<u>Who's Worthy of the Throne?</u>

By Thomas Roback, Jr., CEP, QKA – Blue Ridge ESOP Associates

There is a time and a place for everything. Sometimes a business owner realizes it is time for retirement. Retirement is something we all anticipate, but when an executive has spent his or her whole life building a company, it is an emotional and anxious time. A great deal of the anxiety is derived from the question, "Who is going to keep the company humming when I'm gone?" Thinking about this question sooner rather than later usually makes for a successful transition.

Take Time to Plan. The outgoing business owner and the company board of directors must be prepared to have a robust executive compensation plan in order to influence executive behavior. It is critical to plan this executive compensation plan so that it fits the strategic plan of the company. So what makes a plan most effective? First of all, the plan must be clear and understandable. A plan that is too complicated is frustrating and ends up wasting everyone's valuable time. Second, executive actions must be able to drive the performance metrics of the plan. If an executive cannot impact plan results, what is the point? Lastly, the rewards must be meaningful enough to warrant extra effort from the executive. The bottom line is to find the "sweet spot" where executives are motivated without being over-compensated. This is often more art than science.

Finding the "Right" Leader. Hopefully, the leadership that will keep the company successful is already within the organization. Hiring from within usually makes for an easier transition. Neither her nor there, what characteristics make for the best leader? First of all, you want a leader with a proven track record of "owning" his or her responsibilities while managing people successfully. There are plenty of great employees, but not everyone is a great leader.

Another good signal for leadership is a genuine interest in the well being of the business. Good leaders understand the "big picture" and will do whatever it takes to get the job done right.

Finally, is the prospective leader willing to take some financial risk to reap potential rewards as the company grows? If the answer is absolutely not, how much does he or she really believe in the growth potential of the business?

The Graceful Transition – A Case Study. Now that you think the right managers are set to take over the reins, easing the new management in gradually usually works best. With each new responsibility transitioned, companies should consider transitioning an appropriate amount of company equity.

We at the Beyster Institute recently designed an equity compensation plan for a successful Maryland company. The company's founder wishes to retire in the next decade and came to us for help in exploring how an ESOP might be used to perpetuate his company as an independent entity after his retirement. After analyzing the company in detail, we recommended that the owner sell a 30% stake in his company to his 71 employees through a leveraged ESOP, and sell an additional 30% in approximately three years. We also designed an equity compensation incentive strategy for the new executive team, involving the use of stock purchases, stock bonuses and options. The plan consisted of the following elements:

1. **Stock purchase opportunities.** The company's outstanding stock will be made available to the three future executives for purchase at fair market value. Each executive will buy stock totaling 10% of annual salary. To purchase the shares the executives will pay for them with payroll deductions over the next 18 months. We forecasted that equity derived through stock purchases would total about one percent of outstanding shares this year.

2. **Restricted Stock grants.** The company will award restricted stock to the new executives in double proportion to the number of shares purchased. Assuming the offers are fully subscribed, the total number of restricted grants will equal two percent of outstanding shares.

3. **Stock options.** Executives will be awarded incentive stock options (ISOs) subject to the same vesting schedule as their restricted stock. The first tranche of options will be equivalent to two percent of outstanding shares and awarded in equal amounts to each of the three executives this year.

4. **Performance-Based Option Awards**. An additional tranche of stock options totaling five percent of outstanding stock will be awarded to executives based on performance from 2004 through 2006.

5. **Five Percent Reserved for Future CEO**. An additional five percent of shares will be reserved for sale/bonus/option awards to the individual who will succeed as CEO. 2.5% of outstanding will be reserved for combined stock sales and restricted bonuses, and 2.5% for stock options.

Employee ownership will be spread equally (as a percentage of salary) among all employees through the ESOP. The key executives who will be the beneficiaries of this executive compensation program represent the future leadership of the company and should be incentivized to grow the company with the additional equity provided under the plan. In all, the 15% of outstanding shares allocated to executives over the next five years, in addition to their pro-rata share of the ESOP allocations, amounts to a meaningful ownership stake in the company that will motivate key decision makers and facilitate the business succession strategy. While it is still early, the plan has been well received so far and the owner already sees some extra effort from the new executive team.

Conclusion. An executive equity program is a key strategic tool to motivate management in building a robust, successful enterprise and facilitates business succession planning. Providing key managers with an ownership stake recognizes their contributions to the company's success and provides them with a financial incentive to grow the company and assume greater management and ownership responsibility during the business succession phase.

Haste makes waste. The sooner an executive can plan his or her transition the better. Some people are just irreplaceable, but motivating the new executives with equity can be the next best thing.

Thomas Roback, Jr., CEP, QKA - Managing Director of Blue Ridge ESOP Associates Tom has worked in the accounting, investment and ESOP industry for over 17 years. He is an expert in the design, implementation and execution of ESOP, stock option, stock purchase and restricted stock plans. Mr. Roback received his MBA from the University of Baltimore and a BS in Accounting from the College of William and Mary. He is a Qualified 401(k) Administrator, Certified Equity Professional and on the Board of Directors of the National Center for Employee Ownership. Tom is also the Capital Area Regional Vice President of the ESOP Association's Mid-Atlantic Chapter. He is a member of The ESOP Association, OEOC and the National Center for Employee Ownership.