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Incentives for Employees of Privately-Owned Businesses: The Three Rs

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Some of the most important issues regularly faced by business owners are compensation and equity participation for their employees. The use of employee ownership programs as a tool to incentivize employees is one of the hottest trends in the country.

Owners consider sharing equity or growth in value for a variety of reasons, including:

Encouraging employees to perform better;

Attracting key employees;

Incentivizing key employees to assist in a sale of the business;

Rewarding loyalty and length of service; and/or

Attracting employees who will run the business while the business owner moves to the "sidelines."

There are a broad array of compensation and equity alternatives that are available to an owner, some of which include cash bonuses, commissions, various stock options, severance plans and more.

The owner should keep in mind that the many alternatives are not mutually exclusive but rather, a menu of items that can be mixed and matched to achieve the owner's goals.

Know your goals

Business owners consider implementing employee compensation and ownership programs for many reasons. For one, owners realize that buyers are often concerned that a business is "all about the owner." This creates risk to the buyer and lowers valuation. A well-advised owner will increase the value of the business by making sure that a buyer recognizes the business is not just the owner, but rather is driven by a management team.

Also, better performing employees will "lighten the load" on the harried owner, giving him or her more time to use their talents to increase value while spending more time with their families.

In addition to increasing value, some owners want to make sure that when they have their liquidity event they are not still locked into the business forever. If they have good advice along the way, incentivizing a management team should expedite their personal exit on or after a liquidity event.

Some owners wish to gradually retire while they retain their business and its cash flow. To do so, they believe they need a top-notch executive or executive team to run the business and to continue to grow it for a future liquidity event.

Know your audience

It is important to know your audience. Employees at different points in their careers, at different ages, and with different objectives are looking for different incentives. Some employees are "cash people."

They care primarily about money. Until recently, many employees were "cash people" because of the dot.com bust. To the extent owners can provide certain benefits that are tax effective, they will be heroes. Naturally, these employees are attracted to more lucrative cash positions. Deferring a portion of bonuses is a retention technique that will be referenced below.

Other employees are "equity players." These individuals are looking for the "big hit" that will help them achieve some of the wealth they see the owners have obtained and also fund their future retirement.

The Three Rs

Rewards

Rewarding excellent performance is one of the hallmarks of doing business in the United States. Doing this right is a never-ending challenge for the business owner.

As most owners know, certain bonuses, such as year-end bonuses, become expected and may not continue to drive performance. In some ways, if an employee's performance isn't really where it should be or the business has a down year, many employees have the expectation that they will still get the bonus. A failure to pay that bonus will cause a decline in morale and may cause employees to leave.

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Coming up with the right approach on a general basis, and certainly for your key employees, is crucial. It is not something you can set in stone and leave in place forever. A reward system must be constantly evaluated and adjusted to deal with the owner's

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goals, the performance of the business and the types of employees.

Retention

In addition to putting a reward system in place to compensate people for past performance, the system must create an incentive for the employee to stay with the business on a go forward basis.

As mentioned above, although a pure cash bonus system may be very effective in terms of satisfying an owner's goals and the desires of the employees, it may not result in the retention of those employees.

Simple techniques such as paying a portion of the bonus in the year earned and paying out the balance over time (with or without interest) serves as a mechanism to make it more costly for both a competitor to steal that employee away and for the employee to consider leaving.

The use of ownership plans further incentivizes employees to stay if they view the enterprise as growing and becoming more valuable. As with most things, the value of a business fluctuates and owners must adjust the equity program to deal with those changes during the life cycle of the business. That is why it is important to use multiple approaches, which layer on one another. Employees often do not hold the view that they should be exposed to valuation risk, nor do they handle declines in value well.

Merely putting in place an ownership plan without taking into account how employees view the value of that plan is certain to result in failure.

Also, as a business progresses and the owner gets older, becomes wealthier or either directly or indirectly makes the employees aware that he or she is considering a liquidity event, a variety of programs and tools must be considered to keep the employee with the business.

For example, a CFO is usually very important in the sale process. However, that same individual will naturally have concerns about his or her longevity depending upon the identity of the buyer. Because throughout most of a sale process you are never certain who will be the buyer, a CFO will become nervous and susceptible to considering other employment alternatives.

Implementing either a severance program or a transaction bonus, or a combination of the two, will help keep your infrastructure in place, the CFO hard at work and incentivize the CFO to help you get the best deal possible. Naturally, an owner will never know whether or not he or she can sell the business, hence, keeping the CFO and the balance of the business' infrastructure intact protects the owner in the event a successful transaction cannot be concluded.

Finally, if plans are structured wisely, the owner may be in a position to entice a buyer to pay for all or some of the plan.

Retrading - 2X

An important aspect of devising and utilizing any of these plans is to consider what might happen in the future. Although no one has a crystal ball, there are certain situations that typically arise. An owner can anticipate certain likely events and minimize their impact if they are negative.

I call this "retrading." At certain moments, an employee may use leverage to retrade his or her arrangement with the owner.

If an owner has been successful in selecting a management team to help achieve some of his goals, as time progresses, these employees will have more and more leverage.

For example, if the owner wants to successfully minimize involvement in the business, the management can become more demanding with respect to bonuses and equity participation. The management knows that the owner is faced with what might be an unpalatable alternative, returning to run the business.

Although there is nothing an owner can do to prevent that situation (and in some ways it evidences that you have achieved some of your goals), if the owner makes it expensive for management to request/demand ever increasing bonuses or equity participation, you will minimize the extent and the number of times you are faced with this circumstance.

As mentioned above, deferring bonuses or reducing or eliminating equity participation if an employee voluntarily leaves, creates a disincentive for the employee to make such requests.

What about the term "retrading-2X?" The first retrade can occur any time during the operation and growth of a business. The second retrade, which can be a lot more expensive and a lot more troublesome, is the "retrade upon a liquidity event."

Some of the goals of an owner are to increase value and minimize the length of participation in the business on a go forward basis after a sale. To do so, the owner may have turned over the reins to an executive team. If this is effective, that executive team may prove to be crucial to the buyer.

At the time of a liquidity event, that executive team may be free to pursue other alternatives and, as a result of their economic relationship with the owner, may have achieved a certain amount of wealth which gives them some personal freedom.

However, a well designed plan would have required that the executive team work for the buyer for comparable compensation and benefits within roughly the same geographic jurisdiction for at least a few years. This protects the buyer and hopefully enables the owner to receive maximum value.

A good plan protects the owner and gives him or her the benefit of the bargain with the executive. Hopefully it also reduces the chances that the executive will retrade - to get a bigger portion than was previously bargained for to provide services.

Rewards, retention and avoiding retrading are important goals. Knowing your goals and those of your employees, and planning to deal with those objectives, will not only enhance the business owners' life but also the ultimate value of the business.