

MAY 2011 NEWSLETTER

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## HOW TO RETAIN KEY SENIOR EMPLOYEES-“GOLDEN HANDCUFFS”

Before addressing this topic: (a) Joseph R. Pozzuolo, Esquire, Jeffrey S. Pozzuolo, Esquire, and Florence L. Simonis, Esquire are pleased to announce the publication of their article titled Estate Planning For Pet Owners, in the March 2011 issue of Practical Tax Strategies a publication produced by Thomson Reuters/WG&L. This article may be viewed at our web site: [www.pozzuolo.com](http://www.pozzuolo.com); and, (b) Pozzuolo Rodden are pleased to invite you to attend any of their seminars listed on page 5 of this newsletter.

### I. INTRODUCTION

In the new economic environment where margins have been slashed and companies are trying to increase their market positions in an increasingly global market it is extremely important to retain key employees and make the most of their experience, know-how and business acumen. It is a major

detriment to the business when a manufacturing or sales manager takes his expert skills, information and body of knowledge to a competitor. Not only does it give your competitor a leg up, but it also leaves a gaping whole in your workforce and profits when you must go through the costly search and training process to fill the gap.

One invaluable tool to help defend against this is the use of what is termed “golden handcuffs.” Golden handcuffs are a way to arrange the compensation system so that these valuable employees are incentivized to stay with your company.

#### **A. What are Golden Handcuffs?**

The term golden handcuffs is a general term for compensation mechanisms that incentivize an employee to remain with a company and to maintain proper conduct during and after employment. They are called golden handcuffs because if the employee leaves or commits misconduct, they either forfeit deferred accrued compensation or they suddenly must bear the burden of certain monetary benefits that were previously paid by the employer. The financial benefits essentially lock the employee in with the company and help fend off competitors trying to cherry-pick key employees.

There are generally three types of golden handcuffs that can be used. The first type is where an employee does not become vested in certain deferred compensation until after a number of years of service. Thus, if an employee leaves early, they in essence forfeit all or a portion of compensation that have accrued during his service. Examples of this would be a non-qualified deferred compensation plan (NQDC) or phantom stock plan. In each of these, the employee may vest a portion of the total benefit each year, but the benefit is not fully vested for a number of years. If the employee leaves 8 years into the deferred arrangement that does not fully vest until the 15<sup>th</sup> year, the employee loses the non-vested deferred compensation. The first type is beneficial at helping ensure a minimum number of years of employment after the adoption of such a plan.

The second type is to control the employee’s conduct during and post-employment. This type is that an employee forfeits certain benefits if the employee commits certain acts during or post-employment that may threaten your business. During employment, the employee may lose his vested benefits if terminated for a serious misconduct such as selling trade secrets, committing fraud, or other such acts detrimental to your business. Post-employment, any type of NQDC, phantom stock plan should be paid over an extended period of time where the right to such benefit is forfeited if the employee works for a competitor during the payment period. While the first type incentivizes the length of employment, the second type discourages improper behavior during employment that would lead to termination or post-employment conduct that would harm the company.

The third type is where the employee will suddenly be financially burdened with the expense of fringe benefits if the employee leaves. This encourages both longer employment and proper conduct as the employee loses his benefits if his employment is terminated for either reason. An example of this would be an employer paying for a health insurance, disability insurance, a leased car, automobile insurance, company housing, or for a post graduate degree. For instance, if an employee left or committed serious misconduct, he would be responsible for his health and disability premiums, car

payments, insurance premiums, and the cost of graduate school. This creates an ongoing obligation where the employee will stay longer and avoid misconduct to avoid the loss of these benefits.

These three types provide a financial incentive for key employees to stay longer and avoid misconduct. In addition, they create a disincentive to employees tempted to leave when a competitor attempts to cherry-pick him.

## **B. Benefits of Golden Handcuffs**

Golden handcuffs provide the following direct and indirect benefits for a company:

1) Benefits of Retaining Employees Longer: First, retaining key employees provides a number of benefits including 1) higher profitability, 2) reduces dissemination of proprietary know-how or competitive advantages, 3) avoids hiring/training expenses of new employees, and 4) protects a return on investment.

Retaining key employees greatly increases profitability. These are the senior managers that motivate the front line workers, that sales manager that has 20 year plus relationships with your customers, and that one employee who can greatly out-produce any other. These employees make others more effective, boost sales, and/or enable you to keep up with demand. These employees are a catalyst for success as these are the people that make the business work. These are the same employees who are cherry picked by your competitor.

Further, a lower turnover rate and longer periods of employment will reduce dissemination of proprietary know-how. One danger of losing key employees is that they may be the critical difference between success and failure. If the sales employee with long term relationships with customers or the manufacturing manager who knows the secret to your company's high speed of manufacturing leaves, he could bring the customers to a competitor or utilize the production secrets. With a lower turnover, this means, first, there will be less employees leaving to possibly share such proprietary know-how information. Second, these employees will be long-term employees and likely have a greater loyalty to the company.

Additionally, this avoids the high cost of having to hire/train new key employees. This includes the cost of ad placement, hiring a headhunter firm, the interview process, formal training procedures, and the initial inefficiency and learning curve of the new employee. On top of this, it helps ensure a return on the investment of the hiring/training costs. For example, in certain industries, a new employee might not bring a profit to the employer until the 3<sup>rd</sup> year. A 10 year vesting rule helps the employer keep an employee the extra years and recoup his hiring/training costs as well as earn a profit off of the individual employee.

2) Better Alignment of Employees with the Employer's Mid to Long-Term Interest: If the employee vests over a number of years or accrues/forfeits benefits upon the happening of certain events, this may help in two ways: 1) the employee will want to ensure employer viability so he may receive the future benefits, and 2) if performance related benefits are used, the employee will improve

the company for his own benefit.

If the employee will not fully vest for 10 years or forfeits his benefits upon misconduct, the employee is less likely to injure the long-term business health of the company for his own benefit or the employee loses the vested benefit. As the employee approaches 8 years, he may think in a more short-term frame, but if other incentives are promised on the 12<sup>th</sup>, 15<sup>th</sup>, and 18<sup>th</sup> years, this reduces this effect and creates perpetual incentives.

Second, if performance related benefits are used such as a phantom stock options or a percent of profit deferred compensation, the employee will have an incentive to increase the profits for his own benefit. If these profit targets are in the future and new goals are set periodically as mentioned above, then the employee will work as if it was his company to increase his bonus.

3) Alternative Compensation in Cash-Tight Periods: Golden handcuffs are a great option to give key employees a raise to prevent a competitor from cherry-picking him when you may not currently have the cash flow to increase his compensation. This is perfect for growth companies, those that are transitioning, or a company experiencing a tough market where cash is tight, but future prospects are bright. A growth company may not currently have the cash flow to pay a highly experienced executive a competitive salary. However, if the executive is given golden handcuffs where he receives a large deferred bonus or phantom stock 10 years out when the cash flow will turn around and the company value blossoms, this may justify a lower current salary. With payments in the future, there is always a trade-off between the current salary and the upside profit sharing in the company. Trading some upside potential may be the difference of retaining the critical, senior, key employee and the employee leaving for a competitor.

4) Protect Purchaser of a Business: When someone purchases a business, many times certain senior key employees are responsible for the profit and economic value being purchased. Golden handcuffs may be used to ensure these individuals do not leave the business or are not cherry-picked and hired by a competitor immediately after the sale. If this were to happen, then the purchaser only purchased a valueless shell of a business where the key employees take the real value of the company to a competitor. Prior to closing on the sale, the seller may institute a golden handcuff compensation package as outlined above to retain these key employees for a number of years until the purchaser becomes fully familiar with the business or can find a replacement.

## **II. Conclusion**

Golden handcuffs enable an employer to retain an employee longer by either holding a future carrot out or with a stick of the threat of losing accrued deferred compensation. This provides the many benefits of having a more experienced workforce, better aligning employees with the employer's goals, providing non-cash benefits in cash-strapped period, and protecting business purchasers. Golden handcuffs are an essential part of a compensation package to help get the most out of your senior, key workforce and ensure they are worth the investment. The options in creating such a plan is simple-creative thinking to address your employees, company and industry needs.

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### UPCOMING SEMINARS

JOSEPH R. POZZUOLO, ESQUIRE AND JEFFREY S. POZZUOLO, ESQUIRE WILL BE PRESENTING: ***“THE NUTS AND BOLTS OF ACQUISITION, EMPLOYMENT AND COMMERCIAL LOAN BUSINESS DOCUMENTS FOR THE SUBURBAN GENERAL PRACTITIONER AND CPA INCLUDING ETHICS”*** A CONTINUING LEGAL EDUCATION/CONTINUING PROFESSIONAL EDUCATION (CLE/CPA) SEMINAR FOR ATTORNEYS AND CERTIFIED PUBLIC ACCOUNTANTS ON FRIDAY, MAY 6, 2011 AT NEUMANN UNIVERSITY.

**Joseph R. Pozzuolo, Esquire will be speaking to the CPA Continuing Education Society of Pa. for the Montgomery County Society of CPAs on Wednesday, May 18, 2011 at the Cedarbrook Country Club in Blue Bell, Pa.**

JUDITH P. RODDEN, ESQUIRE AND LESLEY M. IBANEZ, ESQUIRE WILL BE PRESENTING: ***“EMPLOYMENT LAW IN THE NEW TECHNOLOGICAL AGE: AN EMPLOYEE’S EXPECTATION OF PRIVACY IN ELECTRONIC COMMUNICATIONS, THE EMPLOYER’S RIGHTS AND POLICIES AND DOCUMENTATION NECESSARY TO SURVIVE A CHANGE OF DISCRIMINATION”*** A CONTINUING LEGAL EDUCATION/CONTINUING PROFESSIONAL EDUCATION (CLE/CPA) SEMINAR FOR ATTORNEYS AND CERTIFIED PUBLIC ACCOUNTANTS ON FRIDAY, MAY 20, 2011 AT NEUMANN UNIVERSITY.

JOSEPH R. POZZUOLO, ESQUIRE AND JEFFREY S. POZZUOLO, ESQUIRE WILL BE PRESENTING: ***“THE CLOSELY HELD BUSINESS BOOTCAMP FOR THE GENERAL PRACTITIONER AND CPA INCLUDING ETHICS”*** A CONTINUING LEGAL EDUCATION/CONTINUING PROFESSIONAL EDUCATION (CLE/CPA) SEMINAR FOR ATTORNEYS AND CERTIFIED PUBLIC ACCOUNTANTS ON FRIDAY, JUNE 3, 2011 AT NEUMANN UNIVERSITY.

### Publications

All of the following professional publications and past newsletters written by attorneys of this office are available by clicking here: [http://pozzuolo.com/Pubs\\_Articles.shtml](http://pozzuolo.com/Pubs_Articles.shtml)

#### Corporate/Tax

Design Buy-Sell Agreements For Maximum Utility

Deferred Compensation Rewards And Retains Key Employees

How To Use Non-Qualified Deferred Compensation Arrangements As A Business, Retirement And Tax Planning Tool

Protecting A Client's Business From Unfair Competition Using Restrictive Covenants

Money Purchase Pension Plan Falls Out Of Favor

Why An Employment Contract Is Mandatory

What Type of Qualified Corporate Retirement Plan Best Serves Your Business, Tax And Retirement Needs

Structuring Loans From Qualified Plans - How To Handle The Strict Tax Rules

How An S Corporation Avoids The Double Taxation Incurred When Excessive Compensation Is Treated As A Dividend

Bankruptcy - How To Prevent It And How To Cope With It Should It Happen To Your Business

How To Look, Act And Sound Like A Professional Corporation

How Mortgage Lenders Should Draft Broker Agreements To Avoid RESPA Violations

How to Structure a Suitable Buy-Sell Agreement

## **Estate Planning**

Estate Planning For Pet Owners

The Limited Liability Company -A Sophisticated Tool For Estate Planning

Diversify Strategies For An Effective Estate Plan

Use Wills To Maximize Family Protection And Minimize Tax

Six Proven Estate Planning Techniques

Divorce Raises The Need For Performing An Estate Planning Review

Divorce and Estate Planning

Remarriage Situations Can Raise Special Estate Planning Considerations

College Funding Tool Offers Estate Planning Advantage

Drafting The Durable Power Of Attorney For Wealth Protection Purposes

Why Living Wills Advance Directives Are An Essential Part Of Estate Planning

Special Needs Trust - An Estate Planning Tool For The Disabled

Adapt Estate Planning Strategies to Fit the Needs of Same-Sex Couples

***Actual resolution of legal issues depends upon many factors, including variations of facts and state laws. This newsletter is not intended to provide legal advice on specific subjects. It is to provide insight into legal developments and issues. You should always consult with legal counsel before taking any action on matters covered in our updates.***

This newsletter is courtesy of Pozzuolo Rodden, P.C.

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