Motivating and Retaining Employees With a Bonus/Carve-Out Plan

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THE PROBLEM: LIQUIDATION PREFERENCE OVER-HANG

In today's economy many venture backed companies may now find that the liquidation preference associated with this venture money exceeds a fair estimation of the company's value under any reasonable sale transaction. In other words, there is a "liquidation preference over-hang." As a result of a liquidation preference over-hang, a company's common stock, typically held by its employees, is essentially worthless. Companies with such a liquidation preference over-hang must develop new ways to motivate and retain their employees.

A SOLUTION: BONUS/CARVE-OUT PLAN

There are a number of ways to address the problem arising from a liquidation preference over-hang, one of which is the creation of a "bonus plan" or "carve out plan", which typically establishes that a certain amount of the proceeds from a sale transaction will be distributed to employees first before the preferred stock liquidation preferences are satisfied. When establishing such a plan, some of the items to consider include:

SIZE OF PLAN: HOW WILL THE AMOUNT RESERVED FOR ISSUANCE TO COVERED EMPLOYEES BE DETERMINED?

Typically the size of the plan is a percentage of the net proceeds from the sale transaction on a sliding scale. Often, there is a maximum dollar amount reserved for distribution under the plan. For example, the plan may be structured such that in any sale (i) with net proceeds of $10,000,000 or less, no amount is reserved for issuance under the plan, (ii) with net proceeds of $10,000,000 to $20,000,000, 5% of the sale proceeds will be reserved for issuance under the plan and (iii) with a sale in excess of $20,000,000, 7.5% of the sale proceeds will be reserved for issuance under the plan with a cap of $5,000,000. In addition, the plan may specify that it does not apply in the event the acquisition proceeds exceed a certain dollar threshold. This would return the distribution of proceeds to the status quo in the event of a "runaway" success scenario in which the pre-existing capitalization structure and employee incentives should themselves be sufficient.

NET PROCEEDS: HOW WILL "NET PROCEEDS" BE DEFINED?

Typically, "net proceeds" means the aggregate value of the proceeds paid to the company or holders of a company's equity securities after payment of all outstanding obligations of the company (including fees associated with the transaction, all notes, lines of credit and all other obligations to creditors of the company). In addition, net proceeds would likely include proceeds held in escrow, provided that participants would not receive the allocated acquisition proceeds until the escrow is released. Furthermore, earn-out proceeds may also be included in the definition of net proceeds, often with the requirement that an employee remain employed by the acquirer at the time the earn-out payments are released.

PARTICIPATION: WHICH EMPLOYEES WILL PARTICIPATE IN THE PLAN?

The question of which employees participate in the plan is highly subjective, with many plans providing for incentives solely to members of management and other key employees. Under most plans, covered employees who are no longer with the company at the time of a sale transaction will forfeit their right to participate in the plan.

RETENTION: WILL EMPLOYEES BE REQUIRED TO REMAIN EMPLOYEES OF THE ACQUIRER FOLLOWING THE CLOSING OF A SALE TRANSACTION TO OBTAIN THE BENEFIT OF THE PLAN?

Some plans require an employee to remain employed by the acquirer for a certain period of time (typically three to six months) after the acquisition in order to participate in the plan.

ADMINISTRATION: WHO DETERMINES THE DISTRIBUTION OF PROCEEDS FROM THE PLAN?

Under most circumstances, the plan will be administered by a company's board of directors, or a subcommittee thereof, with recommendations and input from the president/chief executive officer of the company.

PLAN TERMINATION: WHEN DOES THE PLAN TERMINATE?

Typically, the plan will terminate upon the earlier of an initial public offering, the date on which all payments have been made under the plan, or two to four years after the effective date of the plan.

COMPLEXITY

The implementation of a bonus plan/carve-out plan to address the concerns arising from a liquidation preference over-hang can have significant implications for the company, stockholders and employees and can be complicated to correctly implement. The implementation of such a plan should not be undertaken without the assistance of legal counsel and accountants experienced in such matters as potentially serious legal, tax and accounting issues are involved.

For more detail relating to the implementation of a bonus/carve-out plan, please contact **Mary Beth Kerrigan**.

Or, for a more complete discussion of the myriad of ways in which companies may address the issues which arise from a liquidation preference overhang, see Motivating Employees in the Face of Substantial Liquidation Preferences — the Overhang Problem.