P&O Summit 2019
Retaining Key Employees and
Succession Planning Trends

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## Designing a Succession Plan

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Retaining Key Employees

• You’re not alone!
• How do you retain your best and brightest?
• How do you develop future leaders and owners?
Long Term Incentive Plans (LTIP)  
Stock Appreciation Rights (SAR)  
Deferred Compensation Plan

- Attract, retain and reward top, key talent
- Complete flexibility in design (customize to meet goals / needs)

**FAR Considerations**
- In addition to compensation and cash bonuses (not a take away)
- First and foremost reward for key employees for their contributions
- Recognition of substantial contributions to the operations and financial success of the organization
- Provide additional financial security as an inducement to remain employed with the corporation
Example Simplistic Model
Discussion points

• Build in a vesting schedule (example 3 or 5 year rolling vesting)
• Some window of time identified to realize vested portion of benefit (i.e. year 4 or 6)
• But if separation, potential to leave an amount on the table
• Individuals continue to be a participant until account is distributed or forfeited in accordance with the plan
• Deferred value meaningful value to be effective (hard to define, based on individual circumstances)
Discussion points

• Fully vest on certain triggering events
  • i.e. Death
  • X years with the company and attend defined retirement age
  • Consider backing with life insurance
• Creating Deferred Compensation Pools:
  • Identify corporate performance needed
  • Identify personal CFI and KPIs for individual performance
• Annual Statement Provided Annually (Pools Created, Interest/Growth, Vesting, Payout and Forfeiture)
Discussion points

• Sample Participant Statements
  – DC Bonus Plan (5 Year Rolling)
  • Other example modeling consideration could include combination of current payout and long term payout on retirement
  – DC Phantom Stock Plan, 5 Year Rolling with conversion option
  – What are your goals and what do you want to accomplish? = unlimited flexibility and design options!
Characteristics of and requirements for a deferred compensation plan

- Non-qualified plan
- Written agreement between the Company and executive/key employees
- Can limit participation to executives/highly compensated/other key employees
- Employee agreed to have part of their compensation deferred by the company and awarded at some time in the future as a bonus plan with earning, deferral and vesting considerations
- Must be substantial risk of forfeiture or strong possibility the employee might leave for plan to be tax deferred
Characteristics of and requirements for a deferred compensation plan

• Pre-determined criteria for participation (optional)
• Predominately a performance based plan (handling of annual change between participants can vary to design)
• Can have various levels of participation (A, B units, etc.)
• Complete flexibility in design
  • Funding Formula (stock value, annual profitability)
  • Vesting Terms
  • Payout Terms
Characteristics of and requirements for a deferred compensation plan

- Obligation accrued on balance sheet, impact financials and ratios
  - Impacts financials, cash if funded, accrued liability, net profit, and equity
  - Impacts ratios, working capital, debt to equity, profitability and others
  - Obligation will have short term and long term components
  - Can pro-rate and net present value obligation as earned
- Tax Considerations
  - Not deductible to Company or included in employee income until earned and paid for federal and state income tax
  - Special FICA / Medicare treatment when earned and not subject to substantial risk of forfeiture
Characteristics of and requirements for a deferred compensation plan

• Funding of obligation (optional but recommended)
• Consideration of use of Rabbi Trust
  • Allows participant “limited” input over investment of funds (careful, need to avoid constructive receipt)
  • Level of protection from creditor claims in ordinary course of business (not company bankruptcy)
• Subject to 409A regulations, tax code with detailed requirements, deferral elections, distributions, etc.
• Thorough preparation of documents to protect Company
Characteristics of and requirements for a deferred compensation plan

- Attorney will draft documents
- Top Hat filings
- Recorded in board minutes and parameters defined
- Often clause that employee death or permanent disability will provide for immediate vesting and payment to employee or estate
- Often life insurance used for funding in case of death
Phantom stock plan design within the deferred compensation structure

- Form of deferred compensation plan; most points from above apply under deferred compensation
- Primary difference is, as name implies, that it is typically tied to a pre-determined member interest or stock formula value
- Key employees are awarded units of Phantom Interest or Stock
- Determined value in issued year is base price of Phantom Interest or Stock (base = zero compensation value)
- Increase in interest or stock valuation from base year equates to annual compensation amounts
- Phantom interest or stock value can increase/decrease based on formula
Overhead Rate Considerations

• Effect of Deferred Compensation on your firm’s overhead rate.
INCENTIVE FUNDING – FINANCIAL FOUNDATION

Profit $ vs Incentive $ graph showing:
- Inverted Curve
- Total Incentives $(no upper limit)
- Support Growth – Equity, Working Capital, Banking, Bonding, investment in infrastructure, etc. (No incentive)
- Pools are funding simultaneously
- Cash Bonus
- Deferred Compensation
- 401K, Profit Sharing
- Financial Foundation $
INCENTIVE FUNDING – FINANCIAL FOUNDATION

**Graph Description:**

- **Profit $**
- **Incentive $**
- **Total Incentives $** (no upper limit)
- **Inverted Curve**
- **Pools are funding simultaneously**
- **Cash Bonus**
- **Deferred Compensation**
- **401K, Profit Sharing**
- **Financial Foundation $**

**Graph Notes:**

- Support Growth – Equity, Working Capital, Banking, Bonding, investment in infrastructure, etc. (No incentive)
Benefits of this approach are:

- The company’s internal growth needs are the first ones satisfied (ROI, assets, infrastructure)
- Incentive awards are available for distribution following allocations to the company (retained earnings) and the owners (for risking their investment). This makes it very clear to the employees in the performance plans that achieving some minimal level of profits is necessary prior to incentive distributions.
Development of a Performance-Based Incentive Plan

- Create corporate level profitability and incentives funding formula
- Determine funding of pools of incentives available for distribution to employees
- Determine methodology to split incentive pools to individual employees
- Objective vs. subjective methodology
Questions?
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