The Board of Directors Role

Long-Term Incentive Plans in Privately Held Companies

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Given the strategic importance of long-term incentive plans in privately held companies, the board needs to be involved when a long-term incentive plan (LTIP) is being designed, implemented, and monitored.

The board's role differs significantly based on the structure of the board. Are the Directors independent, employees or owners? Is there already a formal Compensation Committee or current long-term incentive plan already in place? However, one tenet that holds true for all boards, is that the components that go into a well-constructed long-term incentive plan are board responsibilities, whether there is a long-term incentive plan or not. That is because, at the highest level, the goal of a long-term incentive plan is to retain, reward, and attract key talent while achieving strategic alignment of critical long-term financial and business-specific quantitative and/or qualitative goals. These are board responsibilities even if no LTIP currently exists.

While generally, the impetus for a long-term incentive plan may come from the CEO, other key executive staff, or the Compensation Committee Chair, we propose that all board members have a role to ask proactive questions and understand how a LTIP can be developed. If one exists, they should consider how it can be assessed for its current effectiveness.

TO DO THAT, CONSIDER THE FOLLOWING FOUNDATIONAL CONCEPTS FOR YOUR DISCUSSIONS:

1. Understand the types of LTI plans, the focus, and benefits.
   - Does the plan along with the organization's long-term measures and objectives, support performance or retention or a combination of both?
   - Does the plan support the short and long-term management succession leadership transition objectives?
   - Do the plan objectives and targets retain and competitively reward the current executives, and attract future executives?
   - What are the options for vesting that make financial sense for the organization to retain the executives
2. How does the plan compare to external competitive benchmarks?
   - What is the competitive total cash compensation and total direct compensation position against your relevant industry and revenue?
3. Does the plan manage key risk factors?
4. Who approves and administers the LTIP?

#1: WHAT ARE THE TYPES OF LTI PLANS AND THEIR FOCUS?

By their very nature, long-term incentive plans have a multi-year time horizon versus the one-year horizon with a short-term incentive/ annual bonus. While all long-term incentive plans listed below are performance-based certain LTI plans support performance or retention to a higher degree. Whether the company chooses to have a plan that is more performance or retention-focused, must reward overall long-term performance. This is measured by equity value or some financial or strategic measures over time. There are several common types of long-term incentive plans that have different characteristics, as well as certain advantages and disadvantages.

Plan types that focus more on performance (as they are appreciation-focused)

- **Incentive Stock Options (ISOs)**
- **Nonqualified Stock Options (NQSOs)**
- **Stock Appreciation Rights (SARs)**
- **Performance Units**

Plan types that focus more on retention (as they are full value)

- **Restricted Stock**
- **Restricted Stock Units**
- **Full Value Phantom Stock**

When selecting or evaluating a plan, understand the features as well as the advantages/ disadvantages of each plan to ensure that your LTIP is designed to meet both the company's and the participant's needs.

#2: DOES THE PLAN SUPPORT THE MANAGEMENT SUCCESSION/ LEADERSHIP TRANSITION?

One of the primary goals of a long-term incentive plan is to support the financial measures and strategic/business objectives aligned to the life cycle of the organization. Where does the organization expect to be in 3 to 5 years - or 15 years? For example, we would expect private-equity-backed and family-owned businesses to have different expected life cycles and objectives. Most privately held companies have a time horizon for sale, while some multi-generational businesses have no intention of selling. Also, some businesses and industries mature with limited growth potential while others have significant growth potential. The vesting provisions are also important when designing these plans since the unvested rewards - and the value of those awards - are the "one-two" punch that creates the holding power that long-term incentives are intended to accomplish.

#3: HOW DOES THE PLAN COMPARE TO COMPETITIVE BENCHMARKS?

While market data on LTI eligibility and rewards are not as transparent and available for privately held companies as it is for publicly traded companies, there is enough available information and expertise to provide reasonable guidance on both eligibility and competitive dollar amounts. As the LTIP is a critical competitive advantage for the attraction and retention of individual executives, providing a meaningful market-competitive financial reward is key. It is important for board members to understand and be current on the competitive total cash compensation (the base and annual bonus) and total direct compensation (total cash plus LTIP) in the marketplace for the key executives.

Our experience as both an executive recruiting firm and a compensation consulting firm views the lack of a meaningful LTIP as a competitive disadvantage when attracting executives.

#4. HOW DOES THE PLAN MANAGE RISK?

Risk management, in its broadest definition, is about protecting the assets and future value of the business - including the key human capital. Long-term incentive plans typically have post-employment restrictive provisions that protect the company. This helps ensure the company's value will stay intact and as such, LTI plans could pay for themselves in the future. These provisions can include any or all the following: (a) non-competes to reduce the risk of losing an executive to a competitor; (b) reduces the risk of a terminated executive recruiting key employees; (c) non-solicitation of customers (if there is no non-compete); (d) protects intellectual property.

Note that non-competes may not be enforceable in certain states and situations as they may not prevent someone from going to work for a competitor. However, depending on the provision of the agreement, they may forfeit some or all the money owed to them. This is significant financial leverage if the dollars are meaningful.

In addition, the retention features of the plan are critical to reducing the risk of losing key talent and disrupting the business and succession plans noted above.

#5: WHO APPROVES THE LTIP?

If a formal Compensation Committee exists, then certainly that is the avenue to develop and present the plan to the full board for approval. Without a Compensation Committee in place, a Management Committee, comprised of HR / Finance may be an option to support the CEO in the development, approval, and administration of the plan. This is dependent on the level of involvement desired by the CEO and senior executives.

IN SUMMARY:

Long-term incentive plans offer both strategic and competitive advantages for privately owned companies. Board members can and should be actively involved in both the development and implementation of multi-faceted plans that can positively impact their organizations and bring value to shareholders.

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