When a family-owned business needs to recruit a non-family CEO or COO, a well-structured Long Term Incentive Program (LTIP) is essential in attracting an outstanding candidate. However, LTIPs can make some family business owners uncomfortable. Few families want to give up true ownership, even when they realize that non-family leadership is important for the health of the business. Naturally, the non-family CEOs will want to share in the value they create through an incentive program that enables them to feel, act and think like an owner.

Fortunately, there are ways to structure an LTIP that preserve ownership and make the program a win-win situation for both owners and newly hired executives. The dominant LTIP vehicle among private firms is a cash-based performance incentive which contributes the earned award to a deferred pay account with vesting conditions.

Here are a few guidelines that we have found useful in recruiting.

Start with the Premise that the Program Should Pay Out Only When Value is Created

The architecture of the LTIP should be based on sharing in the value that the CEO helps create. Frequently, the way to measure that value is EBIT or EBITDA (earnings before interest, taxes, depreciation, and amortization), starting with a reference value before the new CEO joins and allocating a percentage of the value created to a pool that is shared by the top few members of the management team. This incentivizes the CEO and provides some tools to attract and retain top talent.

In some programs, a professional third party assesses the company's value each year, providing an independent view of the payout, but this method has a yearly expense attached to it. One recent client simply assigned a percentage of the EBITDA growth over time to a pool.

Work with Experts

Creating an LTIP is not something that should be handled in-house. It takes a professional compensation consultant to translate the family's value system and objectives into an appropriate LTIP architecture, and then to fit the program to the requirements of the finalist candidate. There is always a bit of negotiating that goes on, first within the board and family, then with the finalist candidate. The process usually requires several steps/iterations over a couple of months and needs to be memorialized by a lawyer.

Because the process can take some time, we strongly encourage clients to start developing the LTIP at the beginning of a CEO or COO search. It is too late to start the process once the final candidate has been identified.

If there is an LTIP already in place, it may need to be refreshed to match the current marketplace. Again, this process should be started early, since even relatively minor modifications can take a couple of months to get everyone in agreement.

Keep it Simple

Some of my clients have tried to incent behavior with overly complex metrics, to the point that one candidate likened the proposed LTIP to the tax code. He asked, "What are you really trying to get me to do?" The company did not have a good answer. Also, it was very hard for the candidate to assess what was achievable before he/she had moved under the tent with access to all the needed information. Ultimately, the company decided to simply base the incentive on company value growth based on the formal company annual valuation program.

LTIP payouts should be made in a reasonable timeframe, balancing the needs of the candidate with the need to protect the company from a large cash flow demand. Remember, if the CEO makes a lot of money, the family has made even more!

Of course, the value of the LTIP should be subject to a vesting schedule of a reasonable timeframe, perhaps three to five years. I had one client that wanted the monies held within the company until the CEO turned 65. That was unacceptable to the 43-year-old finalist candidate. He proved he was the right candidate by saying, "I want to be able to take some of my (earned) money out on a regular vesting schedule, invest it and then lose it, just like everyone else." He turned the company profitable within nine months and doubled the value of its minority ESOP within three years.

While a recruiter can provide a sense of whether a program is comparable with others in the market, it takes a compensation consultant who deals with private companies to "turn the dials" and match a program to a specific situation. Recruiters familiar with family-owned businesses are accustomed to collaborating in this way and working with various other consultancies supporting the family-owned business community.

About the contributor

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