First in a series

Recent Trends in Incentive Compensation Plans

In the current highly competitive marketplace for employee talent, many companies are seeking ways to recruit, retain and incentivize key employees. A properly designed incentive compensation plan can accomplish these objectives while aligning the interests of key employees with those of company owners.

There is a spectrum of incentive compensation arrangements, ranging from a simple discretionary annual employee bonus plan to grants of actual equity interests in the employer to employees. Since the nondiscrimination and minimum coverage rules that apply to qualified retirement plans are inapplicable to incentive compensation plans, employers are free to pick and choose key employees for awards under incentive compensation plans.

This article briefly summarizes some common cash-based incentive compensation programs. Each of these cash compensation arrangements results in recognition of ordinary income by an employee for tax purposes when payment is received, and the employer can claim a tax deduction at that time in the same amount.

1. Bonus Plan. The simplest type of arrangement is an annual cash bonus plan. Bonus plans can be totally discretionary, where the employer has complete flexibility in the amount of payment. Alternatively, the plan can be more formulaic. The plan's performance objectives may be tied to company performance, personal performance or some combination of the two. Typically, annual bonuses are only paid to those employees who have continued in active employment with the company through year-end, or through the date bonuses are otherwise payable. There may be exceptions for terminations on account of death, disability and/or retirement, in which case a prorated payment may be made.

Importantly, the definition of profits and/or any other target or formula triggering payment should be carefully crafted so that it is tied to key performance indicators of the employer and employee and provides a reasonable basis for determining awards. Equally important, the target should be challenging but not unattainable.

2. Deferred Bonus Plan. A deferred bonus plan involves a delayed payment of all or some portion of the bonus earned during the year. For example, some portion of the employee's bonus is paid shortly after year-end and some portion may be paid in installments or otherwise credited to a bookkeeping account in the employee's name for later payment. The deferred portion may be part of a nonqualified deferred compensation plan which is payable over time or upon the occurrence of a payment event, such as termination of employment or a change in control of the employer. Additional design issues should be considered (such as vesting, crediting earnings to the deferred amounts and forfeiture events, such as violation of a covenant not to compete) before such a deferred bonus plan is implemented.

3. Sale Bonus Plan. A sale bonus plan allocates to key employees a portion of the net proceeds otherwise payable to the owners or the company on a sale of the company, perhaps above a certain threshold level. As a retention incentive, payment is typically conditioned on the key employee remaining in the company's employ through the sale date.

4. Stock Appreciation Rights ("SAR") Plan. A SAR plan grants to a participant the right to receive a payment tied to the appreciation in value of the company's stock. For example, if the fair market value of the stock today is $1.00 per share, a participant is granted 10,000 SARs, and the stock appreciates to $3.00 per share, upon a distribution event, the participant would receive $3.00 minus $1.00 or $2.00, multiplied by 10,000, for a payment of $20,000. Typically, SARs are subject to a vesting schedule, which means that payment is conditioned both on the company's stock appreciating in value and the employee remaining in active employment with the company through the vesting date or dates.

While some SARs can be exercised from time to time by the participant after they vest, it is more typical for private company SARs to be exercised automatically upon termination of the participant's employment, sale of the company or some other triggering event.

5. Phantom Stock Plan. This type of arrangement is similar to SARs but involves a full-value award. A phantom stock award gives a participant the right to receive the full value of a share of company stock on a distribution event. Stated differently, the participant has the economic rights of a shareholder but not the other attributes of stock ownership. Therefore, for example, the participant has no voting rights, cannot transfer company stock and has no right to access the company's books and records.

Phantom stock awards cannot be exercisable by participants from time to time. Either the participant has to elect in advance when the award will be paid out or the award provides for payment upon the occurrence of a triggering event, such as termination of employment or a change in control.

Note: It is vitally important for an employer to obtain proper legal advice in setting up any of these arrangements. For example, an incorrectly designed incentive compensation plan can subject your employee participants to significant tax penalties under the Internal Revenue Code's rules governing nonqualified deferred compensation plans. Also, potentially, if the plan covers too many employees or the wrong class of employees, the plan can inadvertently be subject to the Employee Retirement Income Security Act of 1974, or ERISA, which can have serious adverse consequences to all concerned.

Additional types of incentive compensation plans such as those involving company stock or other equity interests, as well as employee stock ownership plans, or ESOPs, will be described in subsequent aticles.

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This article is intended to provide an *overview* of different incentive compensation alternatives. If you would like to discuss any of these types of arrangements in greater detail, focusing on your company's unique situation, needs and objectives, please contact Jay Fenster (jfenster@dmlawyers.com) or Mark Hamilton (mhamilton@dmlawyers.com), or call 914-948 -1556.