HUSCH BLACKWELL

Anatomy of Incentive Compensation for Private Companies

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1. Introduction

The purpose of any incentive plan is to motivate employees to behave in certain ways. The key to success is to carefully identify the employees to target, the desired behavior, the best way to motivate that behavior and any constraints based on the company's situation. Husch Blackwell's disciplined planning approach follows these steps to design and implement a successful incentive plan.

2. Who Should Benefit?

2.01 Top Management

2.02 Middle Management

2.03 Everyone

3. Basic Principles in Designing the Metrics That Generate a Reward

3.01 The employee must be able to influence the metric.

3.02 Fairness

- a. The metric should not be subject to manipulation by company (e.g., discretionary dividends or excess compensation to owner should not reduce the incentive payout).
- b. The metric should not be subject to manipulation by employee (e.g., increasing sales by selling at a loss).
- c. Overall compensation (including incentive) should be fair.

3.03 Keep It Simple

- a. The metric must be measurable.
- b. The program should be readily understandable.
- c. The program should be easy to administer.

4. Are There Multiple Companies/Lines of Business?

If so, should the incentive be based on metrics for the whole? For a portion only? Or partly for whole and partly for a portion?

5. Identify Company Goals

The possibilities include:

5.01 Aligning employee interests with company owners' interests

5.02 Employee retention

5.03 Employee recruitment

5.04 Maintaining flexibility re: payment timing

5.05 Employee commitment to noncompete/nonsolicitation

5.06 Tax treatment:

- a. Ordinary income to employee and tax deduction to company; or
- b. Capital gain to employee and no deduction to company

6. Design Timing of Payments

6.01 Termination of employment

6.02 Earlier of termination of employment or date

6.03 Later of termination of employment or date

6.04 Date(s)

6.05 At employee request with option for company to elect delay (works only for option or appreciation right)

6.06 Change of control

6.07 Death or disability

7. Design Form of Payment

7.01 Lump sum

7.02 Installments

8. Design Valuation Method if Based on Equity

8.01 Book value

8.02 Formula

8.03 Appraisal

8.04 Change of control price

9. Design Vesting

9.01 Can set any desired schedule

9.02 Can accelerate upon certain events such as change in control, going public or retirement

10. Examples of Common Designs That Result From This Process

10.01 Equity appreciation award

a. Rewards only increase in value of company following grant date.

b. This is the only form of payment that provides company discretion to delay payments.

c. Often coupled with vesting schedule

d. Sometimes settled every one to three years so employees get tangible reward more frequently

10.02 Metric-based bonus payable every one to three years (subject to a vesting requirement) can be a good retention tool.

11. Summary of Typical Alternatives

The attached chart summarizes key features of the possible types of grants that are typically considered.

FORMS OF INCENTIVE COMPENSATION

Plan Type	Restricted Stock	Book Value Stock	Incentive Stock Options	Nonqualified Stock Options	Stock Appreciation Rights	Phantom Stock or Deferred Cash Bonus
General Description	Stock is transferred to employee but is subject to forfeiture or is redeemable by the Company at less than FMV based on a defined pricing method in the event of termination of employment or for other reasons, including (if desired) failure to reach preset performance goals or for engaging in competition.	A form of Restricted Stock. Book value plan stock is sold to the employee at book value subject to the restriction that it can only be resold to the company at a price equal to its book value at the time of sale, but full realized value upon sale of company to third party.	Employee is granted an option for a limited period (maximum 10 years) to purchase company stock at a price equal to the fair market value of the stock on the date the option is granted. Stock received on exercise is generally freely transferable and non-forfeitable by the employee.	Employee is granted an option for a limited period (no legal limit on maximum period) to purchase company stock at a price fixed at the date the option is issued. Stock received on exercise is generally freely transferable and non-forfeitableby the employee. To avoid 409A, option price must be fair market value on grant date.	A stock appreciation right granted to an employee entitles the employee to payment by the company of an amount equal to the appreciation of a share of company stock on the date of exercise based on defined valuation method over the value of that share on the date the SAR was granted.	Employee is granted a unit entitling employee to a future payment equal to value of a share of company stock. Units may be converted into actual stock or cash based on defined valuation method at payment date. Dividends paid on actual stock can be paid to employee or credited to employee's account.
Consequences to Employee						
Stock Ownership	Immediate, subject to vesting	Immediate	Delayed, and can be subject to vesting	Delayed, and can be subject to vesting	None, and can be subject to vesting	None, and can be subject to vesting
Immediate Cash Outlay Required	No	Yes. Employee buys stock at book value.	No. However, employee must generally provide funds at exercise.	No. However, employee must generally provide funds at exercise.	No	No
Tax Consequences	Employee taxed on fair market value of stock at time when stock vests. Amount is treated as ordinary income. If vesting date is subsequent to date stock is received, employee may elect to be taxed on fair market value on date stock is received. Dividends paid during restriction period are compensation.	Employee is taxed on the excess of the fair market value of the stock over the amount paid for the stock. Arguably, the employee's gain on the ultimate sale of the stock is capital gain.	Generally, no tax on grant or exercise of option. If employee holds stock for two years from grant and one year from exercise, employee recognizes capital gain on difference between price at which stock is later sold and exercise price. However, alternative minimum tax could apply. If stock is sold before such time, spread at exercise is ordinary income.	Employee is taxed at exercise on excess of fair market value on date of exercise over amount paid for stock. Amount is ordinary income. Subsequent gain is capital gain.	Generally, no tax consequences on grant of SAR. Employee recognizes ordinary income on exercise (or lapse of exercise right) equal to amount of cash or stock received.	Generally, no tax consequences on grant of phantom stock. Employee taxed currently on any dividend equivalents currently distributed. Employee taxed as ordinary income on amount of cash and fair market value of property received upon payment.
Consequences to Employer						
Tax Consequences	Deduction to company on date employee includes in income (generally, the vesting date) equal to the amount included in employee's income. Dividends paid during restrictions period also deductible.	No deduction for company on repurchase of shares or on dividends paid on stock, except to the extent of employee compensation. Company does not recognize gain or loss on repurchase of its own stock.	Generally, no deduction. Potential for a deduction in the event that the employee disposes of his stock within two years from the date of grant or one year from the date of exercise.	Company entitled to a deduction equal to amount included in employee's ordinary income at time so included.	Company is entitled to a compensation deduction where the SAR is exercised for cash. If stock is transferred, company is entitled to a deduction when stock is included in employee's income (when it is freely transferable or nonforfeitable).	Company is entitled to a deduction when the units are converted into stock or cash. If converted into stock, deduction applies when stock is included in employee's income (when it is freely transferable or nonforfeitable).
Accounting Impact	Dilutes primary EPS	Dilutes primary EPS	Dilutes primary EPS	Dilutes primary EPS	No EPS dilution, unless SARs are payable in stock, in which case they dilute primary EPS	No EPS dilution, unless phantom stock units convertible into stock, in which case they dilute primary EPS
Discretion to Delay Taxable Event	No	No	Yes, by delaying exercise of option up to 10 years from grant date	Yes, by delaying exercise of option	Yes, by delaying exercise of right	Only if elect 1 year in advance and delay at least 5 years
Discretion to Delay Benefit Payment	Shareholder agreement may set terms for future stock redemption	Shareholder agreement may set terms for future stock redemption	Shareholder agreement may set terms for future stock redemption	Shareholder agreement may set terms for future stock redemption	Must pay in lump sum upon exercise	Only if elect 1 year in advance and delay at least 5 years