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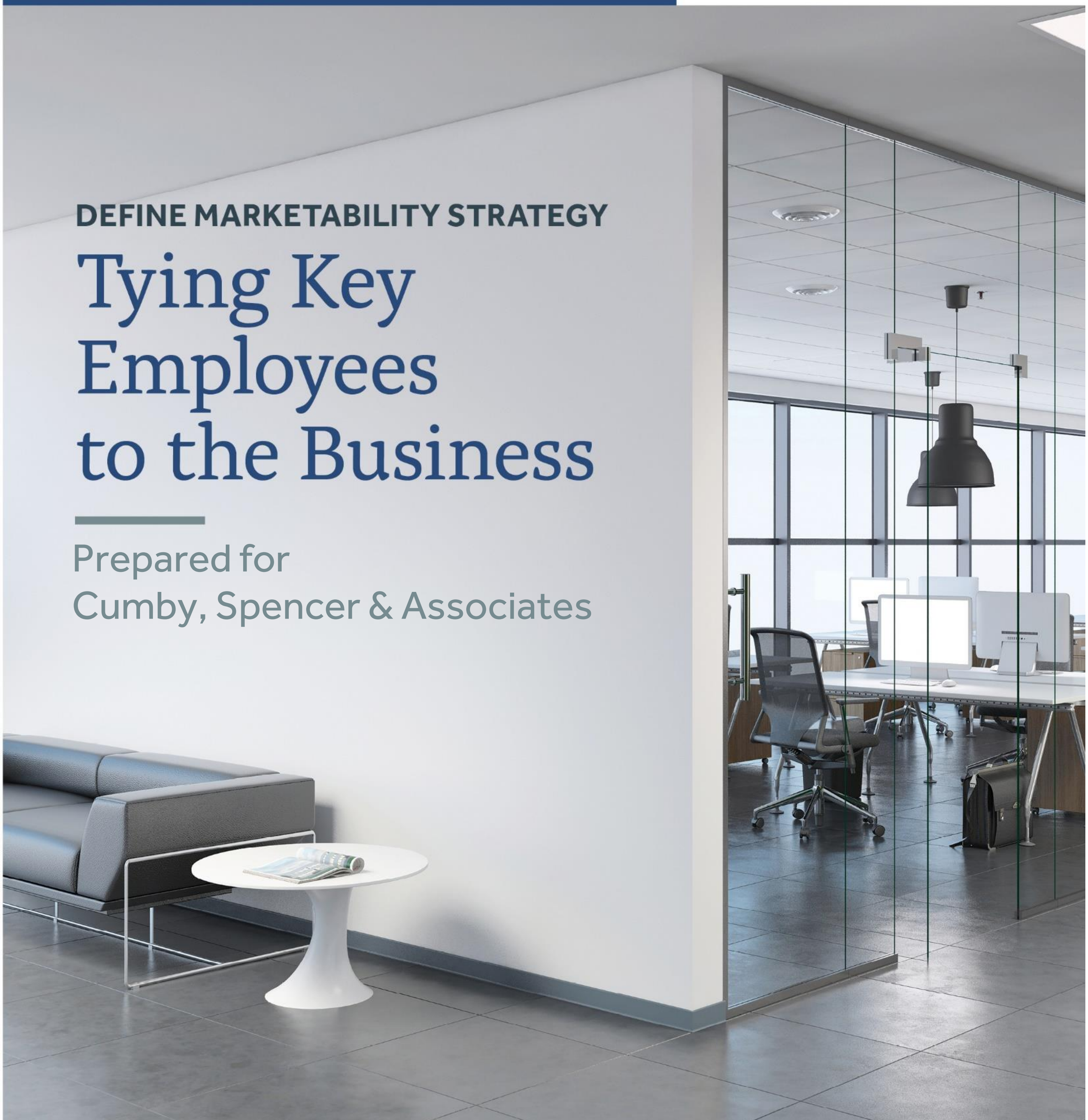
DEFINE MARKETABILITY STRATEGY

Tying Key Employees to the Business

Prepared for
Cumby, Spencer & Associates



Tying Key Employees to the Business

Key Employees

Key employees are duly named not only because they are critical to the profitability of a business, but also because they are key to the business exit plan. A stable management team provides assurance to a prospective buyer that the company can continue to prosper in the owner's absence.

Alternatively, if the owner chooses to sell the company to an insider, a key employee may become the successor of the company. Thus, it is important to provide compensation plans that not only motivate key employees to perform, but also provide them with incentive to stay with the company through a transfer of ownership.

Incentive Plans

Cash vs. noncash compensation:

- **Fringe benefits.** Virtually all employees receive a compensation package comprised of cash and noncash elements. In most circumstances, noncash elements will primarily include employee fringe benefits, offered on a non-discriminatory basis, such as group health insurance. In particular circumstances, certain elements may be of special value to a given employee, such as an executive who may have a high usage of health benefits due to a medical circumstance. In general, however, noncash fringe benefits may be difficult to provide on a completely discriminatory basis. More importantly, as a means of executive retention, they are usually of insufficient value on their own to insure executive loyalty.

- **Compensation based on enterprise value.** If the employer is a for-profit enterprise, compensation may take the form of ownership in the enterprise. For employers with an established market value, such as companies with publicly traded stock, compensation may take the form of stock ownership plans or stock option plans. If a company does not have publicly traded stock, compensation may take the form of "phantom-stock" or stock appreciation rights, related to a share value determined by appraisal or formula.

  This form of compensation often represents a double-edged sword. On one hand, it may provide executives an additional incentive to work effectively to create measurable results—particularly those in a position to drive the bottom-line numbers. On the other hand, if the enterprise experiences down periods from time to time, despite the best efforts of the executive suite, executive loyalty may be in jeopardy at precisely the wrong time. In this case, it is generally prudent not to rely exclusively or even primarily on these forms of compensation.

Current vs. Deferred Compensation

- **Current compensation plans.** A company could provide formula-driven compensation increases or bonuses to its select key executives based on individual performance benchmarks as determined appropriate by the company.

  These types of plans are often simple and easily understood. They require no accounting for future benefit liabilities, and key executives may perceive them to have more value than a future benefit. This could be particularly true for mid- level executives who may likely spend, rather than save, the bulk of whatever increase they might receive.

  The disadvantages of these types of plans are that they provide no real incentive for key executives to remain with the company in the event of a competitive offer. There is nothing the key executives would "leave behind" that might make them reconsider employment with a competitor. In addition, the bonus is currently taxable to the key executives (perhaps in a higher tax bracket than will be expected post-retirement) and provides no future financial security.

- **Deferred compensation plans.** Deferred compensation plans promise future pay for current services and can be further subdivided into qualified and nonqualified plans.

Qualified vs. Nonqualified Plans

Qualified plans are of limited value as instruments of selective executive compensation. The primary reason for this is that such plans are explicitly prohibited from discriminating in favor of highly-paid employees.

Nonqualified Supplemental Deferred Compensation Plans

Many companies have established nonqualified deferred compensation plans as a method of attracting, rewarding, and retaining key employees. These plans provide an opportunity for an employer to provide significant retirement benefits to its top performers on a selective basis. A nonqualified deferred compensation plan is a customized fringe benefit available only to select members of management and those employees who are "highly compensated." Participation must be limited to this "top hat" group to be exempt from most requirements of ERISA, the general federal pension law.

The employer and the key employee enter into a contractual unsecured agreement via a formal written document in which the employer promises to pay a future benefit to the key employee. The plan is not subject to the participation, non-discrimination, and funding requirements of qualified plans. It is normally not subject to the Internal Revenue Code Section 415 dollar limitations imposed on qualified plans. The employer has the freedom to pick and choose which employees will participate as long as the plan is maintained for a "select group of management or highly compensated employees." The plan is flexible, enabling the employer to select a different benefit level for each key employee.

Advantages for the Key Employee

A nonqualified deferred compensation plan provides an opportunity for supplemental retirement income without current taxation. The plan is flexible enough to allow for customization for the key employee's individual needs. For instance, the plan can be structured to provide survivorship income to the key employee's family without any addition to current taxable compensation. To avoid taxation on the value of the accruing vested benefit, however, the employer must not set aside funds into a fund that the employer's creditors cannot reach.

Because funds deferred by the employee or used to fulfill promises by the employer are subject to claims by the employer's creditors, a non-qualified deferred compensation plan is attractive mainly for key employees of economically stable companies.

Advantages for the Employer

The employer is not limited by the anti-discrimination provisions imposed on qualified plans. The flexibility allows an employer to cover anything from a single key employee to a group of key employees. The benefit level can be tied to production benchmarks, providing the key employee with a strong economic tie to the company's continued success.

The plan can create an incentive for long term employee loyalty, through a custom-designed forfeiture structure. Thus, when properly designed, the nonqualified deferred compensation plan may be the best method for retaining key employees.

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Bruce Cumby is the President of Cumby, Spencer & Associates Financial Group. For more than 35 years, he has developed a niche for working with pre- and post-retirement Baby Boomer and business owner clients. Bruce specializes in designing comprehensive, holistic solutions for his client's retirement planning, estate planning, wealth management, and business succession needs, as well as executive and employee compensation and benefits. He focuses on clarifying his clients' goals while creating a road map for their success. He attended St. Joseph's University and earned a Master of Science in Financial Services from the American College.

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