The Exit Strategies Newsletter

To Share Stock or Not to Share Stock That is A Question for Many Exiting Owners

A number of business owners who enter the exit planning process have a management team who helped them bring the business to where it is today.

These owners want to see their management team take the same sense of urgency towards the business that the owner has taken to make it successful. In fact, owners fear that without this proactive approach, the management team will not succeed with either a new buyer (external transfer) or as future owners of the business (internal transfer).

As an owner begins to think about the future of the business, a natural reaction is to make the management team owners of stock in the business to align their interests and motivate better behavior. The theory here is that whether the owner sells to the managers or to an outsider, this management team will be vital to the businesses' future success. In addition, these owners begin to think in terms of solidifying this leadership team and taking a step towards a new form of ownership in the future. The question that needs to answered, therefore, is whether or not sharing equity is the best solution for the succession and exit planning issues?

Let's first look at the positive aspects of sharing equity in your business. On the one hand, the managers may feel appreciated and pay more attention to the business if they 'own' a piece of it. In addition, the granting of stock has a symbolic gesture that accompanies the event – the idea that the manager's participation in the business is highly valued and their status is sought to be elevated in the eyes of the owner. In fact, these are some of the driving forces that cause stock grants to be undertaken.

But, there are some downsides to sharing ownership of stock. Let's look at a few.

What it Means to Own Stock

When someone else owns stock in your company it puts a burden on you, the primary shareholder, to meet certain obligations. Minority shareholders have rights – mostly under the laws of the state of incorporation – which require the owner to be mindful of how these shareholders are treated. It is helpful to know these rights because if the original intention of sharing stock is to motivate behavior, it is often the unintended consequence of this action that owners end up with obligations that they do not expect.

Will Stock Ownership Motivate?
So, if you are going to suffer the burdens of making your employees owners of the stock in your business, it is best to first examine whether or not stock ownership will truly motivate behavior. As a business owner, you are most likely aware that behavior is motivated by many factors. Some employees want to strive to do the best they can, some are looking for recognition for their efforts, while others are simply motivated by the size of their current take-home pay. Be careful not to apply the wrong remedy to the issue. In other words, stock ownership in the company can sometimes be a fleeting gesture that many employees do not value as much as you want them to.

Is a Grant of Stock Valuable / Meaningful
Two (2) reasons that granting stock to your managers can be tricky business are (i) the amount and value of the stock many not be meaningful to them, and (ii) without a future liquidity event envisioned, will these managers see the opportunity to turn the stock into cash?

Is the Grant Meaningful?
The issue of whether or not a stock grant is meaningful goes to the manager's total compensation and how much value the stock holds on a relative basis. In other words, if your business is worth $8 million and you grant 1% of stock to your manager, will they see the value in an $80,000 ownership of stock? Well, if your manager earns $175,000 per year and has $500,000 saved for their retirement, they might not view the ownership in your company as a meaningful contributor to their total financial situation - at least not enough to cause them to stay permanently or to change their behavior entirely.

Can the Managers Achieve Liquidity?
Beyond the question of whether the amount is meaningful, an owner also needs to consider whether or not the manager will be able to cash in this stock. If you think it through, these managers will now be facing the same issue that you are facing, i.e. how do they cash in their ownership into a form of currency that they can use to pay for certain expenses? Illiquid stock only becomes liquid when

someone else is willing to buy it. The larger problem for your managers is that their minority stake interest (a discount for which was not taken into account with the simple, prior valuation formula) is illiquid and essentially non-transferrable.

Knowing now about the meaningful and liquidity issues, do you still think that granting stock is the best motivator?

Beyond Motivation, Where Can Ownership Go Wrong

An important issue to consider is what would happen when your employee – who is now a stockholder – leaves the company to go to work for a competitor and wants to be cashed out. Or, worse yet, has ownership in your business but works for a competitor. Adding insult to your company's injury, you may be in a position of having to redeem those shares and, in effect, pay this manager to leave your company and compete with you.

A Way to Resolve this Dilemma

As you can see, sharing stock in your business can be a risky proposition and may not achieve the results that you intend. Therefore, a few steps may be helpful towards your ultimate decision to begin the exit planning process.

1. Take careful measure of whether you are using stock grants as a motivator, as a retention tool, or as a means to effectively transition ownership.
2. Carefully evaluate the anticipated behavior of the recipient of the stock.
3. Have multiple and detailed conversations with your managers about the future of the company, their relative contribution and your desire to align their interests with yours, and,
4. Most importantly, do not make the mistake of substituting equity ownership for the need to provide leadership in your organization.

Alternatives to Equity Ownership

You should know that there are more than a few alternatives to sharing the actual stock in your business. These alternatives offer more flexibility in structuring benefits but also come with the burden of some complexity. In all cases, these tools should be examined as a substitute for actual stock ownership. A short list of these items include:

- Phantom stock plans.
- Stock appreciation rights plans.
- REBA plans.
- Profit-sharing plan (with vesting schedules).

- Stock Option plans (which should be carefully evaluated for their meaning and liquidity).
- Non-voting stock grants (a different version of stock grants).
- Non-financial incentives, including leadership roles and more authority in the business.

These alternatives are too vast to cover in detail in this newsletter but look for future newsletters that provide details on these plans and talk to your advisors about options that are best for your situation.

For now, we hope that this newsletter helped you think through the implications of offering stock to your managers. We also hope that you take the complexity of these decisions as a motivator to develop a comprehensive exit plan for your business. Being proactive in this area of planning could be your best, first step towards the successful exit from your business.

Bob Biggerstaff
Managing Partner
Strategic Advisors, Inc.
P O Box 41200
Greensboro, NC 27404
336-255-7072 (c)
336-854-9006 (o)
bbiggerstaff@strategicadvisorsnc.com
strategicadvisorsnc.com