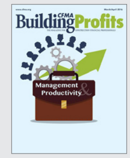




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# KEY EMPLOYEE INCENTIVE/RETENTION PLANS – *What Are You Waiting For?*

**The talent and contributions of key employees are often cited as one of the most significant value drivers within a successful company. Properly motivated key employees help build profits, which in turn builds enterprise value. They also hold the key to successful ownership transition.**

Contractors that plan to transition ownership to an internal buyer need to entice non-family talent to stay the course. And for those owners who plan to sell to an outside party, it's critical to have a capable, motivated, and loyal group of key employees in order to maximize the sale price.

Developing, recruiting, motivating, and retaining key talent is indeed critical to building company value and an owner's legacy.

This article will discuss how to identify your company's key employees and how to design an effective incentive/retention plan that is a win-win for all parties.

## Who Are Your Key Employees?

The first step in understanding the how and why of key employee incentive/retention plans is to identify your company's key employees and understand what is important to them.

While most employees are motivated for typical reasons (e.g., a pleasant work environment, competitive pay/benefits, opportunities for advancement, job security), key employees are different; they think and act more like an owner. They are attuned to company profits, industry trends, competitive advantages, customer/vendor relationships, productivity, etc.

They also offer input on how to improve the company (whether solicited or not). Key employees are known within an industry and may even be the focus of recruiting efforts from competitors, especially given today's limited and competitive talent pool. Top employees want tangible recognition and appreciation for their efforts in helping the company succeed.

So, how can you encourage high-caliber talent to stay the course? While offering higher pay is a common response, it does little to prevent competitors from offering even higher pay and/or better opportunity, nor does it necessarily encourage a leadership mentality. In addition, restrictive economic and regulatory factors often prevent owners from singling out top performers with traditional benefit plans.

This is where properly designed key employee incentive/retention plans can help. They allow owners to hand-pick their plan participants, are subject to minimal IRS intervention, carry no minimum or maximum contribution mandates, and encourage productivity and loyalty. Best of all, if properly designed, they should pay for themselves in the form of increased profitability. So how do you design an effective plan?

## Plan Design Variables

A well-designed incentive/retention plan must include four key variables:

**1)** Financial/Performance Benchmark Attainment

**2)** Substantial Reward Potential

**3)** Deferred Benefit Payout

**4)** Communication

### Financial/Performance Benchmark Attainment

The first and most important step is to identify at least one financial and/or performance benchmark that must be achieved in order to earn an award.

Benchmarks should be easily identifiable and translate to an increase in bottom-line profit. As such, the company's obligation to fund the award only exists when the company reaches its profitability targets.

While performance benchmarks tend to be subjective by nature, financial benchmarks are much easier to identify. Examples may include:

- Percentage of profits above a certain threshold
- Percentage of increase in net profit or profit margins
- Revenue growth if expenses are below a certain percentage of gross sales
- Percentage of savings from reduced expenses as a percentage of sales

Benchmarks might be achieved as a team:

- Division/department: Percentage of growth or sales
- Sales/estimating/business development team: Number of new and/or returning customers
- PMs: Percentage of profit per job

Or, they may be individually based:

- Individual productivity reward
- Individual business development/sales territory performance
- Percentage of savings or growth compared to budget

The financial/performance benchmark must be written, objective, and easy to calculate and track. It should not reward for status quo results or be based upon employee expectations of an annual award.

### Substantial Reward Potential

In order to positively impact and motivate behavior, an owner must ensure projected benefit awards are substantial in the eyes of plan participants. According to Maxim Consulting Group, variable compensation should be at least one month's pay and up to 25% (or higher) of the employee's base pay the further he or she moves up in the organization. Remember, this is a key employee incentive/retention plan, not a seasonal bonus paid to all employees.

### Deferred Benefit Payout

Some percentage (if not all) of the annual award must be deferred for future benefit payout. This is where the retention feature is achieved. Absence of benefit deferral is the most common mistake when designing a key employee incentive/retention plan.

Financially astute key personnel often understand the benefit of deferring additional dollars (and corresponding tax obligation) for future payout, especially if their participation in your company's qualified retirement plan (e.g., 401k, Simplified Employee Pension (SEP) plan, etc.) is limited by IRS mandate. At a minimum, 50% of the annual award should be deferred in order to achieve retention attributes; higher deferral percentage is even better.

Deferred benefit payout and/or years of required participation are determined solely by the owner. Payout age and/or years of participation can be individualized or consistent among all participants. Payout can be lump sum or over a period of years (e.g., three, five, seven). Vesting, prior to payout, is also left to the owner's discretion. The more stringent the vesting, the tighter the retention attributes.

Deferral percentages, time period, and vesting schedules are all plan design variables that must be balanced between the owner's retention goals and the participant's motivation levels.

### Communication

Lastly, the plan details must be communicated via a written plan summary for each chosen participant. While this seems like common sense, it is an often underestimated and overlooked aspect that is critical to a successfully implemented plan. Participants must understand the motivation behind the offer, why they were selected to participate, how the plan is going to operate, and what they might expect in projected benefits once benchmarks are achieved.

Communication about the plan ideally takes place after all designs/projections have been completed and implementation begins. It can occur individually or in a group, onsite or offsite, and with or without professional assistance. This is also an ideal time to determine if any noncompete or confidentially agreements are desired to protect company data and/or keep the plan confidential from other employees.

Confidentiality can be tricky. On the one hand, you want to avoid alienating any up-and-coming key personnel; employees who learn of their exclusion from the plan may become disgruntled. On the other hand, it can also offer motivation for developing talent to work harder to earn an invitation into the plan.

## Types of Incentive/Retention Plans

Once design variables have been identified and modeled, the next step is to determine if the key employee incentive/retention plan should be cash- or stock-based.

### Cash-Based Plans

Cash-based plans are the most prevalent, particularly in small- to mid-sized companies.

#### Nonqualified Deferred Compensation Plans

In addition to employer contributions, Nonqualified Deferred Compensation (NQDC) plans enable key personnel to defer compensation on a pre-tax basis, in excess of qualified retirement plan limits. NQDCs possess many of the same features and benefits of a qualified 401k plan, but without the corresponding nondiscrimination testing requirements.

This feature creates greater administrative complexity with NQDC plans compared to other cash-based design alternatives. Company tax deduction and executive tax obligation are both deferred until benefit payout/receipt.

To ensure "nonqualified" status, and as a result less stringent IRS involvement, NQDC plans must cover only highly compensated employees or management group and must be disclosed to the U.S. Department of Labor.[1]

#### Phantom Stock Plans

Under this design, annual award is translated into "units" of synthetic stock (equity) and held in an account for each key manager. The number of units awarded is strictly dependent upon the dollar amount of the award and the company's underlying stock value. The value of the phantom units increases and decreases in unison with changes in the actual stock value.

As the key employee strives to increase company value, he or she in turn creates more value within his or her unit award balance. Any dividends paid on the underlying stock can also be credited to the employee's account.

When the employee attains 100% vesting, units are exchanged for cash. If he or she terminates employment prior to 100% vesting, then the company pays out only the vested balance in cash equivalent. Cash payment is deductible to the company when paid and taxable to the recipient when received.

#### Supplemental Executive Retirement Plan

Under this design, the company agrees to provide supplemental retirement income to the executive if certain pre-agreed eligibility and vesting conditions are met. Like a phantom stock plan, a Supplemental Executive Retirement Plan (SERP) is 100% company-funded, with no option for salary deferral.

At retirement (or stated age), the key employee receives supplemental income paid out of cash flow from the company. With SERPs, in the event of the key employee's premature death, company owned life insurance is often received to recover the cost of the plan and/or to provide a lump sum benefit to the key employee's named beneficiary. As with previous plan designs, benefits become taxable to the employee/beneficiary upon receipt and tax deductible to the company when paid.

#### Restricted Executive Bonus Arrangement

Under a Restricted Executive Bonus Arrangement (REBA), the company deposits annual bonuses into a cash-oriented life insurance policy for the benefit of the key employee and his/her dependents. Tax-deferred cash value accumulation provides key employees a source of tax-free income, in addition to tax-free survivor benefits, in the event of a premature death. The key employee owns the policy and names a personal beneficiary, but has restricted access to the cash values until the terms of the plan have been met, which encourages employee retention.

Since the employee owns the policy, bonuses are considered taxable income in the year paid. Correspondingly, the company enjoys an immediate tax deduction when the bonuses are paid. The company can choose to "gross up the bonus" (making it fully deductible) in an effort to offset the employee's income tax obligation.

The REBA is the simplest nonqualified plan design of all; it does not require separate financial accounting, valuation, and/or third-party administration. As such, it also does not adversely impact bonding or banking covenants – which are important to many contractors.

## Stock-Based Plans: Risks & Rewards

Prior to awarding stock (deferred or outright), an owner needs to ask one critical question: "Am I attempting to develop a plan to reward, retain, and recruit key personnel, or am I looking for new business partners?"

Awarding stock to the wrong person and/or for the wrong reason can be cause for litigation. Shareholders, even minority ones, have substantial rights and privileges associated with ownership, such as access to company financials or major company decisions (including selling, reorganization, expanding, and capital expenditures). They can even challenge a majority owner's compensation package, if perceived excessive.

On the other hand, if your key managers are your chosen successors, then stock-based incentive plans can go a long way toward helping to finance a stock transfer. As a side note, under cash-based plans, owners often offer immediate vesting of deferred balances if used to purchase stock.

Either way, incentive/retention plans are particularly useful in helping to finance an internal ownership transition, especially since the most common challenge internal transitions face is a lack of available capital to finance the deal.

## Conclusion

Developing incentive/retention plans for your key personnel is something that every owner should explore.

Even for those who have explored or perhaps even implemented one, periodic review of plan design and results is prudent. A company's future, an owner's financial independence, and his or her personal legacy all depend upon it. ■

### Endnote

1. *Employee Retirement Income Security Act of 1974* (ERISA) Sections 201(2), 301(a)(3), and 401(a)(1).

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