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

Trends and Challenges

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Although global growth is slowing, the U.S. economy continues to grow modestly due to a combination of characteristics. Unemployment in 2019 hit 3.7 percent, the lowest since 1969. In addition, we have baby boomers retiring at an accelerated rate. This trend will continue for the next ten years. As a result, the demand for talent at all levels has increased significantly, especially at the executive and key management levels. As business owners and stakeholders strive to anticipate the changing needs of their customers, they must constantly re-evaluate and modify their company's business model. This requires a more innovative and agile business characterized by:

- **Longer-range views of the business model**
- **Increased innovation**
- **Enhanced flexibility and agility**
- **Improved performance visibility, planning and analysis**
- **Process changes that build sustainable value**
- **An increased focus on human capital management**

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 within 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 have the ability to attract and retain executives. With the unexpected crisis underway with COVID-19, business owners and stakeholders are faced with additional challenges.

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 still need a sound long-term compensation program to retain and motivate high-quality executives and key managers.

The following discusses the reasons to use long-term compensation as well as the pitfalls in the design and implementation of these plans.

TYPES OF LONG-TERM COMPENSATION

There are two different types of long-term compensation plans:

- Long-term incentives 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.
- Non-qualified deferred compensation plans 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.

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NEED FOR LONG-TERM COMPENSATION

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:**

Demographic Trends and Retirement Income Shortfalls: The United States is expected to grow older. Most companies only offer 401k plans to employees and most executives need additional benefits to have retirement income to fund their lifestyle.

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 incentive can be a way for executives to create the wealth needed to fund their retirement.

Very few privately held companies (less than 3 percent) offer defined benefit pension plans compared to 17 percent 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 big 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 percent 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 percent retirement ratio is the general rule of thumb that financial planners use as an estimate for the income retirees will need to maintain the lifestyle equivalent to that prior to retirement.

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.

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 career. **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

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 them think twice before leaving for other opportunities

Economic Times: Since the great recession, the economy has recovered but continues to grow modestly in the 2--3 percent per year range with overall stock values of both privately and publicly held companies notably increasing in value over this same period of time with occasional market adjustments. While a minor recession may be forecasted in the next 2 years, the long-term employment trend is strong due to retirements with the United States being one of the most stable markets in the world. COVID-19 has forced many small businesses to close temporarily or permanently.

Private Equity Firm 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 40-50 percent or more of privately held middle market companies within the next five to 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 compensation packages of privately held companies.

Ownership/Management Succession: As baby boomers continue to age and retire, ownership/ management succession is becoming more important. Many owners need 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 totally 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 prior to and after a transaction or transition can be greatly enhanced with either a long-term incentive plan or a non-qualified 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.

BOARD OF DIRECTOR 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 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 which 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 executives.

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

PERFORMANCE-BASED STOCK PLANS

- Qualified Stock Options
- Non-Qualified Stock Options
- Incentive Stock Options
- Restricted Stock

PERFORMANCE-BASED NON-STOCK PLANS

- Stock Appreciation Rights
- Phantom Stock
- Performance Unit Plan
- Restricted Stock Units

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 AND 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.

Nine common pitfalls in the selection, design and implementation of long-term compensation plans are discussed:

1. No 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. **Critical factors to consider are:**

- **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?**

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.

2. No Plan Selection Criteria - Ownership not clarifying and defining what they really 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.

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.

4. No Cost Analysis - Not projecting the cost/benefit of the plan under various scenarios. Owners need to project how much participants could possibly earn based upon organizational level, years of service, company financial performance, sale of 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.

5. No Pay Versus 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 which 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**

6. Poor Initial Communication - Not communicating the overall plan concept objectives, potential financial benefits and key provisions in an easy to understand 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 compliment the legal document. These documents should be augmented with oral presentations when plans are rolled out.

7. Inappropriate Plan Provisions – The company does not think through critical provisions and how they relate to the owner's objectives. It is important that the selected long-term compensation plan 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:**

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

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 financial stability of the company.

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.

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.

10. Impact of COVID-19 - The unexpected pandemic has only accentuated the need to be agile in using solid fundamental compensation practices. More than ever, it is critical to have a compensation strategy in place and to be flexible to adapt by modifying plans as prudent owners and leaders when conditions quickly change. Many privately held boards and executive teams have reduced salaries, and to some extent long-term incentive plans have changed mid-year 2020 to allow for discretion in determining payout levels. Other long-term incentive plans have modified goals during the pandemic. We anticipate continued modification of long-term incentive plans into 2021.

CONCLUSION

Long-term compensation plans should be seriously considered for privately held companies for the reasons stated above. In a nutshell, they can help companies attract, retain and engage the talent they require to drive the company's longer-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.

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