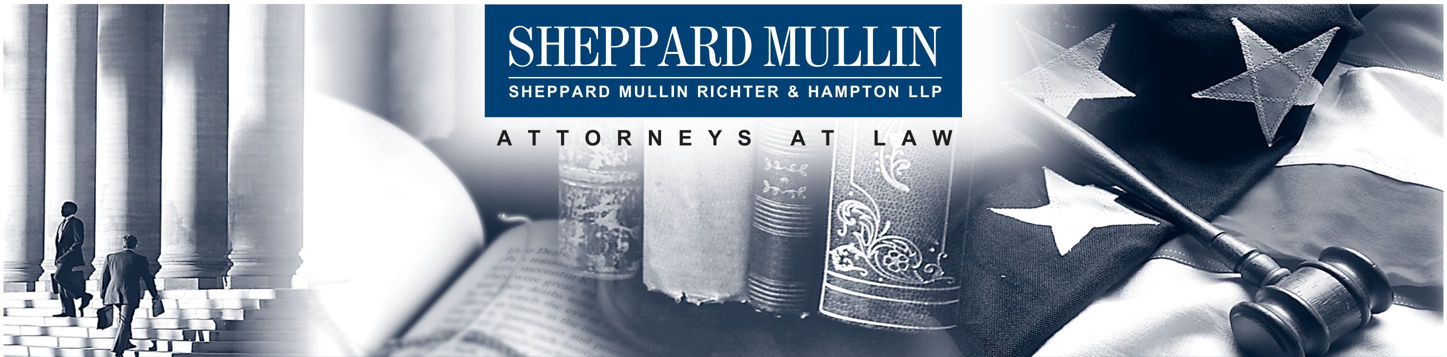

Corporate Update

July 2003

Positioning Your Company for Sale: The Use of Sale Event Bonuses or "Phantom Stock" to Motivate Your Key Employees

ABOUT THIS UPDATE

Maximizing value and maintaining key employee loyalty through the sales process.

Among the challenges faced by a company wishing to position itself for sale is how to align the interests of its key employees with the interests of the owners in obtaining the maximum value. One way of doing so is granting these individuals an equity stake in the company in the form of stock options or stock grants. This technique is not favored by closely-held and family-owned companies who do not want to feel like they are giving up control.

Instead of issuing actual equity, some closely-held companies grant key employees "phantom stock". Under the typical arrangement, the company promises to pay a bonus to the employee equal to a percentage of the purchase price (or a percentage over a base amount) received. The purpose of the arrangement is to retain key employees and to maintain their loyalty throughout the sale process.

Before issuing phantom equity, a company should consider a number of issues. This article highlights some of the many key concerns and suggests how they may be addressed.

- **Documenting the Arrangement**

Often, the bonus arrangements are documented by business people or by attorneys with no mergers and acquisitions experience. Sometimes – and especially in the case of closely-held and family-owned businesses – the arrangements are undocumented altogether. While the company will be saving legal fees up front, the failure to adequately spell out the terms of the bonus arrangement in a written agreement creates the conditions under which an employee can later claim he or she was promised a "bigger piece of the pie." A company is well-advised to engage the careful pen of a seasoned M&A attorney to accurately and comprehensively memorialize the arrangement. That attorney can help the business owner consider the many issues and how to balance the many competing interests.

- **Establishing the Baseline and the Percentage**

The typical arrangement calls for a bonus payment equal to a percentage of the sales price in excess of a baseline. An appropriate baseline might be the fair market value of

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the company on the date the arrangement is implemented or, alternatively, on the date the employee commenced employment. The company's initial instinct may be to pick a high baseline value. Doing so, however, may disincentivise the employee. The company should thus consider selecting the baseline value after also considering it from the vantage point of the employee. Consideration should be given to obtaining an independent valuation to give the baseline additional credibility.

An important decision for the company in creating the bonus arrangement is determining the applicable percentage or whether a "stair-step" approach (i.e., increasing percentages at higher prices) should be utilized. The company should consult with its investment banker, compensation consultant or other advisors as to what is typical for similar employees of similarly situated companies. However, what is selected has to work for both the owner and the employee.

In selecting a percentage, it is critical for the company to understand that the purchase price offered for the company generally will be reduced by the amount of the bonus. This is not always the case, however. In particular, buyers may be more likely to "assume" the bonus without a corresponding reduction of the purchase price if the payment of at least a portion of the bonus is contingent upon the employee remaining with the company for a specified period following the closing.

• Calculating the Purchase Price

An agreement providing for a bonus based on a percentage of the "purchase price" is inherently ambiguous:

- Are assumed liabilities included in the purchase price?
- Are sale-related payments that are not nominally part of purchase price (*e.g.*, non-competition payments; consulting payments) nonetheless included in the purchase price for this purpose?
- What about earn-out payments and escrowed amounts?

A court may likely construe these ambiguities in favor of the employee, especially where the agreement was drafted by company counsel. Accordingly, the "purchase price" should be specifically defined by the bonus agreement with reference to these items. Many of these same issues are encountered in fee arrangements with investment bankers.

The agreement should further spell out rules for calculating the "purchase price" with respect to the following issues:

- Which, if any, sale-related expenses (*e.g.*, taxes; investment banking fees; legal fees; other bonuses) should be deducted?
- Should retained liabilities be deducted?
- How are contingent assumed liabilities and retained liabilities to be valued?
- How is non-cash consideration, such as stock or promissory notes, to be valued?

• Sharing the Risks

The company and/or its owners, depending upon how the sale is structured, will generally be required to indemnify the buyer against breaches of representations, warranties and covenants. Where the employee is to receive more than a *de minimis* amount of the purchase price, the company should consider requiring the employee to contribute to the indemnification obligation. Since the employee will be benefiting from the sale, he or she should share in the burdens.

Often, a portion of the purchase price is contingent upon future events or is escrowed or held back to secure indemnification obligations. In these cases, the company should consider requiring that a proportionate share of the sale event bonus to be subject to the same contingencies.

• Form of Payment

Where the purchase price is paid partially or wholly in stock, promissory notes or other property and the employee is entitled to a substantial bonus, the company may not have sufficient cash resources. Accordingly, the company should reserve the right to pay the employee in-kind. (This is another reason the bonus agreement should establish a mechanism for valuing the non-cash property.) It should be noted, however, that where the in-kind payment consists of securities, there may be securities law issues that will need to be addressed and the consent of the issuing company will be required.

• Avoiding Conflicts with other Contracts

In constructing the bonus arrangement, the company must determine how other arrangements might be affected. For example, if the employee is entitled to an annual bonus based on the company's profits and the company fails to obtain the employee's agreement that this annual bonus will not be calculated by including profits attributable to the sale event, the employee will inadvertently obtain a double benefit from the sale event. Likewise, if the employee is entitled to severance benefits if terminated, the company will want to negotiate what those benefits should be if he is terminated in connection with the sale. A related issue that should be addressed is under what circumstances the employee should be entitled to the bonus if the employee's employment with the company terminates before the sale event.

• **Avoiding Negative Tax Treatment**

Under certain circumstances, the company's ability to deduct the sale event bonus may be limited or eliminated. The company will be denied the deduction for a portion of the bonus if it equals or exceeds three times the employee's average taxable compensation for the five years preceding the year in which the sale occurs and the employee is an officer, shareholder or a "highly compensated individual". Moreover, the employee will incur a 20% excise tax on a portion of the bonus. If the company is not publicly-held, these results can be avoided if the payment is approved at the time of the sale (rather than at the time the bonus agreement is entered into) by direct and indirect holders of no less than 75% of the company's voting power, after adequate disclosure regarding the terms of payment has been made to the shareholders.

A bonus arrangement involving payments in one or more taxable periods following the closing presents unique deductibility problems. Specifically, the company's deduction will be available only as payments are made to the employee and are taxable to the employee as income. If the buyer assumes the company's obligation to make the bonus payments, the company may be treated for tax purposes as having received the associated income (*i.e.*, an amount equal to the bonus obligation assumed by the buyer) in the year in which the closing occurs, thus resulting in a "mismatching" of income and the deduction. Further, should the company dissolve before bonus payments are made, the deductions could be lost forever. Careful planning is necessary to avoid these pitfalls.

Finally, it is helpful to document the phantom equity arrangement early, well before a sale process commences, in order to minimize the risk that the bonus may have to be capitalized rather than deducted, in accordance with the decision of the United States Supreme Court in the "INDOPCO" case. Regulations proposed by the IRS on January 23, 2003, would virtually eliminate this risk. Nonetheless, even after these regulations are adopted, the documents should reflect that entitlement to a bonus is compensation for services historically rendered by the employee before a sale occurs.

Planning for deductibility by the company should also take into account the timing of taxability to the employee. The arrangement generally should be structured so the employee is taxed when payment is received.

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Retaining and motivating valuable employees is of paramount concern to business owners, especially where a sale of the company or other liquidity event is on the horizon. Phantom stock and similar employee bonus arrangements can be effective tools to achieve these goals. Careful planning is necessary to maximize the value of these tools - and to avoid unwelcome consequences – to the business owner.

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