Long-Term Incentives and Non-Qualified Plans for Privately Held Companies

Trends and Challenges

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We anticipate that the challenges in the Attraction, Motivation & Retention of Executives & Senior Management in 2024 and 2025 may moderate compared to the landscape in 2022/23. But since Baby Boomers will continue to retire at accelerated rates, retention of key talent will continue to be a high priority for forward-thinking companies.

Approximately only 50% of the Baby Boomers in the workforce have retired at this point, and many more are projected to follow suit in the next 5-7 years. Both General and Operations Management roles are projected - by the Bureau of Labor Statistics - to be the highest growth areas for top executives in the next decade. Future opportunities exist for business owners and stakeholders to focus on - and anticipate - the changing economic landscape and the needs of their customers.

Since the Great Recession, the economy has recovered and continues to grow modestly in the 2-3% per year range with overall stock values of both privately and publicly held companies notably increasing in value over this same period with occasional market adjustments. While a minor recession or soft landing forecasted in 2023, it never materialized and the long-term employment trend is strong due to retirements and the United States being one of the most stable markets in the world.

A constant re-evaluation of the business model is required to implement a more innovative and agile business characterized by:

- **Quality management**
- **Enhanced flexibility and agility in management priorities and objectives**
- **Improved performance visibility, planning, and analysis**
- **Process changes that build sustainable value**
- **An increased focus on human capital management**
- **Longer-range views of the business model**
- **Increased innovation and efficiencies through technology including AI, and focused capital investment**

Simultaneously, business owners are looking to minimize fixed costs by utilizing variable compensation opportunities to link the interests of company executives with their financial goals. In addition, their companies need compensation programs that help attract, motivate and retain executives. There has consequently been a significant increase in the amount of attention focused on executive compensation in privately held companies. It is through various long-term incentive programs that companies can establish a proper linkage between enterprise success and the opportunity to earn a significant payout in the future. These programs can attract and retain executives.

The primary vehicle for rewarding executives in publicly held companies is stock, either through stock options or restricted stock. However, stock is not always available in privately held companies. Nonetheless, privately held companies must develop a sound long-term compensation program to attract, retain, and motivate high-quality executives and key managers.

In this paper, we will discuss the benefits of using Long-Term Compensation Plans, as well as the Design, Implementation, and potential Pitfalls of these plans.

LONG-TERM COMPENSATION OPTIONS

There are two different types of Long-Term Compensation Plans:

- **<u>LONG-TERM INCENTIVE PLANS</u> provide executives with an incentive based on corporate performance or value creation. Stock options and restricted stock are mainly used by public companies, and stock appreciation rights and phantom stock are used for privately held companies.**

- **<u>NON-QUALIFIED DEFERRED COMPENSATION PLANS</u> provide executives with long-term financial opportunities that are not based on performance. Supplemental retirement plans are non-qualified deferred compensation plans focused on providing additional retirement benefits.**

THE NEED FOR LONG-TERM INCENTIVE PLANS IN PRIVATE COMPANIES

Many executives in public companies have earned significant compensation amounts through long-term programs, sometimes due to, or despite, corporate performance. Accordingly, long-term incentive arrangements have been subject to substantial scrutiny and, in some cases, have been reduced. However, this comes at a time when there is an increased need for long-term compensation in public and private companies alike, for some of the following economic reasons.

THE NEED FOR NON-QUALIFIED DEFERRED COMPENSATION AND/OR SUPPLEMENTAL RETIREMENT PLANS

The US workforce is growing older. Most companies only offer 401k plans to current employees and most executives will need additional benefits to have retirement income to maintain their current lifestyle as they move into retirement.

Even if executives contributed to their 401k at maximum levels, it may not be sufficient to fund their retirement if their employers did not provide pension plans or non-qualified plans as well. Long-term incentives can be a way for executives to create the wealth needed to fund their retirement.

Very few privately held companies *(less than 4%)* offer defined-benefit pension plans compared to 17% of all employers. 401k plans did not become available until the 1980s when the early baby boomers were already reaching the age of 40-45. There is a significant difference in the amount a person can save over 35-40 years versus 20-25 years because of the power of compounding. For these reasons, many managers and executives have not or will not be able to replace 70% or more of their pre-retirement income if they plan to retire at age 62 *(the national average age for retirement per the 2000 Bureau of Labor Statistics)*. The 70% retirement ratio is the general rule of thumb that financial planners use as an estimate for the income retirees will need to maintain a lifestyle equivalent to that prior to retirement.

THE ABILITY TO ATTRACT

Many privately held companies realize that the talent they need either comes from publicly held companies or larger privately held companies that already have long-term incentive or non-qualified plans. To attract this talent, the privately held company must implement one of these plans or be forced to increase base salary and/or short-term incentives to compensate for the lack of a long-term plan.

THE ABILITY TO RETAIN KEY TALENT

The war for talent has always been considerable but will increase as the economy expands and baby boomers retire. In addition, talented people are no longer staying at only one or two companies throughout their careers.

There are three compelling reasons for shorter tenure:

- **Companies are less loyal to their employees as evidenced by layoffs and downsizing**
- **Defined pension plans or generous retirement programs created to retain employees have been reduced or eliminated**
- **The stigma of job hopping has disappeared as people move every three to five years or so**

The Primary Vehicle for Rewarding Executives in Publicly Held Companies is Stock... That May Not be the best Option for Privately Held Companies.

Long-term incentive and non-qualified deferred compensation plans can help retain an organization's key people by:

- **Offering something other privately held companies may not offer**
- **Making the "Walk-Away" cost significant enough to make key talent reconsider before leaving for other opportunities**

THE PRIVATE EQUITY IMPACT

In the last five or so years, private equity firms have aggressively focused on privately held companies to acquire a partial or full interest. There are some estimates that private equity firms will own over 30-40 % or more of privately held middle market companies within the next ten years.

Private equity firms almost always provide current or new management with generous long-term incentives focused on value creation to attract, motivate, and retain top talent. This is quickly beginning to change and influence the compensation packages of privately held companies.

THE NEED TO PLAN FOR OWNERSHIP or MANAGEMENT SUCCESSION

As Baby Boomers continue to age and retire, ownership/management succession is becoming more important. Owners need to retain key management talent to run their companies as they position themselves for any one of the following succession alternatives:

- **Transition the business to the next generation of family (Family Business Model)**
- **Owners plan to shift to part-time or full-time retirement, yet remain owners (Owner Investment Model)**
- **Owners partially or completely cash out with an ESOP (Employee Stock Ownership Plan)**
- **Ownership sells partially or totally to management through a management buyout or internal transfer of ownership**
- **Ownership sells partially or totally to a private equity firm or strategic buyer**

In all these cases, the ability to retain key talent before and after a transaction or transition can be enhanced with either a long-term incentive plan, a non-qualified and/or deferred compensation plan, or a supplemental retirement plan. Without such plans in place, privately held companies bear the risk of losing key people or not being able to attract them in the first place, possibly harming the value of their company and derailing their succession plans.

THE BOARD OF DIRECTOR FACTOR: CROSS-POLLINATION

Many individuals serving as outside directors on private company boards may have also served or serve on the board of a public company. Therefore, these directors are likely to be familiar with and favor the use of long-term incentives to align the agendas of investors and executives.

All of the above-stated factors are contributing to the growth in the use of long-term incentive plans or non-qualified plans.

PLAN SELECTION

Assessing the need for a long-term incentive plan within an overall executive compensation program is a critical first step in evaluating the appropriateness of such a program for a given business. The next step in the process is selecting the most appropriate plan or long-term incentive vehicle. The key to choosing the most appropriate plan is to first establish some plan objectives and parameters. For example:

- **Is stock available?**
- **Should the plan be performance-based?**
- **If performance-based, what criteria should be used to measure value?**
- **What is the appropriate timeframe?**
- **Are there any tax issues that should be considered?**
- **What are the cost considerations?**
- **What do potential plan participants perceive as valuable?**
- **Are there significant individual differences among your executive team that would prohibit a single approach?**

The answers to these questions will help form the basis for selecting the most appropriate long-term compensation plan for the company and its executives.

There are several key considerations in the selection of the most appropriate plan and its design. The different types of plans include:

PERFORMANCE-BASED NON-STOCK PLANS

- **Stock Appreciation Rights**
- **Phantom Stock**
- **Performance Unit Plan**
- **Restricted Stock Units**
- **Long-term profit sharing (non-qualified plans)**

PERFORMANCE-BASED STOCK PLANS

- **Qualified Stock Options**
- **Non-Qualified Stock Options (NQSOs)**
- **Incentive Stock Options (ISOs)**
- **Restricted Stock**

NON-PERFORMANCE-BASED PLANS

- **Supplemental Executive Retirement Plans (SERP)**
- **Deferred Compensation Plans**

The pros and cons of each of these plans should be considered but are not detailed in this white paper. Rather, the remainder of this document focuses on the important steps of selection, design and implementation of these plans.

SELECTION, DESIGN & IMPLEMENTATION

The decision to implement a long-term compensation plan can have a positive impact on the future success of the company. However, if the wrong type of plan is selected, or if it is not implemented properly, it can have a disastrous impact on the company and the morale of its executives.

The most common pitfalls in the Selection, Design, and Implementation of Long-Term Compensation Plans are:

Pitfall #1 - The Lack of a Compensation Strategy Review

Not determining how a long-term compensation plan fits with the company's overall compensation strategy. The company needs to look at how the total compensation package stacks up in terms of base salary, annual incentives, qualified retirement plans and long-term compensation plans.

One of the objectives of any compensation program is to maximize the value of your compensation dollars. Determining the appropriate compensation strategy and selecting and designing a plan consistent with that strategy will help maximize the return on the required financial investment.

CRITICAL FACTORS TO CONSIDER

- **How does the plan relate to our overall business strategy and culture?**
- **How does the plan relate to ownership objectives?**
- **What is the appropriate compensation mix?**
- **How does it compare to the competition?**
- **How does it compare to the general market?**
- **How variable is the plan based on performance?**
- **How does each component compare to the market?**
- **Who should be eligible to participate in the program?**

Pitfall #2 - No Plan Selection Criteria

Ownership not clarifying and defining what they want to achieve with a long-term plan for the employer and the participants. These requirements should be matched with what each plan offers to ensure the selected plan meets their needs.

Pitfall #3 - Poor Plan Knowledge

Not fully. understanding how these plans work and the advantages and disadvantages of each -to the employer and the participants. The company should conduct the necessary research at the beginning of the process to properly educate all parties concerned. If necessary, seek help from outside consultants.

Pitfall #4 - No Cost Analysis

Not projecting the cost/benefit of the plan under various scenarios. Owners need to project how much participants could earn based on an organizational level, years of service, company financial performance, sale of the company, or other considerations. In some cases, owners may want participants to earn just enough in their plan to augment their 401k, or they may want true wealth accumulation which would require the selected plan to be worth far more than any qualified retirement program.

Pitfall #5 - No Pay vs. Performance Modeling

Not assessing the linkages between enterprise financial performance and associated plan award values. Poorly conceived performance-based plans may generate award levels at odds with the level of enterprise value created by the executive team; awards may result that are at one extreme or another, either too rich, generating excessive costs and benefits compared to performance, or too lean, generating insufficient benefits to the participants when they have performed successfully. Modeling multiple scenarios over a 5 to 15-year period, using optimistic, realistic, and pessimistic financial forecasts will help minimize the likelihood of this occurring.

The company should model the following:

- **The impact on the balance sheet and the income statement given resulting corporate gains**
- **The potential benefit to the participants before and after taxes**
- **The impact on the company's tax liability**

Pitfall #6 - Poor Initial Communication

Not communicating the overall plan concept objectives, potential financial benefits, and key provisions in a clear and concise set of communication documents. While the actual legal document may be complex because of typical legal verbiage and 409A rules, there is no reason a practical set of communication documents cannot be developed to complement the legal document. These documents should be augmented with oral presentations when plans are rolled out.

Pitfall #7 - Inappropriate Plan Provisions

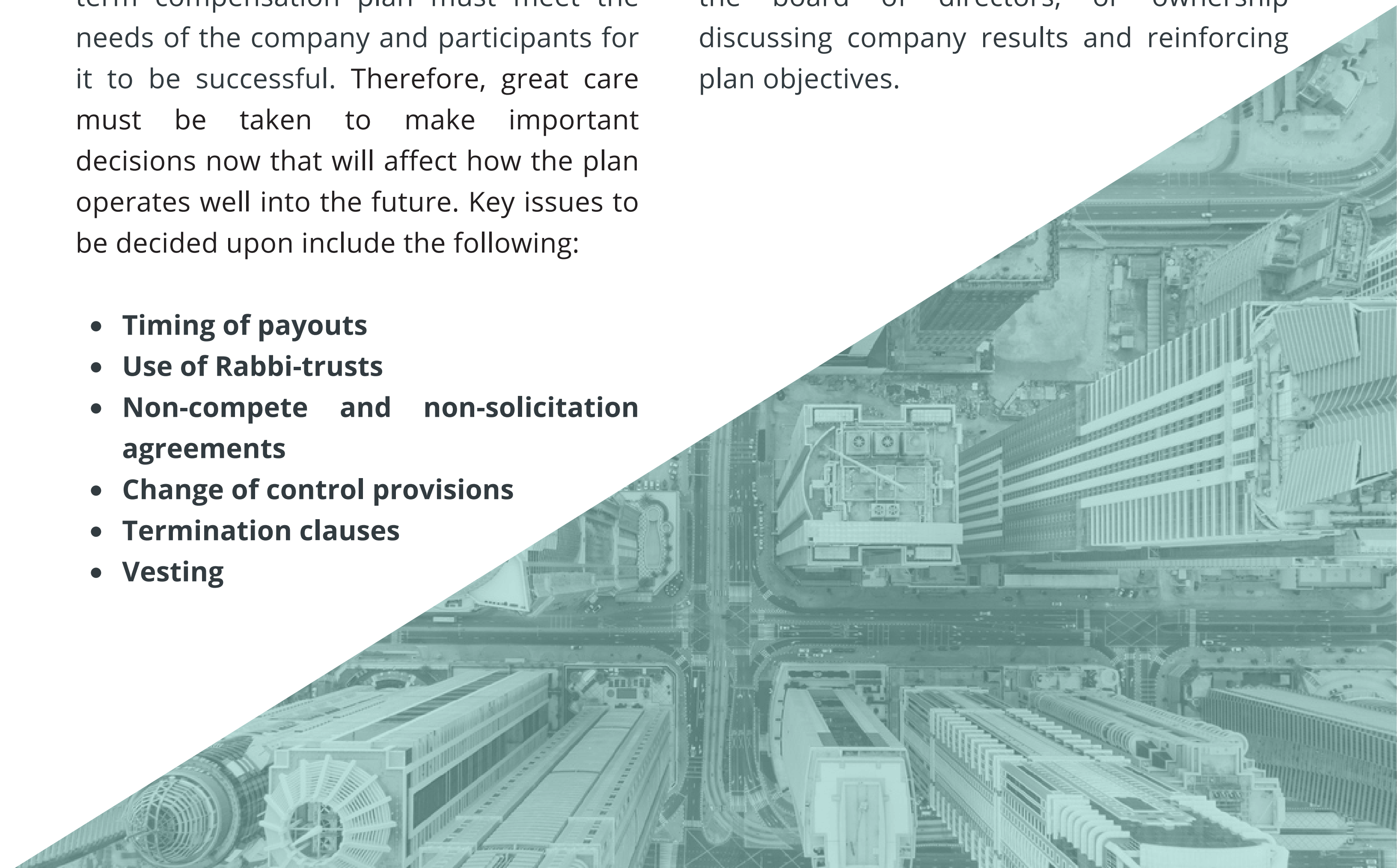
The company does not think through critical provisions and how they relate to the owner's objectives. The selected long-term compensation plan must meet the needs of the company and participants for it to be successful. Therefore, great care must be taken to make important decisions now that will affect how the plan operates well into the future. Key issues to be decided upon include the following:

- **Timing of payouts**
- **Use of Rabbi-trusts**
- **Non-compete and non-solicitation agreements**
- **Change of control provisions**
- **Termination clauses**
- **Vesting**

For example, a rapid payout upon termination may make sense in some situations. On the other hand, an extended payout over three to five years may have diminished value in the participant's mind if the industry is risky or there is a concern about the financial stability of the company.

Pitfall #8 - Little Ongoing Communication

Not reinforcing the plan through periodic communication. The long-term compensation plan will not be effective if it is immediately put in a drawer and left there. At a minimum, plan participants should receive a participant statement of their vested and unvested balances annually. This statement should be in addition to verbal or written communication by top management, the board of directors, or ownership discussing company results and reinforcing plan objectives.



Pitfall #9 - Lack of Periodic Plan Review

Not reviewing the plan's results and effectiveness. Annual incentive plans are usually revisited annually, and performance targets and formulas are modified based on budgets and goals for that plan year. However, long-term plans are not intended to change from year to year. It is usually not appropriate to change plans unless the plan is not meeting the company's objectives or if there are problems with plan mechanics, legal, or tax issues. To tinker with long-term plans too much can not only cost money but breed mistrust or unwanted complexity.

However, it is important for the company to periodically review the effectiveness of the long-term compensation plan in terms of achieving its objectives. If the plan is working properly, then no change is required. But, if it is determined the plan is not effective or causes problems, modifications or replacement may be required.

IN CONCLUSION

Long-term Compensation Plans are vital tools in the creation of a company's long-term success.

They can help companies attract, retain, and engage the talent they require to drive the company's long-range vision.

These plans, however, should be carefully selected, designed, and implemented with appropriate communications to ensure they achieve the desired results.

A well thought out plan can have a very positive long-term impact, while a poorly designed plan can result in an extremely negative outcome.

About The Overture Group

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