

Stairway TO Value

A “Best Fit” Incentive
for Owners Seeking
a High-Value
Change in Control



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In our practice, the Value Band Plan has become the most popular long-term incentive plan among the business owners anticipating a change in control within the next two to seven years.

Our clients often select Value Band Plans (VBPs) because these plans elegantly balance risk and return across the owners and executives. VBPs provide a scalable incentive: they enable executives to receive an increasing percentage of deal proceeds based on company value at change in control. They are conceptually simple plans. No annual valuations are required. There is no buy-in or tax friction at grant, and the plan units can be dynamically reallocated to the highest performing executives. In short, when properly designed and applied in the right context, VBPs are a highly-effective long-term incentive platform.

Nevertheless, VBPs are not as well known among business owners as they should be. For starters, 54% of all private companies have no long-term plan at all.¹ And many of the remaining companies have traditional equity plans, which can expose owners to unaffordable or inequitable payouts, conflicts between legacy and new talent, excessive tax bills, and other factors that can threaten the ongoing viability of the underlying company.

This paper introduces the VBPs and highlights their key benefits and considerations for private companies. Through the paper, we use a sanitized client example, TradeX One, to demonstrate the “best fit” characteristics of the Value Band Plan.

Top Three Benefits Of Value Band Plans

- VBPs are affordable and never impoverish owners
- VBPs are highly flexible
- VBPs align owners and key employees in pursuit of a high-value change in control

TradeX One, a trade advisory firm, had a near-death experience. Its three owners established a stock appreciation rights (SARs) plan to attract, retain, and reward key executives, planning to sell the business before the rights vested. As often happens with private companies, the sale didn't materialize on schedule. Instead, the company experienced a brief period of explosive growth in which it reached a \$400 million valuation. Sensing a financial windfall, many of TradeX One's key executives exercised their SARs. The result: a \$16 million cash call that sucked needed capital out of the company.

The mistake TradeX One's owners made is a common one: Business owners often fail to align their company's long-term incentive plan with their chosen succession pathway—in this case, a sale to a third party (also known as a change in control). The owners of TradeX One had all the right motivations, but they never anticipated how the firm's success might trigger payouts that could threaten its existence.

Owners of private companies who are on a path to a change in control owe it to themselves to become more familiar with the strengths and weaknesses of long-term incentive plans. In particular, they and their advisors should learn about one of the most powerful and flexible of these solutions: The Value Band Plans.

Introducing Value Band Plans

VBP's facilitate successful capital succession via a change in control. We have designed these plans across a diverse set of private companies with disparate cultures, histories, and business characteristics. And when owners exit their companies, we have seen the plans help them realize the maximum potential from these highly contingent events.

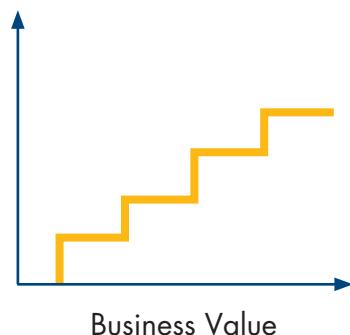
VBP's are a relatively simple and cost-effective synthetic equity incentive, with no buy-in cost for recipients.² They grant plan participants a pre-defined portion of the transaction value at a specified ownership transition event in the future, if certain conditions are met. The key to VBP effectiveness is its ability to motivate the participants to stay loyal, drive up company value, and support the transition event.³ This is achieved by carefully sizing the plan's "value bands" (i.e., the different levels of plan payouts based on the amount of the transaction proceeds) and specifying a set of prudent requirements for payouts.

Value Band Plans elegantly balance risk and return across owners and executives.

VBP payouts are dynamically priced based on two factors: 1) the business value achieved at change in control and 2) the percent of the deal value attributable to the plan. Thus, “the better we do, the better you do” economics of VBPs ensure that key talent is aligned and focused on the same goal as owners: building equity toward a high-value sale of the business. See Exhibit 1.

Exhibit 1: Value Band Plans—A Stairway to High-Value Change in Control

Percentage of Business Value Shared in Event of Change in Control



Improvements over comparable long term plans:

- Pays out only in event of change in control
- Fair & dynamic sharing to key executives
- Wrap around the founder’s objectives
- Values are reallocatable across execs
- No need for annual valuations
- Frictionless grants (no tax, no buy-in)
- Administratively very simple

TradeX One example: Change in Control (“CiC”) Value Band

	Transaction Value	Value to Execs	Value to Owners
Band 1: Threshold CiC at/above \$10M	\$20M	5% / \$1M	95% / \$19M
Band 2: Target CiC at/above \$30M	\$40M	10% / \$4M	90% / \$36M
Band 3: Stretch CiC above \$50M	\$80M	20% / \$16M	80% / \$64M





CiC = Change in Control, typically a sale of a company

TradeX One’s owners turned to a VBP after their near-tragic experience with SARs. They crafted a plan with three graduated value bands, defined by value the owners would achieve at change in control. The owners committed to provide the plan’s participants 5 percent of transaction value at threshold performance; 10 percent at target performance, and 20 percent at stretch performance (see Exhibit 1). This enabled the company to direct its strategic growth capital to its needs and its owners’ needs as opposed to funding interim plan payouts. It also freed the owners to expand participation in the VBP to include key technical talent, an employee group in which top-flight candidates are increasingly difficult to acquire and retain.

Aligning Long-Term Incentives with Succession Pathways

Long-term incentive plans are a means to an end. Tactically, they enhance the recruitment and retention of key talent. Strategically, they play an essential role in enabling ownership succession.

Different kinds of plans support different succession pathways. We highlight four most common pathways below including Change in Control, Partnership Model, Stay in the Family and ESOP. Of course, no matter what incentive plan you adopt, it is critical that it harmonize with your chosen succession pathway.

Succession Pathway	Owner Challenge	"Best Fit" Equity Model (True or Synthetic)
Change in Control 	Founder expects to sell in near term Goal: Flexibility	Synthetic Equity to Key Talent, esp. Value Band Plans.
Partnership Model 	Perpetual company via refreshed ownership Goal: Fair for all Owners	True Equity Transfer to Partners via Sell-Pay-Convey
Stay in Family 	Gen 1 transfers ownership to Gen 2/3 Goal: Preparing NextGen	Family Transfers + LT Bonuses to Professional Managers
ESOP 	Employee Stock Ownership Plan Goal: Manage Financial Risk	Equity incentives adjustable for recapitalizations

Top Three Benefits Of Value Band Plans

- ⦿ **VBP's are affordable and never impoverish owners**
Often, they are designed to payout only if a sale occurs. Moreover, the value share can be wrapped around the owners' unique financial situation – thereby sharing as little or as much as the owner feels is fair given the situation and timing.
- ⦿ **VBP's are highly flexible**
Their features, such as payout triggers, value drivers, and vesting, can be customized to align with owner, executive, and company goals during the plan design stage.
- ⦿ **VBP's align owners and key employees in pursuit of a high-value change in control**
They unite owners and key employees in a collective goal—the drive to create long-term business value.

Benefit 1: Value Band Plans are Affordable and Never Impoverish Owners

The principal distinguishing feature of VBPs is their graduated bands. As the company's value at change-in-control exceeds specific, predetermined levels, the value assigned to the plan's participants can step up into a new band. Thus, owners can offer key talent a graduated share in the growth of the company without risking their own or their company's financial well-being.

Often owners will resist the idea of incentivizing key talent for fear of placing their own financial well-being at risk. This creates a mental conflict in which owners struggle to reconcile their desire to avoid giving too much away with the need to retain the company's precious key talent.

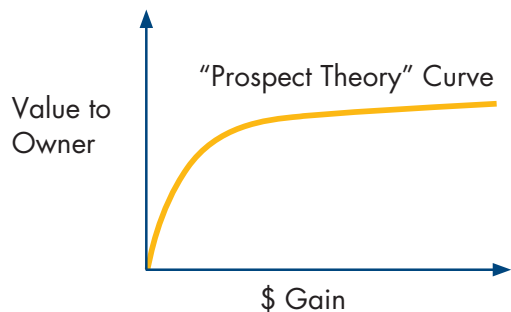
This is a dangerous psychological trap, but economist Herbert Stein discovered that it is avoidable. He argued that most business owners are not like investors, that is, they are not "maximizers" who seek the greatest possible value for themselves to the detriment of everyone else. He found that as owners attain most of their financial goals, they are willing to share incremental gains with the talented people who have helped them grow their businesses (see Exhibit 2).

Exhibit 2: The Surprising Psychology of Value Sharing

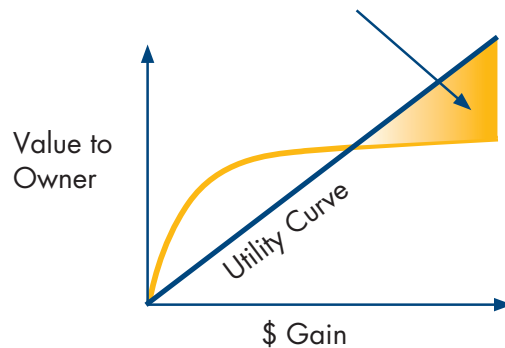
*The "value" of additional gains flatten out as business owners achieve their personal financial targets.
Example: The gain from \$1M to \$2M has dramatically more value to an owner than the gain from \$20M to \$21M.
Value Band Plans reallocate a portion of this excess value to executives.*

Owner of a Private Company...

Incremental Gain → Diminishing Value



often reposition additional gain via value sharing (family, execs, charity)



When TradeX One's owners realized that a VBP eliminated the risk to their own financial well-being, they acted just as Herbert Stein predicted they would. They willingly agreed to a plan that would share a higher portion of financial gains in excess of their needs with the key employees who would be instrumental in the growth and eventual sale of their company.

Benefit 2: Value Band Plans are Highly Customizable

VBP's are feature-rich, enabling dozens of different designs that can be customized to the needs of private businesses and their owners. Their features range across five categories: grants, service and vesting requirements, value calculations, payouts, and administration. (See the Q&A on value band customization on page 9.)

Award allocation is an essential feature for unlocking VBP flexibility.

When designing VBPs, owners can choose either a static (or fixed) award allocation or a unit-based award allocation or a combination of the two.

A static allocation provides pre-determined and fixed awards. It is most suitable for a highly-stable legacy management team deserving of a fixed carve-out benefit.

A unit-based allocation offers owners far more flexibility. Here, the value-sharing carve-out is divided into units and the units are awarded to participants. To ensure that the unit grants are aligned with the strategic goals of owners, the grants can be made subject to individual or group achievement as defined by key performance metrics, such as the quantity, quality, efficiency, and repeatability of earnings.

Owners do not have to distribute all the units; they can be granted at any time. Further, if all the authorized units in a VBP have been granted, owners can simply increase the unit denominator and create more units, without diluting their personal stakes in the company. VBP units offer owners a valuable benefit that they do not enjoy with conventional phantom stock and employee stock option plans, which continue to dilute the stakes of owners. Instead, they increase or decrease the plan's allocations to participants without tax or buy-in friction. (See sidebar "Minimizing the Tax Consequences of Value Band Plans.")

Returning to TradeX One, let's presume that Zachary, a key executive, deserves 20 percent of the plan units. If there are 100,000 authorized units in the plan, the owners would award Zachary 20,000 units. After a few years, Zachary continues to be a high performer, and many more people were added to the plan with the total number of authorized units increased to 200,000. To make Zachary "whole," he could receive an additional 20,000 units keeping him at 20 percent of the total authorized units.

In short, VBPs offers owners far greater flexibility than a stock option or a restricted stock plan, and they eliminate the confusion that the timing and pricing complexities of the traditional plans can cause among key executives.

Benefit 3: VBPs align owners and key employees in pursuit of a high-value change in control

Total Quality Management pioneer W. Edwards Deming decried short-term incentive plans. His complaint: Often, executives will go to great lengths to achieve these short-term rewards even at the risk of sacrificing long-term investments needed to create true shareholder value. Furthermore, executives tend to heavily discount long-term rewards, especially when they are based on complicated vesting schedules, moving targets, and long payout windows.

VBPs avoid these pitfalls. First, their payouts are tied to the same change-in-control event as owners' payouts. When owners get liquidity via a sale, so do the plan participants.

Second, VBPs keep rewards simple. Their bands are based on fixed parameters determined by the sale itself. No interim valuations are necessary. This lack of complication makes it easier for participants to understand and place their own value on the plan. Also, the plan is often communicated as a total carve-out for the team at the owner's exit versus individual SARs or stock option awards, which can appear to reward just individual contribution. VBPs emphasize the best of both worlds: owed-respect to the team and earned-respect to the individual.⁴

Third, key employees often find that their career opportunities are expanded by a high-value strategic sale. A larger company can provide correspondingly greater responsibilities as well as opportunities to achieve the founder's broader vision that may have been inhibited by the constraints of a smaller private company.

Witness what has happened at TradeX One in the past several years. Since the plan has been in place, the company's key employees have successfully embraced the ongoing volatility in global trade and fueled company growth beyond the owners' expectations. Currently, TradeX One is on track to exceed \$1 billion in value, at which time the owners will pursue a sale. If successful, the owners will share more than \$200 million of the transaction proceeds with TradeX One's key employees.

As you consider your desired succession pathway, here's a critical question: How well does your company's long-term incentive plan align with and support your capital succession plan?

Minimizing the Tax Consequences of Value Band Plans

Like most forms of synthetic equity, the proceeds distributed under VBPs are taxed as compensation when paid, not as property. Accordingly, key executives owe no taxes when they are granted an award or when they meet the plan's service, performance, or other vesting requirements. Tax is due when payouts are made, usually at change in control.

Occasionally, participants in VBPs express a preference for incentive plans taxed as property, such as restricted stock plans that feature favorable capital gains rates compared to ordinary income rates. This can be short-sighted: Because there is no buy-in or tax due at the grant of an award, VBPs can be significantly less costly and onerous to participants compared to other incentive plans.⁵

Moreover, companies offering true equity plans give up the potentially material benefit of a tax deduction upon an eventual equity buyback. VBPs, by contrast, are treated as compensation when paid and, as such, are tax-deductible. This allows owners to share some of tax benefit with the plan participants by sweetening VBP payouts, thereby subsidizing some of the participant's tax burden.⁶

Finally, a common concern of advisors is falling into the deferred compensation traps of section 409A of the IRS code. Well-constructed "vest & pay" VBPs are effectively exempt from 409A, because there is no obligation for payout until a change in control, and any subsequent payment is made consistent with the short-term deferral rules.⁷

Alignment Leading Towards A High-Value Change In Control

By and large, private companies have not aligned their long-term incentive plans with the succession pathways to which their owners aspire. The result: company growth, owner succession, and key employee retention are placed at risk.

It's hard to overestimate the value of establishing incentive and succession alignment across owners and key employees. Incentive plan misalignment is not an HR issue; it is a strategic impediment to growth. Properly designed and tested VBPs foster this alignment and, in doing so, help private companies climb the stairway to successful change in control. VBPs are affordable and simple to establish and maintain. They assuage owner fears of overcommitting to key employees, and they align the efforts of key employees with the goals of owners.

Bottom line: if you aspire to have a high-value change in control, it's time to take a closer look at Value Band Plans.

Q&A on Value Band Customization

The following Q&A explains a few VBP design features that can help meet the needs and desires of owners and key talent in private companies headed toward a change in control.

Q: Can VBPs be crafted to share upside value only after owners get a return on their capital?

A: Yes, owners can set a floor below which the plan does not pay out. At TradeX One, for example, the owners set the plan's floor at \$10 million.

Q: If several executives leave prior to a change in control, will the remaining executives receive a windfall?

A: No, the separation of executives does not automatically benefit the remaining executives. VBPs are based on plan units, and the value to any executive is based on his or her awarded units divided by total authorized plan units. Further, there is no obligation to award all the units under the plan.

Q: Do the sharply-defined value bands trigger some game playing by the owners to either get above or below a value band?

A: Some owners are comfortable with a few bands and big incentive targets (a kicker). For others, the plan can include more bands at smaller intervals or, in some situations, a smooth line, such as higher value band award for every \$1 million in transaction price.

Q: Many deals have large escrow and earnouts that are paid long after the sale. How are those handled?

A: Typically, plans require executives to remain employed by the acquirer to receive a share of escrow and future earnouts. Executives who remain are trued-up for their value share after specified earnout and escrow payments are received.

Q: What if the company is not sold because owners decide not to sell or no buyer materializes?

A: Because VBPs are intended to be developed outside the rigid designs of 409A applicable to nonqualified deferred compensation plans, owners can provide discretionary payments to plan participants at a time and in a form that suits their situation and sense of fairness. As circumstances change, the plan can be modified or replaced to reflect current realities with few or no tax implications.

Q: Can a portion of plan value be paid to executives only after a service or performance period following change in control?

A: With careful design, a portion of plan benefits can be subject to a "golden handcuff" while keeping the plan outside of 409A and managing the tax implications.

Value Band Plan: “foreground” or “background”?

In some cases, owners will position the Value Band Plan as the primary focus, AKA, the “foreground plan”. The message to executives: Our company may eventually engage in a change in control, and if so, we want to make sure you are taken care of via a fair compensatory bonus. The VBP truly aligns our interests.

Sometimes more tact is needed. Some organizations, owners or executives may not be ready to promote the idea of a possible, future change of control. In that case, here are a few ideas.

- ⦿ Consider discussing the value band plan with executives as a concept, but delay formalizing the plan and/or awarding any units until the time is right. Remember, no valuation is needed with a VBP — so the plan rollout and threshold values are independent of time.
- ⦿ Consider rolling out a fabric of incentives — one of which is the VBP. These three types of plans work very well together:
 - ⦿ Cash Bonus Plan rewarding loyalty. This plan determines benefits at the end of a performance year and then pays out a few years later to the executives still gainfully employed with the company. The cascaded bonus plan is often the primary focus, or “foreground” plan.
 - ⦿ The Value Band Plan, as described in this paper, is the “background” plan. The plan can be rolled out as a thoughtful incentive to the executive team, but not suggesting an imminent change in control.
 - ⦿ Business Continuity Plan benefiting key executives. This plan establishes a business continuity trust funded with life insurance for the benefit of executives in case the primary founder passes away. This trust coordinates with the owner’s overall estate plan. This is the “contingency” plan.

Owners who deliver an overall value-sharing message such as a cascading bonus plan, VBP, and business continuity plan communicate at a higher (more intrinsic) level of respect.

Footnotes

- ¹ "Incentive Pay Practices: Privately Held Companies," WorldatWork/Vivient Consulting, 2018
- ² Mark C. Bronfman, "Synthetic Equity: Powerful Incentive Plans Fostering Owner Succession in Privately-Held Companies" Sagemark Consulting, 2013.
- ³ Value band plans should fit into a company's overall compensation philosophy. Long-term equity-based awards, like value bands, should be married with fair salary, performance bonuses, and long-term deferred cash incentives.
- ⁴ Kristie Rogers, "Do Your Employees Feel Respected?" (*Harvard Business Review*, July–August, 2018)
- ⁵ Early stage companies with very modest enterprise value can transfer equity with limited tax or buy-in friction. See "The Founder's Dilemma" by Noam Wasserman.
- ⁶ As always, a tax advisor should be engaged to examine the structure, timing, entities, and income associated with a VBP to maximize the tax benefit of the compensatory expense.
- ⁷ A fully-fledged value band plan addresses other payout topics such as termination without cause, death, disability and rights to value after separation. Care should be applied relative to 409A tax topics.

Top 40 Executive Rewards*: A Pathway to Strategic Advantage

Equity Based Incentives

True Equity: Full Value

- 1) Sell Stock to key managers
- 2) Compensatory stock grants
- 3) Owner Redemption (Gross up others)
- 4) Restricted Stock and RSUs
- 5) ESOP (leveraged or creeping ESOP)
- 6) Ramp-down/Ramp-up (new entity)
- 7) Restricted stock paid at CinC **

True Equity: Upside Value

- 8) Profits Interest in LLC
- 9) Drop Down Division (w/upside interest)
- 10) Employee Stock Options ("Options")
- 11) Stock Appreciation Rights (SARs)
- 12) Hybrid Capital/Profits Interests
- 13) Out of the Money SARs, Options
- 14) Options/SARs paid only if CinC

Synthetic Equity (Full or Upside)

- 15) Phantom Stock (enterprise or division)
- 16) Phantom Stock with Owner's Pref
- 17) Enterprise Value Unit Plan
- 18) Graduating Value Band Unit Plan
- 19) Liability SARs
- 20) Performance Shares
- 21) Sales Bonus upon CinC

Cash Based Incentives

LT Performance Cash

- 22) Allocable Profit Sharing
- 23) Profit Appreciation Rights
- 24) Book appreciation rights (BARs)
- 25) Deferred Participation Units
- 26) Discretionary LTIP Plans
- 27) Cash bonus paid at CinC

Deferred Cash

- 28) Discretionary Bonus(group/Individual)
- 29) NQDC Plan (w/ comp match)
- 30) Qualified Profit Sharing Bonus
- 31) Defined Benefit Plans
- 32) Incentive Bonus Plan
- 33) Split Dollar Insurance (or 162 Bonus)
- 34) CinC payouts as multiple of salary

Immediate Cash

- 35) Salary increases
- 36) Annual Bonus
- 37) Sales Commission Programs
- 38) Spot Bonuses
- 39) Fringe Benefit
- 40) Lifestyle Incentives

* Incentives ranked from "Value Now" to "Value Later" (Value Now near top of each of six lists).

** "CinC" refers to Change in Control

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