# RETAINING KEY EMPLOYEES AS PART OF YOUR GROWTH AND TRANSITION PLANS (PART I OF II)

Business owners who are thinking about an eventual transition out of their companies will often consider whether or not their internal management team will, one day, be able to take over the business. What most owners eventually conclude, regarding their key people, is that it is helpful to assure that these people are locked into the company for the longer-term, irrespective of whether or not they become future owners. So, for an exiting owner who is thinking about cashing in their business one day, it helps to think through the ways that key people can be retained by your company.

**Every Business Pays for Its Owner's Exit**

The first concept that is important to understanding how key managers can become your succession plan is to realize that every company sale pays for itself. What this means is that whether you sell to an outsider (i.e. someone in your industry) or to an insider (i.e. your management team), the next owner of your business is going to get their return on what they pay you for the company from the future cash flow that is generated from the company.

The difference between an external and an internal transfer is that an outside buyer will pay you for the value of your business in order to own it, while the management team likely will need to pay you over time. In either case, the business will need to continue to generate profits into the future and your management team is likely key to the success of the company. Therefore, retaining key people, no matter who your future owner will be, becomes a priority for owners to ensure that their business succeeds in the future.

**Typical Benefits vs. Customized Benefits**

Managers at your business likely receive compensation that matches their responsibilities as well as a certain package of benefits. In most privately-held companies, the salaries are 'market rate' and the benefits for the managers are often a part of a company-wide package of benefits for all employees. When you offer benefits to managers that are 'special' or 'discriminate' in favor of the managers, then you begin to drift from a benefit that is qualified to one that is known as 'non-qualified'.

*Qualified vs. Non-Qualified Plans*

To review, your key people are important to the future success of your company and you may want to provide these key people with benefits that are unique to this group. When you discriminate in favor of a certain group of managers, you enter the world of 'non-qualified' benefits plans. The simple explanation for this is that qualified plans have tax advantages that were only intended to be provided to companies that distribute the benefits [somewhat] equally (or at least fairly) amongst all employees. Non-qualified benefits, by contrast, favor only certain individuals – i.e., your key managers.

**Having Managers Act Like Owners Without Giving Them Stock**

What most owners want is to see key managers act more like owners of the business. However, many owners do not want to share actual equity/stock in the company with those managers (at least not right away). The answer to this dilemma may be to provide your key managers with an 'equity-like' benefit package, informally known as 'synthetic equity'.

Synthetic Equity comes in a number of forms, including phantom stock, or stock appreciation rights. This form of 'equity substitute' helps owners to provide a special benefit to key managers (which is not available to the other employees) and ties the payout of that benefit to the performance of the business. In this respect, the synthetic equity serves the same function of having managers think and act like owners because they are receiving a special benefit when the company performance increases.

Synthetic equity is an example of a type of non-qualified plan that discriminates in favor of only certain employees. Therefore, once you start down the path of offering this type of benefit, there is quite a bit that you need to know. First, there is a lot of flexibility in designing these plans to get the behavior and hopefully the performance that you are looking for as an owner.

**Ways to Design Non-Qualified Plans**

For example, let's assume that an owner wants to see the value of their company increase. And, that same owner is willing to pay a bonus to the managers if the value increases. Then what is required is a way to measure that growth in value. This can be done in a number of ways, the most obvious of which is increased cash flow. Another way is to have an outside, 3rd party, value the business each year to show the growth. Once your method of measuring growth is chosen, the managers need to be educated about how their specific performance within the company can increase the value of the business. Once that is done, managers should be empowered to act to increase the value of the business and they should understand the financial reward that is coming to them if the value does, in fact, go up.

**Vesting of the Benefit**

One of the most attractive features of a non-qualified / synthetic equity plan is that it can be designed so that the manager does not receive the benefit until a point in time in the future (hence the title 'deferred compensation'). Moreover, if the manager is no longer with the company at that point in the future, then they do not receive the benefit. This 'vesting schedule' is an important way to keep key managers aligned with the company's goals as well as retained by the business.

**Making the Benefit Meaningful – Writing the Check to Invest in Retention**

One of the most important components of this form of benefit planning for your key people is that the amount of potential bonus available to managers is a 'meaningful' number. In other words, if your objective as an owner is to retain your key people with this financial tool and strategy, the amount of money that the managers may receive for growing the value of your business, should be a projected figure that actually makes that manager think twice before leaving the company and losing the potential of receiving that amount of money.

As owners, it is therefore important that you come to grips with the fact that in order to retain key people under a plan such as this, you need to be ready to write the company check each year to set aside money that will be made available to the managers if the performance is achieved.

**Concluding Thoughts**

In summary, your key people are a critical part of any future succession plan that you may create. Whether you currently envision an internal or an external transfer, spending time to think through how and when your key people are compensated is a critical part of the planning process for most privately-held businesses. This newsletter is written to help owners think through the key points to a management retention plan to see how and where the key people fit into this overall strategy and future vision for the company.

If you have questions or would like to explore these ideas further, we'd be happy to connect. Reach out to Ed at ed@egwealth.com

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