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

Management is the lifeblood of many privately-held businesses. And, owners who are planning for the future want to retain and reward these key managers. These owners will often turn to planning programs and structures that favor these key individuals. In this 2nd part of a two (2) part newsletter, we want to discuss and address some of the planning details relating to establishing these special types of incentive plans. This newsletter is written for owners of privately-held companies who are looking to figure out the key manager incentive plan which best achieves their personal and business goals, particularly as they relate to a future transition or exit from your business.

## First Step: Selection of the Key Management Team to Participate

Once an owner decides that a retention plan is the best way to favor his key employees and align their behavior with the performance that he seeks, the selection of the management team needs to be made. For many owners of privately-held companies, it can be a difficult chore to determine who will be in the retention plan and who will be left out. An important question to ask in this process is 'who are the managers that are critical to the running of the company that the company cannot afford to alienate by leaving them out of the plan? This group of managers will form your 'core' group who will participate in this plan.

*Is this core group envisioned to be future owners?*

Are these key managers potential, future owners? You see, if the core group of managers is envisioned to be future owners of the business, then the money that goes into the retention plan that you design, may become available for the purchase of some of your company stock when it comes out of the plan in the form of bonus payment to the managers. This is one reason to try to determine early on whether or not these key managers are anticipated to be future owners as it will likely impact the design of the benefit plan that you create to retain and reward the key managers.

**Next Step: Writing the Check - Can Your Company Afford the Benefit?**

Once you've decided who is going to be included in the retention plan, the next critical step is to figure out whether or not your company can afford a 'meaningful' program. First, a 'meaningful' benefit is one that will actually capture the attention of your managers. As a general rule, this can be one (1) to two (2) times their annual salary (accumulated over a period of time). For example, a manager who is earning $120,000 per year is likely not going to be overly impressed with a benefit plan that pays him or her $20,000 or $30,000 in a few years. While that may be a nice gesture, it probably would not be enough money to keep that manager in place when a better offer for a career change comes along.

So, furthering this example, if you have three (3) key people in your organization and you want to provide a benefit that is equal to their annual salary (and they all make $120,00 per year), then you'll need to forecast a benefit plan that accumulates $360,000 at the end of a certain period of time.

So, can your company afford an annual payment to this plan in order to have the program be meaningful to these key people? Also, do you want to invest at this level to increase the value of your company through this form of retention?

In this example, if the plan were to run for four (4) years before the pay-out occurs, can you plan for an allocation of $90,000 per year (after taxes and without accounting for growth) to contribute to this plan? For many privately-held business owners, this is where the 'plan design' meets with reality as well as a need to commit, financially, to this plan in order to invest in this form of retention plan. *NOTE that this newsletter will not delve into the tax issues related to these types of plans – just know that the tax rules are long and complex, as are many of the compliance-related rules for having this type of plan in place at your company.*

**A Benefit that Pays Out (Unlike Equity Ownership)**

It is worth noting that unlike a gift or a sale of stock to these key managers, the planning that we are discussing will actually have a cash payout at a point in time in the future. Remember that one of the challenges with owning illiquid, privately-held stock is that a ready market does not exist to purchase your shares. In lieu of putting your key managers in the same position that you are in, you are creating a benefit plan that will actually pay out the cash that is being set aside for them. This can be a very important motivator when presenting this plan to the key managers – in other words, if they increase the value of your company, they get more money themselves. There is a direct correlation between performance and bonus payout.

**Cash Flow to Purchase Shares of Your Stock in the Future**

Let's come back to the earlier question as to whether or not your key people are envisioned to be future owners of your business. If you are accumulating this type of benefit that will pay out to the key people in the future, then it is worth noting that this plan may serve a dual purpose of providing your key people not only with a retention incentive and bonus plan to keep them at and performing with your company, but it may also serve the purpose of providing your key people with a portion of the cash that they may use to purchase shares of your stock in the future. In other words, if your key people are envisioned to be future owners of your business, then the bonus payments may be cash that they can use to come into a larger ownership position when they receive that bonus. When you are planning for retention of key managers along with an exit strategy, this is the type of plan design that can assist with helping you to achieve your overall goals.

**Vesting Provisions in Preparation for an Outside Sale Transaction**

However, if you are designing a management retention and incentive plan with an eye towards keeping your key managers in place to make for a more successful sale transaction to an outsider / competitor, then you'll want to consider that the proceeds inside of the plan may be designed to pay out according to a vesting date that triggers after the envisioned transaction.

In this case, you are looking for the buyer of your business to have some assurances that the key people will stay with the company after a sale transaction. Therefore, you do not want to have the vesting occur at the time of the transaction. Rather, the vesting should be designed to happen at some future point in time after the company has transitioned ownership to the outside buyer. By structuring your incentive plan in this manner, you are in a position to present the investment in the retention plan as a benefit of the sale transaction (NOTE also that another benefit of this plan design is the future tax deductions that the buyer will receive for taking over the plan but, again, that topic is outside of the scope of this newsletter).

**Concluding Thoughts**

In summary, a properly designed management retention and incentive plan can serve the dual purposes of keeping key people in place at your company while also being a part of your future transition plans. This 2nd newsletter, in the 2-part series, is designed to get the owner who is thinking about their future exit to more closely examine the benefits of management retention programs. While there is a lot to consider, the exercise of designing this form of plan should be helpful towards the overall planning for your future transition. We are hopeful that this newsletter achieves this objective and that you have a clearer picture of what this type of benefit plan may look like for you and your key managers.

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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