RESTAURANT FINANCE MONITOR®

Volume 31, Number 3 • Restaurant Finance Monitor, 2808 Anthony Lane South, Minneapolis, MN 55418 • ISSN #1061-382X

March 19, 2020

Is There Equity Participation in Your Future for Your Key Employees?

Obviously with the cost of labor and the shortage of key management personnel for restaurants, operators need to be creative, particularly in promoting participation in the ownership for key employees to incentivize and develop the kind of culture necessary for success. This article will outline five different approaches that can be taken with employees to provide the kind of upside in equity younger employees in particular want in this very demanding business.

1. Stock appreciation rights: We are seeing more of what we call stock or membership appreciation plans. We recently implemented a plan for a very large multi-unit operator, and the appreciation rights participation went all the way down to the assistant manager and supervisor level.

The plan works as follows: the company or the store in which the manager is involved has a starting value. Normally, it's just a multiple of store operating profit less any debt, or sometimes it's just a multiple of store operating profit.

Then the management team shares in the appreciation of the value. The appreciation is divided into units, and employees are granted a certain number of units. Upon either termination of employment (other than for cause), retirement, disability or death, the employee receives the then-current value of the store, less the starting value times their percentage (units) of the appreciation. For example, if the store was valued at $1 million (which was five times store operating value of $200,000), and the store operating profit increases to $300,000, that would make the value $1.5 million. If the employee was entitled to 2% of the appreciation, they would be entitled to a payment of $10,000. That's 2% x the appreciation. It's common to have the pool of appreciation somewhere in the neighborhood of 20% to 30% to be shared by the management team.

What's unique about this approach is that when the payments are made, they are a tax deduction for compensation, or what we call deferred compensation. This appreciation right can either be implemented at the corporate level, regional or at the individual store level. It is a great way to encourage the employees to drive increased value of the company.

2. Profits interest: In this instance, an employee—at the store, regional or corporate level—has an actual legal interest in the profits from that individual entity. If each store is in a separate entity, then the profits interest can be at the individual store level; otherwise it can be applied at the holding-company level.

The employee (in most cases, management) gets a share of the profits distributed to other owners. This does not necessarily include equity participation on sale, but it does include a current distribution of profits and also the tax obligations. This is implemented through an operating agreement. Also, this profit interest shifts tax on the portion that is distributed to the manager. The IRS has ruled the grant of the profits interest is not taxable.

A great example of this is the classic Outback incentive plan which has been in existence for years. Outback does require some employee investment, and then they receive a percentage of the cash flow generated by the restaurant each year.

3. Straight profit sharing: The major form of incentive compensation is a straight sharing of the store or company's profits. This is paid as a bonus monthly, quarterly or annually. This profit sharing is usually computed on amounts over established budgets, and these come in various formulas. Many companies are using this approach. Shake Shack, Chuy's and Texas Roadhouse are just a few examples we have found.

4. Restricted stock: Another common approach, particularly for non-chain restaurants, is restricted stock. These are shares of ownership in the company granted to the employee. It can be at any entity level. The restriction on this stock, to deter premature selling, normally is tied to employment, usually something around two to five years. There may be some tax obligation for the employee created upon the grant of the stock. Normally an election can be made for the IRS to determine the value on restricted stock. This Section 83(b) election discounts the interest substantially, so we can normally avoid most of the tax. This is a great way for people to participate, but it means that they do become real partners, subject to the restrictions and buy-sells.

5. Options to buy and buy-in: This approach involves a right to buy the restaurant. One of the companies most notable for this is Chick-fil-A. They have allowed franchisees to buy into the franchise at a de minimis amount or to have the right to buy-in. We have also set up buy-ins with large operators where individual managers have the right to buy a store under a given set of circumstances, such as an expiration of a certain number of years. We worked with a large QSR operator who gave individual store managers, after they have been in that position for 10 years, the right to buy the store or have a right of first refusal. Normally, the manager has to come up with some cash and then buys under an installment note. Even if a store is not in an individual entity, this option can be implemented by an asset sale.

These are five ways that companies can effectively provide ownership and equity for key employees. While there is every other combination you could ever imagine, these five have shown a good record of success. You certainly should be looking at them to attract and keep employees.

(Special thanks for all the wonderful research from Allison Cole, a student at the University of St. Thomas Law School and an extern at Franchise Times Corp.)

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