RESTAURANT FINANCE MONITOR®

Volume 33, Number 3 • Restaurant Finance Monitor, 2808 Anthony Lane South, Minneapolis, MN 55418 • ISSN #1061-382X

March 15, 2022

Compensation Options for Restaurant Owners in Today's Tight Labor Market

By Dennis Monroe

While revenue is still the biggest issue affecting the restaurant industry, recruiting, securing and retaining employees are all tied for second place. To be considered an employer of choice, restaurant owners need to use creative and aggressive compensation techniques.

I have divided compensation techniques into four categories:

1. Direct compensation: If you haven't already, develop a good bonus program. In my estimation, good bonus programs are tied to revenue or store-operating profit; or for supervisory managers, possibly the general administrative costs applied to restaurants. It's crucial to have written agreements regarding bonus arrangements that are tied to a percentage of compensation. This figure tends to be in the 10%-to-25% range of base compensation, and it should be paid at least quarterly. Another issue has been service charges versus tips. In today's climate, I've found it's best to continue with tips. It creates a lot less hassle with servers, while also alleviating customer confusion.

2. Phantom ownership: It's not so much "phantom ownership" as it is tying additional compensation, on a deferred basis, to the growth and value increase of a single restaurant or to the overall company. These phantom interests (Stock Appreciation Rights, or "SAR") are granted during the employee's tenure and are based on a starting value for the company. An appraisal is not required, since you can simply use a formula, such as 5x the last 12-months' EBITDA as a starting point for the value. Then you create units of increase in value for employees.

For example, if the company has $5 million of EBITDA, using the 5x multiple, that's $25 million. If EBITDA goes up $500,000, that creates an increase in value of $2.5 million. If you allow employees to share in 20% of that appreciation, that means $500,000 in a plan for participating employees. The plan is allocated based on units or percentage grants to select employees and deferred for a set amount of time. There are some adverse tax consequences to SARs, because you don't get the deduction until paid out and the employee picks it up as ordinary income. There is a liability accrual when there is valuation increase for GAAP. We have implemented SARs with both small companies and large multi-unit operators, and they are very effective for retention and recruitment.

3. Actual ownership: The next approach is ownership, which is usually restricted and has a vesting period. This can be in the form of an actual grant of restricted stock or membership interest at either the holding-company or individual-store levels. There are valuation and taxability issues when granted, but that can be minimized with certain tax elections. Typically, the company has a right to repurchase the ownership interest, triggering events like termination of employment, disabling or involuntary conversion. The buyout price, using a formula, is key, and many people like this approach because it is real ownership with reasonable restrictions.

Or you can take another approach and grant options to buy stock or membership interest in the future, typically exercised upon a liquidity event.

In another ownership path, profits interest, an employee has an actual interest in the profits of the company. From a tax standpoint, they are given a K-1 and participate in the profits and cash distribution related to those profits.

4. Deferred compensation: The last technique is pure deferred compensation. This is a form of retirement plan set up by the employer. It can be funded or non-funded; it can use insurance or not use insurance, but basically, it's a promise to pay the employee in the future with funds based on their performance and/or time spent as an employee. Other factors can be considered, as well. This is a great way to retain people and can be done at any level— even at the hourly one.

One caution, however, is to structure it so employees don't quit to get access to these funds. A solution is to set up rights to loans. There are requirements to keep it from being taxable when granted or taken out as a loan. But most of these can be easily navigated by a professional who works in this area.

While it seems counterproductive in this environment to give up any profits, retaining good employees is key to making those profits. Employee incentives that are aligned with ownership value increase and performance are a must. Look at the various options and choose one or more that is right for your company.

Dennis Monroe is chair of Monroe Moxness Berg, a law firm which focuses on M&A, taxation and other business matters for multi-unit restaurant businesses. You can reach him at dmonroe@mmblawfirm.com, or at 952-885-5962.