USING SHORT-TERM KEY-EMPLOYEE INCENTIVES TO INCREASE SALE PRICE

WHITE PAPER

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Introduction

One of a business owner's greatest challenges is to attract, motivate, and keep key employees. As owners approach the end of the marathon of exiting their businesses, often tired and distracted by everything they've done, they begin to assume that it is no longer worthwhile to keep and motivate key employees. However, keeping key employees is not only worthwhile but also *necessary* if the business is to be 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).

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. The key employees' efforts to maintain cash flow are critical to maximizing the business' eventual sale price, and these key employees may need to shoulder extra duties as the owner's attention wanes or is diverted.

However, 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 earnout portion of the sale price, or the buyer may default on the owner's carryback (e.g., promissory note) for the balance of the purchase price. This is one reason why it is common for owners to offer key employees a share of the "spoils" when the business is sold.

Of course, the ideal time to begin key-employee incentive planning is well before a business transfer occurs. However, even owners who are already considering a would-be buyer's offer would do well to begin the planning process. As the old saying goes, "The best time to plant a tree is 75 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., as told by an Exit Planning Advisor.

We weren't even 60 seconds into our meeting when it became clear that while John Ewing may not have 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 as key as they are when the owner begins exiting the 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 have grown bored with daily business activities. 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, but it was all John could do to simply show up 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 exits. 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. Particularly, sophisticated buyers 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 remain 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.

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 (e.g., long-term vesting and gradually increasing benefits) but also two additional attributes.

First, John recognized that a *condensed time frame* 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 payout*. It is during this period that the business will be marketed and sold, and the key employees will be employed for one to two years by the new owner/company.

However, planning techniques that work well over long time frames are not as effective and may be counterproductive in the short time frames in which owners actively try to sell their businesses. Plans designed for short time frames 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 against the desires of their key employees must walk these fine lines.

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 plan 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. John was caught on the horns of a dilemma.

To fully appreciate his situation (one shared by many owners), we first need to 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 10% ownership using a low value over a number of years.

Thus, John's dilemma was as follows:

- If, at the time of sale, the vesting under each plan were 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 (i.e., 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 were *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 Is John to Do?

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

1. Motivate them to increase the company's cash flow.
2. Keep them on board before, during, and after the transition.
3. Reward them when the business is sold (provided that the reward 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. Otherwise, the benefit is diluted. For example, an owner who may wish to include 8–10 key employees in an incentive plan that offers 25% 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, no employee stands to benefit significantly. Remember that key employees will want a significant slice of the future value that they help 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 the company and key employee(s).
- The plan must handcuff the key employees now, during the actual sale process, and through any earnout period that may be imposed by the buyer.

Let's examine a situation in which John has *not* created written incentive (or "golden-handcuff") plans for key employees but 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 companies that acquire other companies 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 the business in which they work. 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, especially in a volatile labor market, to remain employed by a company it did not choose. Thus, key employees will leave. This dictates what you must do for your key employees if you are to leave your business in style. On the other hand, if the prudent owner promises key employees a "share of the windfall" upon a sale, they will certainly accept but may leave shortly after the owner does.

If you wish to avoid teetering between these dilemmas (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 that comes not from the new organization but rather from the existing owner (i.e., 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 or her key employees.

Presenting the Plan to Employees

Once owners have worked with their business-planning attorneys, CPAs, and insurance or financial advisors to develop what they believe is a plan that benefits themselves, their employees, and their companies, they can congratulate themselves; their job is half finished. The other half is to convince the key employees to view the benefit plan as favorably as they do. 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 Advisor Team (attorney, CPA, financial advisor, etc.) to discuss the specific objectives he or she 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 following:

- The owner's objectives.
- The pertinent facts, such as the value of the company.
- The number of employees that will benefit under the plan.
- A suggested course of action intended to meet each objective.
- The steps necessary to implement the plan, who is responsible for implementing each step, and when each step should occur.

In creating the memorandum, each of the advisors should provide input. For example, the attorney should explain the types of plans available to meet specific objectives. He or she should 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 should also offer planning input, but his or 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 advisors, in addition to offering planning input, should 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 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. However, if an owner is focused on creating the employee incentive plan, 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 generously 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 payout as the sale is undertaken, finalized, and becomes yesterday's news. Providing a short-term key-employee incentive plan prior to a sale can help you capitalize on your key employees' talents, which gives the buyer peace of mind during the ownership transition and allows you to sell for top dollar. Without such a plan, your key employees are likely to cut and run, preventing you from selling the business for top dollar or, worse, at all. If you'd like to learn more about the best way to construct a short-term key-employee incentive plan, please contact us today.

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