee will have taxable income on the difference between the fair market value of the stock and the price actually paid, and the company will have an offsetting deduction.

CASH-BASED PLANS

Most of the key employee incentive plans prepared are cash-based rather than ownership-based. While granting ownership is an excellent way to motivate performance it carries an element of risk and most key employees prefer cash to stock, unless they have plans to own and run the company. For those reasons, owners choose a non-stock incentive plan that provides cash or gives rights to appreciation in stock value rather than to the stock itself. The primary non-stock (or cash-based) incentive plans are:

- Non-qualified deferred compensation plans;
- Stock appreciation (SAR) and "Phantom Stock" Plans; and
- A blended plan combining current cash bonuses with deferred benefits.

Non-Qualified Deferred Compensation Plan

Properly designed, the non-qualified deferred compensation plan (NQDC) is often the simplest, most effective, and single best method of motivating and retaining your key employees. The NQDC plan is a promise to pay benefits in the future based on current or past services of a key employee (or group of employees)."Non-qualified" simply means that as long as certain requirements are met, the plan does not have to meet the formal funding, reporting, discrimination, and employee coverage requirements of the Employee Retirement Income Security Act. With the exception of withholding for Medicare and, in some cases, FICA taxes, in certain situations the benefits awarded to an employee under a NQDC are not taxable until the date on which such benefits are actually paid to the employee.

A NQDC plan includes several important characteristics.

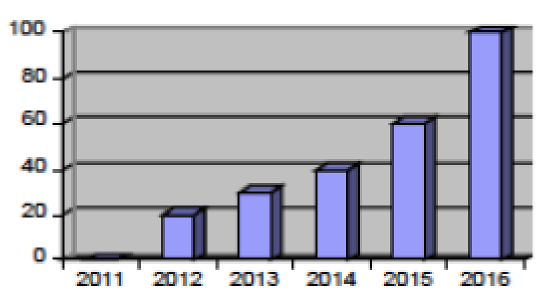
A benefit formula motivates the key employee to increase the profitability of your company. Unless the business meets its profitability objective, the key employee cannot meet his objective. Therefore, the owner carefully sets the performance standards so that the business's liability to fund the plan exists only when the company is profitable. For example, an owner might decide to make 30 percent of the company's taxable income in excess of $100,000 available for bonuses. For a company with $300,000 in taxable income, the formula would be:

$300,000 taxable income
<100,000>
$200,000
x 30%
$60,000 fund available for key employee bonuses

Let's assume that our owner has one key employee (Sharon) and that he has determined that he will award half of the bonus ($30,000) immediately to Sharon in cash or stock and the other half ($30,000) will be awarded as non-qualified deferred compensation subject to vesting. Using this formula benefits the company because as an employee works to increase her reward, the income of the business must increase. As business income increases, the value of the business increases by a multiple of the increase in income.

A vesting schedule "handcuffs" the key employees to the company for a time period necessary to become entitled to the benefits that have accrued to them under the benefit formula.

Consider a continual or "rolling" vesting schedule in which a single vesting schedule is applied separately to each year's contribution. Using this schedule, an employee is handcuffed to the company for a long period of time because the key employee is never fully vested in the most recent contributions. In our example above, one half of the award ($30,000) is assigned to Sharon ($30,000) subject to a five-year vesting schedule. If the award is earned in 2011, the effect of vesting is demonstrated in the following graph:



As you can see, only in the year 2016 is the employee fully vested in the award earned in 2011.

Should Sharon leave the company prior to that time, she is only entitled to a percentage of the total award amount.

The benefit to the company of continual or rolling vesting is that it financially handcuffs your best employees to your business.

Forfeiture provisions allow the owner to terminate an employee's otherwise vested rights in benefits under the plan. An employee loses all deferred compensation if he leaves your company and violates his agreement not to:

- Compete
- Take trade secrets, or
- Take vendors, customers or company employees.

The benefit to the company of forfeiture is that it provides a powerful incentive for former employees to live up to the promises made to the company.

Be certain to discuss this feature with your business attorney as state law may restrict your ability to compel forfeiture.

Payment schedules determine when payments of vested amounts commence and how long they are to be continued after an employee leaves. A payout over a multiple-year timeframe helps the key employee because he is taxed on income only as it is received.

The benefit to the company is that payment schedules are usually combined with forfeiture considerations to prevent recently departed employees from using monies from the deferred compensation plan to compete with the owner.

Funding devices ensure that cash is available when needed. It is also important for your key employee to know that the funds actually exist (although tax restrictions exist which prevent the company from formally funding the plan). Proper investment should be guided by income tax timing considerations. The choice of funding vehicles can influence the timing and amount of income taxes at the company level.

PHANTOM STOCK AND STOCK APPRECIATION RIGHTS PLANS

Like other Non-Qualified Deferred Compensation plans, Phantom Stock and Stock Appreciation Rights plans include benefit formulas, vesting schedules, forfeiture provisions and a payment schedules.

Phantom Stock Plan

In a Phantom Stock Plan, owners give employees something that looks like stock, grows in value like stock, and can be turned in for cash just like stock, but is not stock. As the employee strives to make the company more valuable, he makes his interest in the Phantom Stock plan more valuable.

Typically, phantom shares corresponding to shares of stock – but not representing actual ownership – are allocated to the participating employees' accounts. As the value of true stock increases, so does the value of the phantom stock. Any dividends paid on the stock are credited to the employee's account. When the employee terminates his employment, the company typically pays him the per share equivalent value of each of the phantom shares vested in his account. The amount paid is deductible to the company.

Stock Appreciation Rights Plan

A Stock Appreciation Rights (SAR) plan is similar to the Phantom Stock plan in that the value of benefits in the SAR plan is tied to the value of the corporation's stock. Unlike phantom stock, however, the employee under an SAR plan is only entitled to receive the growth in value of the Company (as represented by the SAR units) since the date of the grant. For example, assume that key employee Sharon is granted a two-percent SAR interest equal to 2 percent of the company's value (say $1 million). Her two-percent SAR value equals $20,000. When Sharon terminates employment, she will receive the growth in value of the two percent between the date of the grant and her departure. When Sharon leaves the company, depending upon its design, Sharon may receive her benefit (to the extent vested) in a lump sum upon departure or in a series of payments over several years.

In both Phantom Stock and SAR plans, success depends on careful design of vesting, forfeiture, payment schedules and funding devices. The benefit formula in both of these plans is the valuation of the company's stock. Both plans incent the key employee to grow company value-–just like an owner.

If you have not yet installed a key employee incentive plan designed to motivate your employees to increase the value of your company, now is a great time to meet with your advisors. They can talk to you about the IRS regulations that apply to these plans.

We suggest that you use the attached Employee Benefit Checklist to hone in on the important issues in creating employee incentive plans.

If you have installed a plan, but find that it is not meeting your objectives, use this White Paper to evaluate why it is failing you. Sit down with your advisory team, adjust your plans where necessary and prepare to see the value of your company take off.