Employee’s Incentive Plan

By François Giroux, Lawyer

More than 50% of Canadian employees are actively searching for a new job or are open to change. Business owners who do not recognize this reality may pay a hefty price when the time comes to sell their business. A significant portion of a business’s value is derived from its human capital: if this human capital is unstable, the business’s ability to generate profits may be unstable as well, and the value of the business will be reduced accordingly. Implementing a key employee incentive plan will have an impact on employee retention, and will help stabilize the business’s human capital.

The incentive plan should have two goals: to increase key employees’ motivation and performance, and to improve the long term retention of such key employees.

There are generally three categories of incentive plans:

1. bonus and fringe benefits plans;
2. retirement plans (individual pension plans and supplementary pension plans); and
3. equity participation plans (stock-purchase plans, stock-option plans, phantom-stock plans, etc…)

Each category has its advantages and disadvantages. For example, the implementation of a bonus plan is very simple and such a plan is easy to administer (although in some cases sophisticated bonus regimes use performance criteria which are extremely complex) and are an important source of motivation. However, such regimes do not favour long-term retention of an employee: bonuses paid to an employee over the years may carry little weight when a competitor offers a similar bonus plan, a better fringe benefits plan, and a pay increase of 20%.

In theory, a retirement plan is a better long-term employee retention tool. Changes made in 2001 to the *Loi sur les régimes complémentaires de retraite* have had a significant impact on the number of individual pension plans (“IPP”) set up for owner-managers, but have not had a similar impact with respect to non-shareholders. Briefly, although an IPP is a slightly improved version of a registered retirement savings plan (“RRSP”), more particularly with respect to the maximum amounts which may be contributed to the plan. RRSPs and IPPs both aim at providing a comfortable lifestyle for employees who earn $100,000 per year or less. However, since rights under the plan vest with the employee very quickly (i.e., the employee may leave his employment, and take along with him his RRSP or his IPP with very little or no divestiture) the impact on the long term retention of key employees of such plan is limited.

Such is not the case with a supplementary pension plan (known as a retirement compensation arrangement or RCA under the *Income Tax Act*) which are aimed at employees who earn more than $100,000 per year. Such a plan may provide important restrictions when an employee quits too soon to his employer’s liking. For example, the employee’s right to receive pension benefits may be acquired at the rate of 10% per year

of service, which means that the employee must stay with his employer for 10 years in order not to be penalized upon retirement. Such a regime, with reasonable restrictions, can be an excellent employee retention tool.

However, it remains to be seen whether pension plans (both regular and supplemental) are good tools for motivation and performance purposes.

Is there such a thing as the perfect key employee incentive plan? Equity participation plans are being more and more used by businesses who take a proactive approach to employee retention and motivation. Such plans should allow the business to solidify its ties with key employees, while being in a significant source of motivation for them.

There are two general categories of equity participation plans: shareholding plans and synthetic plans.

Shareholding plans include share purchase plans and stock-option plans. In both cases, key employees are offered the possibility of acquiring participating shares of the employer. A stock purchase plan will provide the conditions (personal targets, departmental targets and overall corporate targets) which must be met in order for the employee to be entitled to purchase shares in the capital stock of the employer. This acquisition is typically financed in great part by long-term loans granted by the employer. This type of regime can be particularly advantageous for the private business owner, since the shares can be sold by the owner-manager, which will allow him to receive up to $500,000 without tax, by claiming the capital gains deduction of $500,000.

A stock purchase plan requires a complex legal structure, since minority shareholders are involved. A unanimous shareholders agreement is required to manage this situation, more particularly to avoid minority shareholders interference, for example in the context of the sale of the business. It is equally important to clearly establish the profit distribution policy of the employer: without such a clear policy, minority shareholders may even be able to contest the remuneration of the majority shareholder, should they feel that dividends are being hampered by such remuneration.

A stock option plan is similar to a stock purchase plan, but allows the deferral of the cash outlay necessary to purchase the shares.

In the past few years, synthetic incentive plans have been more and more popular: they essentially have the same advantages as shareholding regimes while avoiding the principal flaw of the latter, the management of minority shareholders. The most common form of synthetic regime is a phantom stock plan. In such a plan, key employees are granted units, whose value is based on the increase in the fair market value of the participating shares of the employer. Periodically, employees may call for the redemption of their units for cash, or keep them in the hopes that the units will continue to increase in value. For example, where the plan provides that units may be redeemed starting in the fifth year following their issuance, an employee who leaves his employment loses the value of the units granted in the four years preceding his departure.

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Sometimes, the employer wishes that the employee incentive be given based on very specific objectives, rather than on the basis of the general performance of the business. In such a case, the value of the units will be pegged on the variable determined by the employer, rather than on the fair market value of the participating shares of the employer. The flexibility of such regimes is almost boundless. For example, the Vice-President/ Sales may be issued units whose value fluctuates as a function of increases in sales and the gross profit margin on such sales, and as a function of his ability to retain the sales force of the employer, as evidenced by the average years of service of the members of the sales force.

In summary, the implementation of an employee incentive plan will simplify the business transfer process to the next generation or to a purchaser, by giving them additional assurances with respect to the human capital of the business. Even where no family transfer is anticipated, the implementing of a creative incentive plan may be the first step in … a management buy-out!

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