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Transaction Bonuses for Executives

Help motivate key executives and employees during the sale process.

by Mark Working

Often in sales of privately held businesses, special compensation arrangements are made for executives and key employees. Bonus arrangements are made for at least several reasons: a sense of fairness and appreciation for contributions in making the business successful, extra work in support of the sales process, and an alignment of interests in making the transaction and transition successful. The amounts, timing, and forms of arrangement are all issues that must be decided and customized to each situation.

ESTABLISHING A REWARD SYSTEM

Putting aside "fairness" as a motivation, as each ownership group has their own meter and metric for what is appropriate for the situation and individuals, very practical reasons exist for establishing a reward system for executives.

Every business combines assets and people working within a dynamic system to carryout the everyday functions of the business. When all parts work in unison, great results can be achieved. At least one of the reasons why buyers pay high prices for a business is if they believe the "system" can be continued following ownership transition. Correspondingly, a significant due diligence effort focuses on assessing the ability to execute the company's business model, the identification of key employees, and the longevity and motivation of those key employees as the business moves forward.

Professional preparation for a sales process requires a company to describe how its specific business model works and why it is successful. That is almost always best accomplished with the involvement of the key people who direct and carry out the different functions of the business. When it comes to considering different potential buyers, these same managers will be involved in presenting the intricacies of the business from their perspective and answering questions arising during due diligence. They can be critical to achieving the best result for owners.

RISKY ASSUMPTION

Human resources are not assets on the balance sheet that can be transferred through a legal assignment. Individuals have their own motivations and ideas of what is best for them. Expecting them to fall in line because that is what would be best for the owners is a risky assumption. When an employee learns of a business being "for sale", their first thought is to determine what a transaction means for them. Despite most buyers wanting to retain the workforce, especially critical people, the usual assumption is that there will be layoffs or replacements. In any regard, change is expected and the unknown causes two destructive activities—replacing focus on business activities with thinking, talking, and imagining what the future will be, or taking action to find a new job where stability is perceived to be greater.

To be a valuable structure, the employee must appreciate and trust the fairness of the bonus calibration, as well as understand his or her role so as not to cause unintended consequences as a result of the incentives.

The primary goals of a transaction bonus program, consequently, should take the fear of change away while at the same time encouraging employees to embrace the new opportunity. The selling owner wants employees to keep their eyes on the business and know that it is in their best interests to assist in the sales process as directed by the owners and their advisors.

IDENTIFY KEY EMPLOYEES

Not all employees will be aware of or involved in the sales process. The first task in designing a program then is to identify the key employees whose loss would be detrimental to the organization. Most likely this will include all executive managers, but could also include certain others who have specific technical knowhow critical to the organization.

Generally, owners will benefit from approaching these employees in advance of a specific sales process with a message along the lines of:

"Options for selling all or part of the ownership's interests are going to be explored. You are very important to me and the organization and any new owner will desire that you remain on board, but in any case, I want you to feel protected against any other result."

The "Stay and Perform" agreement is the typical agreement used for transition situations. These agreements usually have two components:

1. Employee Promises. As a valued employee, the agreement provides for the employee to make certain promises to the company:

a. A non-disclosure agreement intended to assure no disclosure of trade secrets about the business that could be detrimental if known by competitors, suppliers, or customers.

b. A covenant not to compete agreement, if it does not already exist, assures that the employee won't leave and work with a competitor.

2. For the employee promises, the company agrees to pay to the employee:

a. A cash bonus at the time of a change of control transaction equal to an amount that reflects the special effort made to help prepare for and accomplish a successful transaction. This can be customized to the individual but often represents up to 50% of annual compensation; plus

b. A transaction bonus to be earned by the employee at the earlier of a certain amount of time passing following a transaction (often 6 - 12 months) or the loss of employment as a result of the new owner. Care needs to be taken to differentiate between employment being taken away from the employee and the employee leaving of their own accord.

The amount of the transaction bonus needs to be sufficient to deter the employee from searching for another job. Therefore, it needs to safely cover any gap in employment and risk of compensation change that could occur if the new owner decides their services aren't required. At a minimum, it should be equal to one year of compensation and any differential in future pay due to the non-compete (unless the non-compete is waived).

(continued p.2)

AVOID LAST MINUTE AGREEMENTS

It is better if these agreements don't need to be employed at the last minute. These agreements should be in place as part of normal course executive employment. Our recommendation has always been (see "Aligning Interests: Management Bonus Plans" IN$IGHT Winter Issue 2013) that the interests of owners and managers align, with value being a foundational component. If this has not been an historical part of the culture of the business, it is more challenging to implement at the time of a transaction. To be a valuable structure, the employee must appreciate and trust the fairness of the bonus calibration, as well as understand his or her role so as not to cause unintended consequences as a result of the incentives.

If implemented properly, key employees will embrace and fully support the desire of owners to liquidate their holdings, knowing that they will be protected from the risk of change, and buyers will gain confidence that the operating model will remain intact following ownership transition. As there are many subtleties to these arrangements, if is helpful for advisors familiar with these agreements and how they will be interpreted to assist in their creation. **ZS**

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ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, go to **ZacharyScott.com.**

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