

September 18, 2000

Golden Handcuffs

For Key Employees

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1. DEFINITION.

“Golden handcuffs” refers to a program designed to economically *bind* an employee to remain with the employer. Of course, the law prevents the employer from forcing someone to work. Therefore, this type of program entices the employee to work through a variety of economic incentives.

2. TYPICAL SCENARIO.

2.1. About The Owner.

Owner, age 55, is currently taking \$300,000 per year from the business. Owner owns the land and building which the business occupies.

Owner has been working hard for many years to build the business. Now, Owner would like to spend less time operating the business and more time pursuing hobbies and other leisure activities.

2.2. About The Key Employee.

The key employee is 32 years old and earns \$40,000. The key employee likes the business and would like, someday, to own it. Likewise, the Owner views the key employee as bright and capable of, with enough guidance over time, operating the business profitably.

2.3. Owner’s Goals & Perceived Benefits.

Owner wants to create incentive so this key employee will:

- (i) remain with the business; and
- (ii) assume increasing responsibilities.

As a result, Owner will be able to:

- (i) gradually spend less time operating the business;
- (ii) gain confidence of management stability; and
- (iii) get, in effect, a partial buyout by keeping the same level of compensation while performing less services.

3. SAMPLE PROGRAM.

3.1. Stock.

3.1.1. Strike Price.

Owner explains that the business is worth \$3,000,000 today. However, because the key employee has been with the business for 6 years, Owner will allow the key employee to become an owner based on a corporate value of \$2,500,000. That option is only available if the employee continues with the business for the full 15 years as described below.

3.1.2. First 5 Years.

Every year for the next 5 years the key employee will receive an option to buy 3% of the business based on a \$2,500,000 strike price.

3.1.3. Second 5 Years.

Then, every year for years 6 - 10 the key employee will receive an option to buy 4% of the business based on a \$2,500,000 strike price.

3.1.4. Third 5 Years.

Finally, for years 11 - 15, the key employee will receive an option to buy 5% of the business based on a \$2,500,000 strike price.

3.1.5. End Of 15 Years.

As a result, at the end of 15 years, the key employee will have the right to buy 15% + 20% + 25% = 60% of the business based on today's \$2,500,000 value.

3.1.6. Triggering Events.

Key employee is able to purchase the stock at the earlier of the following two events:

- (i) when the business is sold; or
- (ii) at the end of 15 years.

In other words, if the business is sold for \$5,000,000 after 10 years, the employee will be able to buy 35% for (35% of \$2,500,000 =) \$875,000, but can simultaneously sell it for (35% of \$5,000,000 =) \$1,750,000. In other words, the key employee will net \$875,000.

3.2. Compensation.

Owner agrees to increase the key employee's compensation by a certain amount each year for the next 15 years. That amount is a certain percentage of the excess of the Owner's compensation over the key employee's compensation, as follows: 4% for 5 years; 6% for 5 years; and 10% for 5 years.

Example: assume at the end of year 1 Owner is entitled to exactly \$300K (meaning the profits have not increased). The key employee would get (\$300K - \$40,000 = \$260,000 X 4% =) a \$10,400 bonus.

3.3. Benefits To Owner.

3.3.1. More Leisure Time.

Owner is able to spend less time working, since the key employee is motivated to operate the business as an owner would.

3.3.2. Deduction But Taxed As Capital Gain.

Assume the employee is entitled to a share of the business when it is sold. The employer receives a deduction for compensation paid, but is taxed on capital gain for the funds received.

3.3.3. Chance For Larger, Future Capital Gain.

Were the Owner forced to operate the business without this level of long-term, key employee management, the Owner might be forced to sell the business now. This technique enables the Owner to retain the business and potentially receive a much greater capital gain in future years.

3.3.4. Retain Valuable Employee.

Owner is able to reasonably assure the key employee will remain with the business and be motivated to operate it as an owner would.

3.3.5. Mere Contract Rights, Not Statutory Rights.

The key employee will not be a shareholder (until the triggering event occurs). Therefore, the key employee will not have any of the rights and privileges California law grants shareholders. Instead, the key employee's rights will be governed by the contract, which the Owner's attorney will draft (heavily weighted in the Owner's favor).

4. CONSIDERATIONS.

Following is a list of information which is helpful in attempting to structure and prepare this type of an agreement.

4.1. Format.

4.1.1. Free-Standing Stock Option Agreement.

The agreement typically takes the form of a "Stock Option Agreement."

4.1.2. Part Of Employment Agreement.

Alternatively, it can be a schedule to an Employment Agreement for the key employee. The advantage of an employment agreement is that it may give the owner the opportunity to include these types of contractual provisions:

- (i) agreement to arbitrate any employment-related claims, to avoid going in front of a run-away jury for issues of age, etc., discrimination;
- (ii) acknowledgment that the business has certain trade secrets or other intellectual property, the violation of which would harm the business.

4.1.3. Information Needed.

Does the key employee already have an employment agreement? _____

4.1.4. Your Decision.

Would you prefer to have this as part of an employment agreement or as a stand-alone "Stock Option Agreement"? _____

4.2. Shareholders.

How many shares is the corporation authorized to issue? _____

How many shares have, in fact, been issued? _____

List each shareholder, the shareholder's age, and the number of shares owned.

Is there an existing buy-sell agreement among the shareholders? _____

4.3. Corporation.

What is the corporation's name? _____

Is it an "S" or a "C" corporation? _____

At what cash sales price, paid tomorrow, would you sell the corporation right now?

Based on what corporate value should the key employee be allowed to acquire stock? _____

4.4. Key Employee.

How many key employees will be eligible for this program? _____

What is each employee's name, age, length of service with the business and job category? _____

4.5. Term.

Over how many years should this program continue? _____

4.6. Stock Percentages.

What percentage of the stock or what number of shares should the key employee receive the right to acquire each year during the program? _____

4.7. Compensation.

Will the employee's compensation increase over the life of the program?

If "yes," please describe how those increases will be determined. _____

4.8. Right Of First Refusal.

Should the key employee be granted a limited right of first refusal? That would enable the key employee a limited period of time to match any offer to buy the business made by an outsider. _____

4.9. Phantom Stock.

Should the key employee be entitled to buy stock? Or should the key employee only be entitled to the contractual equivalent of owning stock? The latter approach, referred to as a “phantom stock plan,” provides benefits for both the owner and the key employee. The owner will never face a time, even for a minute at a triggering event, when the key employee becomes a shareholder. The key employee will never be bound by a covenant not to compete to protect a buyer’s right to the business’ goodwill.

4.10. Miscellaneous.

Describe any other pertinent information.