Case Study

Creating Long-Term Value for Companies & Their Executives
Tools & Strategies Involved

Business Succession Planning - Ownership Transition - Key Employee Rewards

Buy/Sell Planning
- Entity stock redemption—fewer shares outstanding—no basis change
- Cross purchase—owners insure each other and buy deceased shares—Basis increase
- Hybrid

Split Dollar Life Insurance
- Used often when the person or entity that needs the proceeds does not have the resources to pay for insurance, or as an executive benefit.
- Endorsement method
- Collateral assignment

Estate Tax Planning
- With two generations (or more) involved, we are presented with challenges and opportunities. Challenges primarily are to avoid increasing the senior generations estate without giving up control. Opportunities are to bypass the traditional taxable transfers and thereby legally avoiding estate tax

Long Term Incentive For Key Employees
- We all know the challenges of retaining & rewarding key people in successful family businesses. How can we help our clients win the war for talent?

409A often is the answer.
“ABC” Company Has 3 Huge Problems

Closest Trusted Advisor calls “ABC” Company’s accountant who then calls Fulcrum Partners.

PROCESS:

- Gather all facts and objectives, and listen
- Use all transfer tax minimization strategies available that do not conflict with objectives
- Design Plans
- Establish budgets
- Execute
Two Families - One Business

“ABC” Company

Ralph & Alice Kramden  
Ralph Age 60

Ricky & Lucy Ricardo  
Ricky Age 65

The Family Business

Tom Richard  
Harry

Work For KRV

Lucie Little Ricky

Not in Business

$200,000,000 Valuation

The Good News: They make a lot of money
The Bad News: They have to!
Those Huge Problems Are:

- **Business Succession/Continuity**
  - Ralph wants to pass business on to Tom, Dick, and Harry
  - Ricky’s kids have no interest; Lucie & Little Ricky are living off royalties
  - Very outdated shareholder agreement

- **Keeping Their Key People**
  - Competitive pay and discretionary bonus
  - Equity ownership is not an option

- **Earnings Flat -- EBITDA $40M +/- in last several years.**
I. Business Succession

Ralph Kramden

- Shares Pass to TDH, LLC
- By Will
- Transfer Cost = $40M FET
- Insure For $40M

Ricky Ricardo

- Insure for $100,000,000

“ABC” Company, LLC

- $200,000,000 Valuation
- 50/50 Ownership

Establish “XYZ” LLC

- No Cash to Pay
- All 3 are Employees

Split Dollar Agreement

- Assigns $100M to “XYZ” LLC
- Imputes Income

Split Dollar

- Assigns $40M to “XYZ” LLC
- Imputes Income

$40M Policy

$100M Policy

$40M FET

$100M Stock

$100M Stock

$100M Cash

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II. Keeping Great People / III. Flat Earnings

“ABC” Company has Great People

F & I: Moe
New Sales: Larry
Used Sales: Curly
Service: Shemp

+ Another 10 High Performers that “ABC” Company CAN NOT LOSE.
How to Retain & Reward Key People?

Almost all forms of deferred compensation fall under 409A

- We usually don’t have the luxury of just increasing an already competitive Base & Bonus package
- This industry is notoriously generous with retirement programs – NOT!
- We have to build something that will drive behavior in such a way that the program pays for itself.

Design Objectives

- Two Groups:
  1) Moe, Larry, Curly, Shemp
  2) Next 10 Top Performers
- Discretionary awards must be performance driven = pay forthemselves
- Establish performance metric(s) and threshold hurdles
  1) ROE, ROI, EBITDA /adjustments …
  2) Bank Covenants …
Establish Performance Metric Award Ranges

Fulcrum Partners designs are based on flexible platforms that will allow changes as required to drive desired performance. Based on the annual achievement of predetermined performance criteria, below are sample ranges for awards. Below threshold, no award is earned. The performance metrics may vary among participants and may change from year to year.

Typically the LTIP will start at the top one or two levels. Over time, we see it cascades down few levels at lesser award opportunities.

<table>
<thead>
<tr>
<th>Annual Award Range</th>
<th>Group</th>
<th>2015 Salary</th>
<th>Bonus Average</th>
<th>Projected LTIP Target</th>
<th>Projected LTIP Range</th>
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<tbody>
<tr>
<td></td>
<td></td>
<td></td>
<td></td>
<td>%Salary</td>
<td>Target ($)</td>
</tr>
<tr>
<td>I (4)</td>
<td></td>
<td>$200,000</td>
<td>100%</td>
<td>50%</td>
<td>$100,000</td>
</tr>
<tr>
<td>II (10)</td>
<td></td>
<td>$125,000</td>
<td>50%</td>
<td>30%</td>
<td>$37,500</td>
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<tr>
<td>Totals</td>
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<td>$2,060,000</td>
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<td>30%</td>
<td>$778,000</td>
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Assume EBITDA = $40,000,000

<table>
<thead>
<tr>
<th>Annual Level</th>
<th>EBITDA Growth 3 Yr. Average</th>
<th>Year-Over-Year Growth $</th>
<th>Awards</th>
<th>Share Rate</th>
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<tbody>
<tr>
<td>Threshold</td>
<td>3.0%</td>
<td>$1,200,000</td>
<td>$387,500</td>
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<td>Target</td>
<td>4.5%</td>
<td>$1,800,000</td>
<td>$775,000</td>
<td>43%</td>
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<td>Max</td>
<td>7.0%</td>
<td>$2,800,000</td>
<td>$1,162,500</td>
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What is the cost of attrition?
...A whole lot more than the cost of the award!
What Do We Do With the Awards?

Almost all forms of deferred compensation fall under 409A - So we must navigate successfully through 409A

- Let's follow Moe's Award at target
- Moe is 48 years old
- Each award vests ratably over 3 years (rolling vesting)
- Half of award is paid in cash as vesting occurs (instant reward)
- Half of award is deferred until retirement and paid over 5 years (retention)
- We often use restrictive covenants that will forfeit unpaid balances for breach
Vesting & Current Cash Awards (at Target)

<table>
<thead>
<tr>
<th>Award Date</th>
<th>Age</th>
<th>Target Award</th>
<th>12/2017</th>
<th>12/2018</th>
<th>12/2019</th>
<th>12/2020</th>
<th>12/2021</th>
<th>12/2022</th>
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<td>$0</td>
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<td>34,333</td>
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<td>35,363</td>
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<td>$109,273</td>
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Annual Vesting $33,333 $67,666 $103,029 $106,120 $109,304 $112,583 $115,962 $119,441
Annual Cash Payout at 50% $16,667 $33,833 $51,515 $53,060 $54,652 $56,292 $57,981 $59,720
 Deferred Award at (Target)

The second half of the awards are deferred until retirement at which time the account balance is paid out over 5 years.

<table>
<thead>
<tr>
<th>YEAR</th>
<th>AGE</th>
<th>BOY</th>
<th>AWARD</th>
<th>AWARD EYO BALANCE (5%)</th>
<th>RETIREMENT DISTRIBUTION</th>
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<tr>
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<td>50</td>
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<tr>
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<td>106,575</td>
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<tr>
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<tr>
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<td>$232,786.5</td>
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<td>2038</td>
<td>70</td>
<td>0</td>
<td>0</td>
<td>$232,786.5</td>
<td></td>
</tr>
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</table>

LTIP Summary

- Awards based on clear performance metrics
- Performance measures may be different for different participants
- Metrics may change year to year
- Must be communicated well
- Super vesting typically at:
  - Death
  - Disability
  - CIC – Double Trigger
  - Involuntary Termination without cause
- Can be effective tool to set leadership succession plan in place
- Restrictive covenant - Forfeiture
Fulcrum Partners LLC: Creating Long Term Value For Companies & Their Executives
Q. & A.

How often are you asked for counsel on...

- Buy Sell Agreements?
- Ownership Succession Planning?
- Estate Tax Planning?
- Split Dollar Insurance?
- Life Insurance in General?
- Long Term Incentive Plan “LTIP” Design?
- Deferred Compensation Plan?

How can incorporating these tools into your off season client conversations add value to your relationship?
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