What if...

a key employee wants to leave me

The most important assets most businesses possess are their key employees. Keeping and motivating your key employees is the best way to increase the company's income stream, provide potential buyers for the business and increase your business's value by providing a management team for a new buyer.

Most employers give their key employees what we call "good guy bonuses." The company has had a good year, the owner of the company is a "good guy" so he is going to give a bonus to his key employees. Any bonus check that can be cashed and the employee can leave you the next day is an ineffective bonus.

There are four common elements to a successful bonus plan. The bonus must be specific, not arbitrary, and in writing. No longer should you pay for activity. You should pay for results. The bonus should be tied to performance standards. The bonus should have the ability to be substantial. Most importantly, the bonus should "handcuff" the key employees to the business.

You should motivate your key employees with equity-like positions but not actual equity. Unless a key employee is going to eventually buy your business, minority stock ownership is not always a great idea. What have you actually accomplished with minority stock? You now have a "partner" who is entitled to question your business practices and have access to your financials. The employee does not really have anything with a minority interest. They cannot vote their interest, they cannot force a dividend or a distribution, and they cannot, in most cases, sell their stock. All they really have is a liability.

As the owner of a well-run business, which pays his key employees adequately, you should expect a certain amount of profit before anybody gets bonuses. You should only pay bonuses once that profit has been exceeded. We often suggest that a bonus should be paid to those who help make that profit on a percentage basis. An example would be: 30% of the company's taxable income in excess of a certain number would be divided amongst the company's "rainmakers." This is truly an "equity like" position. We like to see half of the bonus paid in cash and half deferred, so if the key employee wants to leave, they will have to forfeit the deferred part. This is what is referred to as a combination cash and equity option with a deferral.

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For a bonus plan to be successful there must be accountability. The key employee needs to know what the bonus will be predicated on. They need to be kept informed of where they stand in the process towards earning that bonus throughout the entire year. For example, if the bonus is predicated on profits, either monthly or quarterly, they need to know what the current profits are at any given time. You never want an employee to feel that they were "blindsided" at the end of the year.

Remember the goal is to "handcuff" your key people to your business. There are various vesting schedules that are effective for the deferred portion of the bonus. We prefer cliff or step vesting. An example of cliff vesting would be: half of the bonus in cash and half 36 months later, if the employee leaves before the 36 months are up, they forfeit the vested portion. An example of step vesting would be: half of the bonus in cash and 1/3 of the deferred portion every year for the next three years. With vesting, the time period can be arbitrary.

You have virtually no chance of selling your business to an outside buyer unless that buyer can feel assured that the management team is going to stay with the business. The most effective way of accomplishing this is by demonstrating to the buyer how much in deferred bonuses the key employees will lose if they leave the company. If you decide to sell your business to your key employees, they can use these deferrals as a down payment on the business.

If done correctly, a bonus plan should act as a golden handcuff. It should lock in your key employees for the long run. You want your business to be the business that your key employees eventually retire from.

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