Masters Series

Retaining key employees can maximize the value of your business

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Strategies

THIS IS ONE OF A SERIES OF ARTICLES PREPARED FOR CIBC PRIVATE WEALTH MANAGEMENT. THE SERIES IS WRITTEN BY PROFESSIONALS IN SUCH FIELDS AS TAXATION, TRUSTS, AND ESTATES.

Owners of private companies face difficult choices when trying to capture the value in the business they have created. An outright sale of the business to a third party, or the transfer of it to family members, can diminish the hidden value of the business assets.

In building a successful business, one asset that is often overlooked is the value that key employees contribute.

An important business asset

As a business owner, you want to secure the long-term commitment of your key employees — to ensure the company's ongoing profitability, and also to maximize the value of your business on a sale or other ownership transfer.

One way to secure the long-term commitment of key employees is to allow them to participate in the ownership of the business. However, this strategy may also reduce the value of your own interest in the business.

The dilemma business owners often face is how to maximize the value they will receive if they sell their business, while at the same time ensuring that key employees will continue to provide their services to the purchaser of the business.

Key employees are valuable assets

If you're a private business owner, your key employees will usually fall into three categories:

- **Product experts.** Employees who are experts or have unique technical skills may give your products their competitive edge.
- **People who bring in new business.** Employees who bring in large amounts of new business are one of your company's greatest assets.
- **Employees with significant business relationships.** If your business is dependent on a large customer who has a close relationship with one of your employees, losing the employee might mean losing the customer.

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Reward employees — and realize goals

As a business owner, you want to create a structure that:

- Encourages key employees to make a long-term commitment to the business.
- Allows key employees to realize some of the value they have brought to the growth of the business.
- Maintains business continuity if you decide to sell your business — whether by a sale to a third party, a transfer to family members, or some other transaction.

If you're interested in ensuring the long-term loyalty of your key employees, you'll need to put this structure in place long before you're actually thinking of selling your business.

A study in retaining key employees

Consider a typical situation involving a small business. Gordon's Services Inc. is wholly owned by its founders, Alan Gordon and his wife, Sheryl. Alan founded the business more than 20 years ago and it now has 12 employees.

Four of his employees have been with the company for more than 10 years. One of them runs the day-to-day operations and is responsible for making important business decisions. Three others have important relationships with major clients of the company, and are also very successful at attracting new business.

Alan and Sheryl have been gradually reducing their day-to-day roles in the business, and are looking forward to retiring completely within the next five years. In order for them to afford the retirement they want, they'll need to sell the business.

They know that in order to maximize the sale price, they'll need to ensure that the four key employees will stay with the business after the new owner takes over.

They believe that giving their key employees ownership shares will ensure their commitment to the business after it's sold. At the same time, they don't want to give up control of the business by losing voting control, nor do they want to give away too great a share of the value of the company.

Although Alan and Sheryl have considered creating a subordinate level of non-voting shares, which could then be issued to the key employees, their key employees want to participate in the business on the same basis as Alan and Sheryl, and aren't interested in holding subordinated shares with a reduced bundle of rights.

Here are four alternatives that could be considered by Alan and Sheryl to satisfy their goals of securing the long-term commitment of key employees, giving their key employees a level of equity ownership, and maintaining continuity — all while preserving control over the business.

1. Grant employee stock options

Stock options give employees the right to buy shares of the company. The options are issued either by the company itself (in which case, money paid upon exercise of the options would go to the company for shares issued from the treasury) or by the owner personally (in which case, money payable on exercise of the options would go to the owner, who would transfer some of his or her personal shares accordingly). The concern with stock options is that they don't create immediate equity in the hands of the key employees, because the employees don't receive the shares until they exercise the options at some future date. If the employee decides not to exercise the option, he or she is unlikely to feel like an owner and have the loyalty to the business that the owner intended.

As well, options are often treated as an exit parachute to be exercised on the sale of the business, which may be contrary to ensuring the ongoing commitment to the business of the key employees.

Lastly, as Gordon's Services Inc. is a private company, the absence of a ready market for the sale of the shares once the options are exercised presents difficulties. As a result, Alan and Sheryl Gordon decide not to use stock options. However, this issue can be addressed through a unanimous shareholders agreement; see sidebar on page 3.

2. Establish a share savings plan

Share savings plans allow employees to contribute a certain portion of their salary to buying shares in the business. The employer will often match the amounts contributed by the employee. The shares bought under the plan are usually purchased from the treasury, but they may also be transferred from the owner personally.

These types of plans tend to work more effectively as a true savings vehicle. It's unlikely that key employees of a private company could acquire a meaningful level of equity in the business, except over a long period of time.

In the case of Gordon's Services Inc., the five-year time frame before Alan and Sheryl intend to retire makes this an inappropriate solution.

3. Use an equity buy-in

An equity buy-in arrangement allows the business owner to make a certain percentage of the business available for purchase by the key employees on an annual basis, at its fair market value. The key employees are allowed to buy a proportionate share of that annual percentage.

If any of the key employees don't exercise their right to buy their shares, other key employees can take up the unpurchased interest on a *pro rata* basis. Although the key employees use their own funds to buy the shares, the owner may assist them through bonuses or loans.

If Gordon's Services Inc. decided to use an equity buy-in, Alan and Sheryl could offer, for example, 5% of their business for purchase by the key employees each January, with the employees' paying a purchase price equal to the fair market value of the shares on the preceding December 31.

If any of the four key employees decided not to purchase their portion of the 5% of the shares in any year, the other three key employees would be entitled to share the portion not purchased.

If the key employees were to purchase the interest offered to them over five years, they would collectively own 25% of the business by the time Alan and Sheryl intend to retire, and Alan and Sheryl would have already sold one-quarter of the business at fair market value. This should be a sufficient interest to commit the employees to staying with the company after its purchase.

The key employees may also decide to finance the purchase of Alan and Sheryl's remaining shares when they are ready to retire, so that they ultimately own the entire company. In this case, a third party may not need to be involved. However, should a third party be interested, they would most likely be inclined to purchase 100% of Gordon's Services Inc., which would benefit Alan, Sheryl and the key employees.

The equity buy-in solution proves to be a viable choice for Alan and Sheryl and their coworkers. It provides the key employees with the flexibility to gradually purchase a significant ownership stake in the company they have helped to build. At the same time, it provides Alan and Sheryl with annual cash flow in the years leading up to their retirement without having to give up control of the company.

Why you need a unanimous shareholders agreement

If you're considering issuing or selling shares to your employees, you'll need a unanimous shareholders agreement ("USA") that governs how key employees may dispose of their shares in the company.

You probably don't want your employees selling their shares to an unrelated third party who has no interest in the business, so the USA will contain provisions preventing that from occurring.

Instead, you can require key employees to sell their interest *pro rata* to the remaining shareholders (including you) if they ever leave the business — at a sale price equal to the fair market value of the shares.

The USA could also include a "drag along" right that allows you to require the key employee shareholders to sell their shares if you sell your shares. Many third-party purchasers will only be interested in buying a business if they can purchase 100% of the shares — so you need to be able to require the key employees to sell their shares in order to preserve your flexibility in disposing of the business.

While requiring the employees to sell their shares may defeat the goal of securing their long-term services, the prospective purchasers will be able to determine how important retaining the key employees is to them — and can then decide whether or not to require the key employees to sell their shares. And even if the employees are required to sell, they will still realize a benefit from the sale of the business through the amount paid for their shares.

4. Establish an employee profit sharing trust

According to Section 144 of the Income Tax Act (Canada), an employee profit sharing trust enables the business owner to

distribute profit from the business to certain beneficiaries such as key employees over time.

Gordon's Services Inc. could make awards to its key employees that are contingent on specified events; for example, a key employee's remaining with the company for a certain number of years after it's sold.

Here's how it could work:

Gordon's Services Inc. establishes the employee profit sharing trust and duly registers it with Canada Revenue Agency ("CRA"). Each year for five years before Alan and Sheryl sell the business, they contribute an amount of money into the trust for the benefit of the named beneficiaries: the key employees.

Alan and Sheryl would then stipulate that they will pay out the awards (after-tax) to their key employees if they remain with the business three years following the sale of the business. They could even, immediately prior to the sale, make an additional contribution to the trust which could be a share of the profit of the sale of the business (assuming revenues are sufficient to permit such a contribution), and accordingly share a portion of the profit of the sale of the business with the key employees.

For Alan and Sheryl, the employee profit sharing trust becomes a valuable tool to both securing key employees following the sale of the business and sharing with them some of the up-side resulting from the sale. In addition, giving the key employees incentive to remain with the company increases the appeal of the business to potential buyers.

Alan and Sheryl decide to use this tool as well as Option #3, the equity buy-in, so that the key employees will receive the benefit of realizing profit on a sale of their buy-in shares, and the purchaser will get the benefit of retaining the key employees until their awards under the profit sharing trust are fully vested and paid out.

Make an employment agreement work for you

In addition to a unanimous shareholders agreement, you may also want to consider entering into employment agreements with your key employees that contain provisions preventing them from competing with, or soliciting customers or employees from, your business for a specified period of time after their employment ends, and providing for their continuing employment following the sale of the business.

These provisions must be very carefully drafted because if they're onerous, they may be unenforceable. However, the arrangement may be upheld if the key employee enters into an employment agreement with reasonable terms in connection with an equity buy-in, and understands that a future sale of the business may require the sale of his or her shares and may trigger the employment obligations.

Planning ahead pays off

Arrangements made to realize the value in a business can be quite complicated — particularly when the goal is to secure the greatest value upon its sale. It is important for the owners of a business to take the time to properly implement these arrangements well before they intend to sell it. In the long run, dealing effectively with key employees can help owners maximize the company's value.

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