

VIEWPOINT

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INCENTIVE COMPENSATION- PLANNING FOR SUCCESS

By Peter Alternative

Many times in the Viewpoint we have discussed the value of advance planning regarding aspects of your business that will come into play at the time of an exit. In this issue, we explore another important area that needs such advance consideration: Whether key people who have contributed to your company's success will be rewarded with incentive compensation and, if so, what issues need to be weighed when putting such a plan in place. Similarly, we'll look at alternatives for business owners who are nearing an exit without having an incentive compensation plan in place but who still want to reward and incentivize key employees.

WHY THIS MATTERS:

- *Establishing an incentive compensation plan well in advance of a potential exit helps avoid having an M&A deal jeopardized because of unhappy or uncommitted employees.*
- *Careful consideration of the financial ramifications of an incentive compensation plan is essential to maximizing the after-tax dollars shareholders receive at the time of an exit.*
- *Shifts in corporate tax laws make getting the right advice about incentive compensation plans more important than ever.*

EARLY PLANNING IS IMPORTANT

As investment bankers, we are always concerned with ensuring that clients begin a sale process with the highest probability of achieving success. One of the keys to making this happen is making sure key managers have the proper incentive to motivate them to contribute to the desired outcome during the M&A process.

Our experience indicates that being proactive about this issue well in advance of a potential sale reduces risk at the time of exit. One of the key pitfalls that can be avoided by proper planning is having senior executives who are disgruntled and unmotivated just at the time when you need them to perform at their best. We've even seen situations in which a deal is held hostage by a key person who demands more compensation.

Failing to be proactive can also have serious negative tax consequences for the people you're trying to reward, motivate or retain. "The later you do the planning, the harder it is to keep the tax man out of the transaction," pointed out [Lawrence Schwartz](#), partner in the Tax Services Department of Carlin, Charron & Rosen, LLP. "In cases where

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someone makes you an unexpected offer for your company and you want to reward people but don't have a plan in place, often that reward ends up getting taxed as ordinary income. With federal income taxes at 35 percent and Massachusetts income at 5 percent and then FICA on that top of that, you're looking at something that is really inefficient."

"If you haven't been proactive about putting a plan in place, you have no options at the time of exit," said [Carol Tully](#), director of Tax Services for the Commercial Industries Group at Wolf & Company, P.C. "At that point, you are in a more expensive, cash-based situation."

DECISION POINTS

"Looking at this topic from the 30,000 feet level, you want to reward people for valuation increases since they've been with the company and you want to tie all of those values to the liquidity event and the ultimate valuation," said [Andrew Liazos](#), a partner with McDermott, Will & Emery, LLP. "Or you want to reward them for what they are going to contribute to making the transaction happen and be successful after the fact. You have options for doing that."

What are the key points to consider when evaluating those options? When you chose the legal form of your company, you already made a decision that impacts your options. The most common type of equity based compensation, incentive stock options, cannot be used by partnerships or LLCs. Companies with these forms of ownership tend to turn to vehicles such as profits interests and capital interests, with low value partnerships issuing capital interests and higher value partnerships issuing profits interests. "If you're working with an LLC, you very many times will see profits interests because it gives the partnership future appreciation that is similar to an option and you get capital gains treatment if you do it properly," said Liazos. For LLC owners, make sure your advisors are following closely proposed *Regulations & Notice 2005-43*, which is related to the tax treatment of partnership interests.

If you are interested in setting up an S Corporation, while you can't have two classes of stock, you can have an option plan with non-voting stock. This allows companies to provide equity-based incentive plans to employees without many of the risks associated with adding new owners. Other nuances of note with respect to S Corporations are that you can't have more than 100 individual shareholders and those shareholders need to either be U.S. citizens or resident aliens. Otherwise, every equity compensation program that is available to a C corporation is also available to S corporation.

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How important retention is as a motivating factor can perhaps be judged by looking down the road and trying to anticipate what type of buyer might eventually be interested in your company. "If you envision attracting a financial buyer that is not going to be directly involved in running the company, you'll want to make sure the key people will stay," said [Ken Dreyer](#), who consulted with companies about their compensation programs, including equity based plans, before becoming CEO of Eliassen Group last year. "Relatively speaking, this is less relevant to a strategic buyer because they'll have their own people."

The program Dreyer helped Eliassen Group founder Mona Eliassen put in place five years ago was predicated on a desire to drive growth and also a desire to keep management in place. "In our case, when it came time for the exit, our founder and owner was committed to going with a private equity group so that the leadership team would continue," he said. "People got paid out whatever their percentage was in the growth of the enterprise value and reinvested a significant amount of that into the new company."

After focusing on your motivation, Carol Tully advises looking at whether you actually need an equity plan or whether the same objective can be achieved with phantom stock. "If you go to an equity plan, you now have a new owner at the table, and that's not always a good thing," she said. "If everything goes as planned, it's great. But if everything doesn't go as planned with that employee, now you have a variety of issues in terms of getting rid of the person."

"If the plan does have to be equity, the question you need to ask is how does it unwind if things don't go well?" added Tully. "There should be a buy back plan or agreement so that if things don't work out with an employee, the process for unwinding is well thought out."

The possibility of things going off track if a key employee doesn't work out is why Ken Dreyer advises making sure you have the right management team in place before instituting a plan. "You want to be sure the people on the leadership team are the ones you really want to have there," said Dreyer, "Ask yourself if these are the people you're really counting on. You don't want to put a plan in place until you have that core team in place."

COMPANY STAGE MAKES A DIFFERENCE

The stage of your company also guides decision-making regarding what type of plan to select. "If I'm dealing with founders and first people who are coming on board, I would give them a form of equity that is sure to generate capital gains," said Liazos. "A form of restricted stock or actual grants are appropriate at that stage. Usually the more mature a company is, it becomes more expensive to use restrictive stock. That's why options are used in this context; there's no tax on receiving the options; there's only tax when they are exercised."

"Companies that are early to mid-stage aren't going to have enough cash to pay compensation so you've got to give people a stake in a liquidity event," added Liazos. "And I would say

options are still the choice du jour; that's the primary mode of compensating people".

A MULTITUDE OF VESTING CONSIDERATIONS

The whole area of vesting is another important topic to consider. "Vesting goes back to your motivation," said Tully. "If your motivation is to retain people, you can't have the vesting be so long that it's not motivating. At the same time, it has to be long enough to keep them there so they either build the growth or contribute toward the deal. So depending on what stage the company is in, sometimes you'll see a larger chunk of vesting within a year and then monthly vesting or sometimes you'll see it over a period of years. Which ever way you do it, there should be some thought as to whether the vesting is meeting the goal of retention rather than just automatically saying 'five years and 20 percent a year.'"

"You need to make sure your equity program doesn't create a problem in terms of retaining people after a sale," said Liazos. "An executive who has lots of fully vested options that are worth \$5 million at the time of exit may say 'I'm going to exercise my options and walk away with that cash.' If people power is really your business, is that going to be an issue when the buyer is saying, 'If I buy this business, am I going to have those people?' So more people are making sure not to have 100 percent vesting. Or if you do have 100 percent vesting, what sort of incentive are you putting into the plan to retain people after the deal?"

Of course, you can always hope that an acquirer will be so interested in retaining key people that they will jump into the gap left by a lack of planning. "In many cases, the acquirer deals with rewarding the people to stay," said [Richard Weiner](#), a tax partner with Carlin, Charron & Rosen, LLP. "If they're looking for the human capital, then they want golden handcuffs. If, for example, a buyer really wants that general manager to stay to help get the organization to the next level, when they may hope to exit in a few years themselves, you'll see instruments come in like restricted stock and unqualified options."

The issue of how to retain key employees and who is responsible for doing so is always a component of the broader valuation negotiation. As such, your investment banker needs to proactively manage the buyer's expectations both with respect to the assumption (roll-over) of unvested options and their need to provide key managers proper incentive compensation in their employment agreements. The pretext of that discussion is to establish the distinction between consideration (cash, stock, options, etc.) for the equity value that has been built and is being acquired an incentive compensation for future value creation.

Another vesting issue that crops up is how to handle incentive stock options that are not fully vested at the time of exit.

Among the points to be handled when you draft your option plan is to be sure it allows for assumption of the options by the acquirer. Also, avoid modification provisions since any substantial modification of an incentive stock option at time of exit is deemed a new issuance and requires a step up in the strike price to current market value. Finally, when exchanging stock options into options in the acquiring company, be sure to follow guidelines that specify

that the strike price, spread and fair market value of the shares to be received match those of the old options.

In the event you are a profitable flow through entity (e.g. S corporation, LLC, partnership) take the necessary steps to ensure the related tax deduction associated with stock option cancellation payments is on your final tax return. This can be accomplished by making payment prior to the stock purchase, at the same time as the stock purchase agreement with a binding contract, or a combination of both.

Note that a vesting acceleration clause in your plan that says some or even all options automatically vest upon change of control of the company is not deemed to be a modification and is, therefore, allowable. This is a common way to reward people who have helped build the value of a company and made the exit possible. Acceleration comes in a number of different flavors. It can be full or partial, and sometimes the board has decision-making power over whether acceleration will occur and, if so, what it will cover.

One critical issue and sometimes misunderstood, arises with acceleration is when those who exercise their newly vested options at the time of exit want to immediately sell the underlying stock in order to participate in the deal. Such a sale will be taxed as ordinary income since they will not have held the stock for the year-long time period that is required to qualify for capital gains treatment.

REGULATORY ISSUES

Regulatory changes over the past few years appear to have complicated the decision making regarding equity based compensation options. Among the best known of these changes was the introduction of Section 409A into the Internal Revenue Code, which tightened the regulation of a wide array of deferred compensation arrangements, including stock options. Another big change occurred when the Federal Accounting Standards Board issued SFAS No. 123(R), which stipulates that all forms of stock compensation is to be treated as an expense to the issuer. For more information, please visit [Mirus' 409a Valuation](#) section on our website.

"Even though SFAS 123 (R) has made it a pain in the neck to do accounting for stock options, companies are still interested in attracting the best and the brightest and those people want options," said Weiner.

"The new regulatory environment has added new people to the table for the discussion of equity compensation," said Carol Tully. "It has moved accounting treatment from very low on the decision tree to a much higher place. If you're packaging your company for a transaction, you don't want to have a plan designed without the accounting treatment being considered. Another change that has occurred is that we are seeing a lot more restricted stock plans because of the expensing of options."

COMMUNICATION IS KEY

Once your plan is in place, your work is far from done. "Going forward, it's really important to communicate how people are doing under the plan," said Dreyer. "At the Eliassen Group, we gave updates quarterly to keep the program top of mind with people."

"Educating people about the tax implications is very important," said Tully. "I am fascinated by how many employees really don't understand what they have. Companies should encourage employees to get the proper tax advice. If someone has never exercised their stock options, they may find themselves in an adverse tax situation at the time of the exit if they have to exercise them then. All of a sudden they have ordinary income tax treatment, which they would have avoided if they had exercised the options earlier. Even if the proper communication does occur at the time the options were granted, people may have forgotten about it because it's so complicated."

"It's rare in a company that has sophisticated advisors that you only have one type of plan in place," pointed out Larry Schwartz. "So it takes a whole lot of planning for the people who are being rewarded to know when to exercise what piece of the mix."

In practice, our experience suggests that non-executive stock option holders rarely receive efficient tax treatment at exit. This is because they are rarely made aware of the business owner's intent to sell beforehand and therefore are less likely to have exercised their options to qualify for long-term capital gains treatment.

"If they had exercised their options earlier on, the employee would have the potential for capital gains treatment, but now they're going to have ordinary income. The question becomes to what extent are you going to make that employee whole?" explained Tully. In practice, it's not uncommon that key employees will receive additional cash bonuses to "gross them up" to simulate capital gains treatment. This issue may lead you to consider other alternatives to equity based compensation plans already discussed.

IDENTIFYING THE ALTERNATIVES

In lieu of using equity based compensation plans to retain, reward, and incentivize key employees who have helped build the business and will be integral to a successful sales process, there are several alternatives you might consider. A key point to reiterate is that it's critical that whatever alternative you decide on, it must be documented and communicated to the employee.

Several other types of equity oriented plans provide similar benefits as equity based compensation without the inherent company risks associated with stock ownership. These include but are not limited to the following:

- Phantom Stock
- SARs
- Performance Share Plan
- Formula Value Plan

While a detailed discussion of these alternatives and their respective pros and cons is beyond the scope of this piece, please contact [Peter Alternative](#) for a summary analysis of various equity oriented compensation arrangements.

JUMPING IN

Clearly, a lot of work and consideration goes into determining whether to grant equity or the equivalent to key managers and, if so, how best to do it. As Andrew Liazos pointed out, "A lot of people know they have to grant equity, but it's hard to think about it in a disciplined manner. You don't want to give out equity like candy. Understanding your dilution and pools of equity is a complicated process to go through."

For this reason and perhaps others, some company owners remain opposed to the notion of giving out equity. "Psychologically, some people just don't want to do it," said Dreyer. "I've worked with people who say, 'I'm not giving up any piece of my value to anyone. I'll take care of people at the exit.' But that's not helpful if you're trying to get help from people in creating value."

In this situation, we encourage business owners to proactively put an exit cash bonus plan in place for all key employees and do a good job documenting and communicating its contents. We've seen agreements that are based on an absolute number or fixed percentage of the transaction value, as well as, performance-based plans that contemplate a sliding scale of percentages that increase as enterprise value increases. It's also fairly common for business owners to provide the entire staff with token cash bonuses at close. Finally, we encourage business owners to consider proactively putting in place retention bonus plans for key managers that are tied to a sale of the Company. For example, such an arrangement could specify that key employees would be entitled to a bonus at the one-year anniversary of a sale, and that the bonus would be accelerated if the employee were terminated earlier without cause. While the costs of such arrangements are ultimately borne by the seller, they help mitigate concerns about displacement and help deliver the management team to the buyer.

With the use of equity based compensation to attract and retain top talent still the norm in most high-tech industries and with the increasingly common prospect for unexpected offers coming your way, perhaps now is the time to get your incentive compensation plans in line. An immediate next step for those business owners who have key employees they want to motivate, retain or reward but have yet to explore the various flavors of incentive compensation, talk to your key advisors, such as your lawyer and your tax accountant, about what kind of plans are best suited for your motivation and organization. Beyond getting the best advice from seasoned professionals, proactive planning will position you for success regardless of your motivation in pursuing an incentive compensation plan.

Peter Alternative is a partner at Mirus Capital Advisors, Inc. Mirus is a middle-market investment bank that specializes in advising companies in strategic mergers and acquisitions. By combining a proven process, industry and transactional expertise, creative thought, and personalized service, Mirus has completed hundreds of transactions for both public and private companies. Mirus is a registered broker-dealer and FINRA/SIPC Member. For more information, visit www.merger.com.

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