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Using Short-Term Key Employee Incentives to Increase Sale Price White Paper

One of a business owner's greatest challenges is to attract, motivate, and keep key employees. As owners near the finish line (the exit from their businesses), often tired and distracted by the end of the race, they often assume that it is no longer desirable to keep and motivate key employees. Keeping key employees is not only desirable, however, it is *necessary* if the business is to be sold—and sold at the highest possible price.

A basic premise of key employee incentive planning is to keep the key employee as a long-term, contributing member of the company. Consequently, incentive plans incorporate relatively long vesting schedules and provide benefits that are relatively moderate in the early years but become substantial as the years pass (usually after the employee has participated in a plan for at least five years). Incentive planning is discussed in the book *The Completely Revised How To Run Your Business So You Can Leave It In Style.*

Planning techniques that work well in long timeframes, however, are not as effective and, indeed, may be counterproductive in the short timeframes of owners who are actively selling their businesses. Plans designed for short timeframes must provide a substantial benefit in a short period of time, provided the business is sold. Keep in mind that this "short period of time" must be long enough to keep the key employee productive during and beyond the sale. Additionally, while the benefit should be *rich* if the business is sold, it must be *affordable* to the company if the business is not sold. Owners who wish to successfully balance their needs again the desires of their key employees must tread these fine lines.

This article focuses on short-term incentive plans. If you desire more information about long-term incentive plans please read Chapter Four of *The Completely Revised How To Run Your Business So You Can Leave It In*

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Style or refer to the page of this White paper for a quick synopsis.

Business owners considering a sale to a third party must take every reasonable step to ensure that their key employees remain at their posts even as the owners prepare to leave theirs. Not only are the key employees' efforts to maintain cash flow critical to maximizing the business's eventual sale price, these key employees may need to shoulder extra duties as the owner's attention wanes or is diverted.

Finally, given that few sales to third parties are all-cash sales, owners are usually exposed to post-sale financial risk. If the business does not continue to perform after closing, the owner may not be entitled to receive the earn-out portion of the sale price, or the buyer may default on the owner's carry-back (promissory note) for the balance of the purchase price. This is one reason why it is not uncommon for owners to offer key employees a share of the "spoils" when the business is sold.

In our experience, selling owners typically have three objectives with respect to their key employees:

1. To *motivate* them to increase the company's cash flow:
2. To *keep* them on board before, during, and after the transition; and
3. To *reward* them when the business is sold, (provided that the award is not so great and so immediate that there is no incentive to continue working with the new owner).

Using a sound and thoughtful incentive-based plan for key employees, owners can achieve these objectives. A sound and thoughtful plan includes the following attributes:

- It provides a substantial benefit in the eyes of each key employee. This means that only a small number of participants can be included in an incentive compensation plan or the benefit is diluted. For example, an owner who may wish to include eight or ten key employees in an incentive plan that offers 25 percent of the company's profits or equity will find the effect of this plan severely muted. Because the number of participating employees is so great not one stands to benefit significantly.

As long as we're on the subject of "significant," remember that key employees will want a "significant" slice of the future value that they help to create. If the company is to be sold in the near future, management will want its "share" of the "windfall" to be received when the new owner pays fair market value (rather than the current value) for the company.

- The plan must be perceived as a "win-win" for both company and key employee.
- The plan must "handcuff" the key employees now, during the actual sale process, and through any earn-out period that may be imposed by the buyer.

Of course, the ideal time to begin key employee incentive planning is well before a

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business transfer occurs. However, even those owners already dancing in the arms of a would-be buyer would do well to begin the planning process. As the old saying goes, "The best time to plant a tree is seventy-five years ago. The second best time is today." So, today, let's look at the fictional case of John Ewing, owner of Ewing Lubricants, Inc.

We weren't 60 seconds into our meeting when it became clear that, while John Ewing may have not formally launched the process of selling his company, he had mentally checked out months ago. Ewing Lubricants was being maintained by the efforts of its three key employees, all of whom were well aware of—and increasingly nervous about—John's desire to sell the business. In fact, it was John's relationship with these employees that brought him into my office. In a sound effort to retain these employees during an eventual sale process, John had "sort of unofficially, informally promised" them a "piece of the pie" upon a successful sale. In addition, his "promise" reflected his desire that they benefit should he sell the business for his asking price.

John's problem is typical. As he thinks about how to exit the business, he must give equal thought to discouraging his key employees from doing the same. Key employees are never so "key" as they are when the owner begins exiting his business. There are several reasons for this.

- Owners often lack motivation—"the fire in the belly"—to enhance the success of the business on a daily basis. They are either tired of slugging it out in the trenches every day, or they have grown bored with the daily activities of the business. In order to keep the business successful and on track, they must have a properly motivated, strong management team in place. John Ewing was acutely aware of the need to motivate his key employees. Somebody had to propel the company forward and it was all John could do to go to work each morning.
- Buyers buy cash flow—and they pay top dollar for cash flow that they expect to increase after they buy the company. Think like a buyer. Owners cannot allow cash flow to stagnate simply because they are planning their escapes. Once again, it falls to the key employees to drive cash flow upward.
- Key management is as vital to a new owner as it is to exiting owners for its role in maintaining and increasing cash flow. Sophisticated buyers, in particular, will pay far more for a business if key management will stay with the company after it is transitioned. In fact, a potential buyer may have little or no interest in acquiring a business, at any price, without assurance that the key employees will continue under new ownership.
- Key management provides an owner with an alternative exit strategy. If a sale to a third party fails or is unworkable for some reason, the management team may be willing to purchase the business.

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Although John may have checked-out emotionally, he was still a quick study. He readily understood that the long-term key employee incentive plan he had previously implemented needed modification to include not only the elements of regular incentive plans (long-term vesting and gradually increasing benefits), but two additional attributes.

First, John recognized that a *condensed timeframe* was crucial to employees. Owners and their employees need a plan that lasts no longer than two to four years from its inception to its *total pay out*. It is during this period that the business will be marketed, sold, and the key employees will be employed for one to two years by the new owner/new company.

Second, John needed to assure his key employees that, even though the ownership of the company would change, their benefits would not be affected. While the incentive plans was created to provide substantial benefits to his three key employees, (assuming they stayed long-term) the incentive plan also created substantial problems if he sold the business in the near term. Ewing was on the horns of a dilemma.

To fully appreciate his situation, (one shared by many owners) we need to first understand what the company had done to *handcuff* management to the business.

Ewing Lubricants had two plans. The first was a non-qualified deferred compensation plan designed to provide two of his three key employees with as much as $750,000 cash upon full vesting (about 10 years). The second was a stock purchase plan for the operations manager. That plan allowed the manager to acquire ten percent ownership using a low value over a number of years.

John's dilemma then was:

- If, at the time of sale, the vesting under each plan was accelerated, the key employees would receive the windfall John intended to provide, but the windfall would be so great that the employees might take it and run (exit the business) along with John. That would spell disaster for John's chances of successfully selling the business. He knew that, without the assurance of management remaining when he departed, no buyer would want to purchase his business.
- If, at the time of sale, vesting was *not* accelerated and the key employees lost their assurance of a "windfall," they (being almost as strong-willed and independent as John!) might pack their bags and leave-with the same deal-killing results as if they had received the enhanced benefit!

What to do?

Before answering that, let's examine one other situation.

That is the owner who has *not* created written incentive or "golden handcuff" plans for key employees, but who is nevertheless concerned about key employees leaving when the business is sold. When employees contemplate their employer selling out to a larger and, (in their minds at least) less employee-friendly company, they are naturally apprehensive. Although acquiring companies

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typically provide their own stock option plans, or similar benefits to key employees, the risk that the acquiring company's stock will not retain its value undermines the employees' sense of security. The only thing employees fear more than the unknown is the "loss of the known:" their job security, their roles within the company and their existing benefits. Over time, they come to trust the direction and mission of your/their business. Will what they know evaporate only to be replaced by promises made by an unknown and more remote owner? A common response to these uncertainties is for key employees to seek alternate employment. Rather than lose key employees at the very time the company needs them most, smart selling owners provide a formal plan to handcuff and motivate management. This plan is also helpful if (for some reason) the sale is not completed; the owner will still have this company and its key management team intact.

That brings us to how owners who have not created incentive plans for key employees find themselves facing the same dilemma as did John. If a selling owner provides no incentives, management has little motivation, in today's labor market, to remain employed by a company they did not choose. They will leave. This certainty dictates what you must do for your key employees if you are to leave your business in style. On the other hand (or horn), if the prudent owner promises key employees a "share of the windfall" upon a sale, they will certainly accept but may leave shortly after you do.

If you wish to avoid teetering between these horns (and already have an existing plan) consider adding a "conversion feature." If you have no such plan, consider creating a short-term bonus plan. This short-term bonus plan must provide the key employees with a reason to continue with the new company. That reason is a promise: a promise that comes, not from the new organization but, from the existing owner - you. And that promise is: *cash*. We call these plans "stay bonus plans."

Part of John Ewing's exit plan involved installing a stay bonus plan for his key employees. To determine the proper amount of a stay bonus, look at either the unvested benefits of any existing key employee benefit program or at the percentage of the anticipated purchase price that the owner wishes to give to his key employees.

Ewing had already "informally" promised his three key managers a total of 20 percent of the anticipated sale price. Using that as our basis, we began to design a plan. (If you do not have an existing plan, the method to create a stay-bonus is still the same.)

FORMULATING THE STAY BONUS

Step 1. Upon the sale of the company, John agrees to escrow an amount equal to 20 percent of the purchase price. The escrow will be outside of the acquiring company's ownership. In effect, John will own the monies in the escrow account, subject to the three key managers vesting in that money.

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Step 2. Each manager will be entitled to a *stay bonus* equal to his *prorata share of the escrow amount*, as he or she becomes vested. The vesting schedule provides for vesting at the rate of 33 percent per year for each of three years.

Step 3. Unlike typical key employee compensation plans, the vesting schedule is also the payment schedule for this stay bonus plan. A manager becomes vested in his share at the first anniversary of the sale date and receives payment of that amount at that time: one-third at the second anniversary, and the remainder at the third anniversary. If a manager chooses not to remain with the new company for the entire three years, he or she will not receive the full amount of the stay bonus. Any funds remaining in the escrow after three years will revert to John.

This stay bonus program accomplishes several vital objectives for John's management team. These include:

Cash. The key employee's economic reward is divorced from the rise or fall in the value of the acquiring company's stock. Rather, it is based upon the value of the company at the date of sale. Payments are in cash, not in stock of the new company.

Accelerated vesting and pay out. Payment will be made from the escrow account when the key employee vests in that portion of this account. Unlike most incentive plans that vest over an extended period of time and pay only after vesting is completed, this program provides a rapid reward for the key employees--provided they remain with the new organization.

Minimal risk. Because the money is in escrow for the exclusive benefit of the management team and is not controlled or owned by the acquiring company, the chance that key employees will leave the new organization is minimized or eliminated. The key employees must simply remain employed for a period of three years. As they stay, they receive their entire benefit amount, in cash.

Outside of new employer control. Because the stay bonus plan is completely separate from the acquiring company, it is easier to negotiate the management team's participation in the acquiring company's stock option program, or other program, provided for its key employees. Ewing Lubricants' existing stock option and deferred compensation plans for its key employees were replaced with a stay bonus program thus making it easier for the key employees to participate in a new plan.

The stay bonus program meets John's exit objective of selling his company for top dollar. Having the plan in place makes the company more "saleable" and makes Ewing Lubricants more valuable in the eyes of a prospective buyer, for the following reasons:

Management continuity. Key employees have a significant reason to remain with the new organization; namely, the cash benefit to be paid by the former owner as they stay with the new company. This benefit provides an acquiring company with the assurance that the individuals who have been instrumental in the

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purchased company's success will remain with the new company for a substantial period of time.

Simplification of key benefit programs. Attempting to continue Ewing Lubricants' stock purchase plan and deferred compensation plans for its key employees would make the acquisition of Ewing Lubricants unnecessarily complex. By assuming these plans, the acquiring company would incur not only administrative costs, but also redundancy or competition with its plans for its existing employees. Additional complications never make a company more attractive and often lead to delays in the closing.

For all of these reasons, John recognized the merits of a stay bonus program. He planned to present a hybrid of a stay bonus to his key employees. Of course, if both the employees and employer are to view the benefit plan as a "win-win," the manner in which the program is presented to key employees is critical.

The next step, then, is to properly present the plan to the employees. If your company has no key employee incentive/golden handcuff plan, consider implementing one now even if you view the company sale as near term. Combined with a stay bonus, the longer-term incentive plan gives you the flexibility and backup of providing needed benefits to your management team regardless of your success in selling the business to an outside buyer.

PRESENTING THE PLAN TO EMPLOYEES

Once an owner has worked with his or her business planning attorney, CPA, and insurance or financial advisor to develop what he believes to be a plan that benefits him, his employees and his company, he can congratulate himself; his job is half-finished. The other half is to convince the key employees to view the benefit plan as favorably as he does. Consider the following approach:

Step 1. Initial Meeting Once an owner recognizes the value of the stay bonus or other incentive plan, he or she meets with the Advisory Team (attorney, CPA and financial advisor) to discuss the specific objectives he hopes to achieve. At the end of this meeting, the outline of a plan should be established.

Step 2. Drafting Meeting During a second meeting the owner and advisors review a previously drafted planning memorandum.

This memorandum describes:

- the owner's objectives;
- the pertinent facts (such as the value of the company);
- the number of employees, who will benefit under the plan, and so on;
- a suggested course of action, intended to meet each objective; and finally
- the steps necessary to implement the plan, who is responsible for implementing each step, and when.

In creating the memorandum, each of the advisors should provide input. For example, the attorney will explain the types of plans

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available to meet specific objectives. He or she will counsel the owner about implementation ideas and issues such as the impact of such a plan on the sale (or non-sale) of the business or what happens if a key employee leaves. The CPA will also offer planning input but her main function will be to perform a financial pro forma describing the financial consequences to both the business and the employees of the proposed plan. If necessary, the CPA, attorney and owner will create a valuation formula. The financial and insurance advisor, in addition to offering planning input, will be prepared to suggest a variety of funding vehicles, as necessary, to make the plan work financially.

Step 3. Modification Meeting After the business owner reviews the planning memorandum, the team discusses and modifies the plan as necessary.

This step is often completed by telephone, with copies of changes provided to all advisors and the owner.

Step 4. Employee Presentation The amended planning memo is presented to the key employees for their consideration. Usually the business owner asks one advisor to make the presentation to the employees and to answer any questions they may have.

Step 5. Employee Input Key employees are given an opportunity to review the planning memorandum with their advisors, ask further questions, and provide suggestions to improve the plan.

Step 6. Final Changes Often there is a final meeting with the business owner, the key employees, and the owner's advisors to finalize the planning memorandum.

Step 7. Documentation Finally, the necessary legal documents are prepared and signed by the key employees. The plan is complete: the employees now have to perform.

Typically, it takes three to six months to move through these steps. If an owner is focused on creating the employee incentive plan, however, the process can be completed within 30 days.

CONCLUSION

As we've seen, the knotty problem for John Ewing and thousands of other owners is providing for key employees in a generous manner while simultaneously advancing their own exit strategies. This problem is best solved by installing a long-term key employee incentive plan with a conversion feature that changes the long-term plan to a short-term stay bonus plan providing for accelerated vesting and pay out as the sale is undertaken, finalized, and becomes yesterday's news.

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