The Long-Term Incentive Challenges of Private Companies

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The phenomenal growth of executive pay over the last three decades is largely due to the development and rapid expansion of short-term and long-term incentives. Executive incentive pay has reached the point where long-term incentive (LTI) values dwarf executive salaries at most publicly traded U.S. companies. Yet, LTI plans have always been a challenge to set up and implement properly for the non-founder executives of private companies. Ironically, LTIs were first established at publicly traded companies over forty years ago to parallel the way private companies motivate and reward successful entrepreneurs. LTI structures are difficult to get right, but they are almost a requirement in the competitive marketplace for any private company that wants to attract and retain top-level executive talent.

Private companies, unlike publicly traded companies, are not required to disclose their executive pay practices to the general public, so successful and unsuccessful models of addressing LTI pay needs often go unnoticed. Following are three primary options that private companies use in addressing LTI for their top executives and the implementation challenges of each.

OPTION ONE: NO LTI PLAN

Until recently, the most common approach by private companies to LTI-related pay mix issues was to ignore LTI pay, and address the deficiency with minor tweaks to salaries and short-term incentive opportunities.

A U.S. subsidiary of a large overseas corporation did this by adopting an executive talent strategy of hiring candidates who were in distressed career situations. Without an LTI plan, the company couldn’t compete dollar for dollar with the combination of salaries and incentive opportunities offered by competitors. They actively sought to hire executives with blemished resumes who otherwise had the background and experience necessary to be successful in the position. These candidates were often willing to accept below-market incentive pay opportunities for the chance to move their career back on track. The problems with this strategy were predictable. Several of these executive hires did not work out. Many of those who did succeed were eventually poached by competitors once their careers were back on track. This company was constantly in the process of hiring replacement executive talent.

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Other companies enhance their salary and annual incentive pay opportunities to make up for the missing element of LTI pay. Instead of offering median salaries and bonuses plus LTI, they strategically pay higher salary and bonuses. While this may not fully compensate for the value of an LTI plan, this approach can be effective in hiring and retaining talent, especially candidates who are risk adverse. However, this pay mix does not reinforce long-term corporate objectives or link pay to long-term performance. In fact, this approach may prevent executives from exploring opportunities to take the company public or be acquired. Enhanced pay levels could make the executives a target for termination in a transition. This enhanced pay approach also makes it difficult to add LTI later without implementing pay cuts or other unpopular pay level/mix adjustments.

**OPTION TWO: CASH-BASED LTI PLANS**

Cash-based design approaches are effective when they are tailored to address specific strategic needs. However, they may fail to accomplish desired design objectives when they are hastily constructed.

*IRS Code Section 409A of the American Jobs Creation Act.*

One of the most important regulations impacting private company LTI plans over the past decade was IRS Code Section 409A of the American Jobs Creation Act (409A) and its amended treatment of deferred compensation plans or arrangements. Executive compensation deferrals were once relatively flexible to accommodate a broad range of executive and corporate deferral needs. However, 409A requires specific payment and deferral election timing, minimums and maximums, and plan funding restrictions that must be met to avoid excise taxes and interest penalties to executives, which could include:

- Retroactive tax filing adjustment for values delivered, but not recognized for tax purposes, above the current fair market value (FMV) at the time of each award, e.g. premium Stock Appreciation Rights (SARs) or stock options;
- A federal penalty tax of 20% of amount included in income; additional state and local penalties could also apply; and
- Interest assessed on the tax underpayments at underpayment rate plus 1%.

These tax liabilities would generally be imposed on employees rather than the company. However, the employer would still have income tax withholding and reporting obligations related to the enforcement of these penalties.

This tax-code change eliminated some cash-based LTI plans at private companies, for example many traditional phantom stock programs. The phantom stock valuation approaches used at private companies often did not meet and could not easily be amended to conform to 409A safe harbor methods. These phantom stock plans, therefore, became subject to rigid deferral timing and election window restrictions effectively making them undesirable. The 409A regulations also made formal documentation of all LTI plans and attorney plan review a fundamental requirement both for cash-based or equity-based LTI pay vehicles.

**Performance Metrics**

Equity-based incentive plans have a built-in performance metric: stock price. Cash-based incentive plans have an open-ended array of performance measurement possibilities that can be used for incentive purposes. Choice, while often good, also can lead to implementation difficulties.

Subsidiary companies of global multi-company conglomerates often have difficulties with cash-based LTI plans. These problems stem from intra-company transfer pay-
ments directed by the parent organization. Transfer payments are usually made to optimize the parent’s global tax and accounting position. However, transfer payments make it difficult to determine the organic profitability or contribution of individual subsidiaries, and may diminish the integrity of many common measures used for LTI incentive purposes. Subsidiaries at some countries can experience transfer-related windfalls while subsidiaries at other countries receive no payouts from their LTI plans due to unplanned transfer payments. In effect, the performance measured under these plans is based both on performance and on international tax and accounting dynamics. This can have a devastating impact on executive motivation, morale, and ultimately retention. It can also be a source of tension between the parent organizations and subsidiaries, and lead to dysfunctional events or behaviors if the issue is not addressed.

Stand-alone domestic companies are not immune to performance measure-related difficulties. Owners and management may have a difficult task to find the most effective way to measure the company’s long-term performance for incentive purposes. Some companies have implemented up to twenty measures of performance in an LTI plan (an outcome especially likely when engineers, MBAs or both are involved in the process). This structure can be further layered with modifications and adjustments tailored to capture the unique performance contribution of each plan participant.

Complexity is the issue. The motivational impact of an incentive plan largely depends on the ability of participants to identify and modify behaviors that will increase the size of their variable pay awards. Multiple performance measures can muddy the connection between day-to-day activities and payout results, and complicate communication of the plan’s objectives. Participants tend to heavily discount the value of plans they don’t understand. This diminishes the positive impact an LTI plan might otherwise have on overall executive retention and reinforcement of long-term goals and objectives.

Not-for-profit organizations face a unique performance-measure LTI hurdle. The IRS has challenged not-for-profit institutions’ incentive plans that have only financial performance metrics. The IRS argument is if a non-profit does not have to pay corporate taxes to deliver on its mission, it should not compensate executives solely on financial performance.

Another performance metric-related LTI issue is the long-term lag between measure selection and incentive payouts. A strategic direction charted in the past may change and have little or no bearing on current company objectives. Plan participants may have earned LTI awards that supported past strategic direction, and continue to earn them going forward. This could be a barrier to executive focus on the company’s current business vision.

Incentive Measure Goal setting

LTI performance measures are not the only challenge to designing successful cash-based incentive structures. Formulas that translate how these measures impact incentive payouts are equally important to the design process. Many cash-based LTI plans link participant rewards to corporate financial performance relative to pre-established strategic targets.

The impact of the 2007 recession on annual financial performance shows that many companies’ performance prediction models are, at best, imperfect. These predictions become even more theoretical as performance is estimated over a three to five year span. LTI plans that use performance targets over multiple years might reward executives more for their ability to budget, negotiate and sidestep performance
targets than for actual performance delivery. Plan performance could also reflect the relative health or weakness of the economy as it applies to the industry’s sales and revenues. The company may outperform the competition in lean years and miss LTI targets, or underperform the market in boom years and achieve LTI targets. Variations of this argument are often made as a critique of equity-based LTI plans.

Unforeseen corporate events may also impact cash-based LTI plan payouts. Corporate acquisitions of comparably-sized companies may have a dramatic impact on cash-based incentive plan performance. Acquisitions can cause an LTI to fail or succeed based on circumstances other than performance, or cause companies to maintain a separate set of books of acquisition-adjusted performance for incentive tracking purposes. In these cases, the original goals established for the cash-based incentive plan become compromised, suspect or irrelevant. Some companies plan for these possibilities when developing their annual cash-based LTI awards and make provisions accordingly.

Cash Flow

Cash-based LTI plans ultimately convert to cash and income for plan participants. This may stress corporate cash flows if LTI payouts are significant. In the past, this outcome could be addressed by mandatory elective deferral features integrated into the LTI plan. However, with 409A, cash award deferrals now must adhere to rigid and often undesirable timing and election guidelines or be subject to excise taxes and penalties. While corporations can ultimately deduct these compensation expenses, LTI payouts still will draw down cash reserves as they occur.

OPTION THREE: EQUITY-BASED LTI PLANS

Equity-based LTI awards inevitably create new shareholders. Current owners must be willing to share control and dilute their ownership position in return for enhanced performance opportunities when they establish an equity-based LTI program. LTI award participants who become owners can be a source of significant friction and future litigation or strategic white knights in times of ownership transition.

Ownership Exclusivity. Owners of private or very closely held companies generally do not want outsiders, or worse—competitors—as voting shareholders. Equity-based LTI awards could make this a reality if the plan is not carefully designed. This scenario can be the result of a direct or indirect chain of events:

- Executive shareholders who are now owners could be hired away by a competitor.
- Executive shareholders could sell their shares to a third party, and these shares could be purchased by a competitor or a dissenting shareholder.
- Creditors could receive shares of the company though a bankruptcy settlement with a company executive.
- The death of an executive and the subsequent disbursement of estate assets could transfer shares to outside interests.
- The spouse of an executive shareholder could receive shares of stock that were a part of the redistribution of the marital estate as a part of a divorce settlement.

Valuation. Private companies do not have market-based quotable stock prices. They may, however, receive a favorable fixed accounting treatment for equity awards if they use their best estimate of the FMV of their stock at the date awards are granted. Recent arms-length transactions and appraisals by a qualified valuation expert could serve as market value estimates, but the cost of frequent qualified valuations for many private compa-
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Most private companies use one of the following approaches to estimate the FMV of their equity:

- Independent outside appraisals by qualified experts of equity valuation
- Formulaic valuations (based on book value, earnings multiples, cash flow multiples, etc.)
- Hybrids of the appraisal and formulaic approaches

These estimates of value may be prepared internally or by outside professionals. With either method, the estimates should be approved by the Board of Directors and be consistent with IRS safe harbor techniques. The key to using any approach for valuing equity award grants is based on the ability of the model to consistently generate a best estimate of the FMV of the company’s stock.

Many private U.S. companies select formulaic valuations because they are the most inexpensive approach to implement and administer over the life of the equity-based awards. This approach often works well until a shareholder requests a valuation or sells shares of stock for a price that is inconsistent with the current value estimate used for the LTI plan. This variance between FMV and actual experience could cause LTI plan awards to fall out of conformance with 409A guidelines. This would expose companies to variable accounting, and expose executives to 409A tax penalties. Fortunately, this potential problem can be avoided with planning before equity-based incentives are awarded.

Corporate Tax Status. Undesirable shareholders are not the only worry of private companies. In the U.S., many private organizations elect to be taxed as S corporations to eliminate the double taxation of both earnings and dividends. S corporations can have a maximum of 100 owners. Having more than 100 owners changes the tax status of the company and reduces the after-tax income available for dividends. A company with an equity-based LTI plan could approach or exceed this maximum number of owners through one or more distributions of shares due to events like bankruptcy, death or divorce.

Mergers, Acquisitions, and IPOs. Unlike publicly traded companies, LTI awards issued by private companies do not have a readily available market to convert shares into cash. This lack of liquidity could make mergers and acquisitions a potential source of stress and hardship. In a transaction where an acquirer demands a large or exclusive ownership position, minority shareholders could extort a disproportionate payment for their shares. Minority shareholders could even block a merger or acquisition. Conversely, majority owners could sell their shares to an acquiring organization and effectively transform the company into a private division of a larger parent. This could bar minority shareholders from converting shares held into cash and effectively reduce or eliminate the value of their LTI awards.

As the price of a company’s stock increases, the value of the equity-based LTI awards increase. An initial public offering (IPO) will often increase the value of equity held by shareholders and provide a more liquid market to sell off some or all of their ownership position. This stock value increase from an IPO or sale presents a significant wealth-creation opportunity to executive LTI award holders. A well-structured LTI program can establish a very strong parallel link between executive rewards, shareholder interests and corporate strategy prior to an IPO or sale.

Timing is a major design challenge of equity-based LTI...
awards prior to an IPO or sale event. If equity awards are issued to executives too far in advance, executives may heavily discount their value, diminishing their effect. If equity-based LTI awards are issued and valued significantly below the IPO price less than a year and a half before the company goes public, the company could be forced to recognize an unanticipated “cheap” stock compensation as accounting expenses.

Cash Flow. Generally, most private, and many public, companies are able to fund LTI plans with minimal additional impact to cash reserves. Over time, the value of an executive’s share holdings may become significant. This is not an issue for publicly traded companies. Executives have readily accessible markets where they can sell their shares. However, many private companies require a right of first refusal for these equity transactions. This right typically is established as a way to limit ownership to investors that already own stock and executives receiving stock-based incentives. Exercising the right of first refusal to purchase stock from an executive selling shares could trigger a very large unanticipated corporate cash transaction. In a few cases, this share purchase could dramatically alter a corporation’s cash position and its liquidity.

CONCLUSION

Cash and equity-based LTI approaches can be an effective and meaningful way for private companies to deliver competitive executive pay for in return for superior performance outcomes. They can also powerfully reinforce strategic objectives. However, LTI awards can also carry heavy administrative burdens and be an obstacle to pursuing a company’s strategic vision. The key to the success of any LTI design is to clearly understand corporate needs and long-term objectives before considering incentive structures, and allocating sufficient time and talent resources upfront to avoid design pitfalls over the life of the LTI plan.