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# Golden Handcuffs

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## What are golden handcuffs?

The term "golden handcuffs" does not refer to one specific method of retaining key employees. Rather, it refers to a combination of any of a number of different rewards and penalties given to key employees to encourage them to remain with a particular firm. Essentially, an employer interested in golden handcuffs would provide a very generous compensation package--with strings attached--to his or her key employees. There are two ways to convince valuable executives to remain with a company. One is to reward them if they stay. The other is to penalize them if they leave. Many employers combine both approaches by mixing generous economic incentives (like bonuses and stock grants) with vesting schedules and holding periods.

## What are some examples of golden handcuffs?

There are several creative ways to compensate executives. Indeed, employers go a long way toward pleasing key employees if cash bonuses, fringe benefits, below-market rate loans, or nonqualified deferred compensation retirement plans are provided to them in addition to salary and traditional retirement plans. Nevertheless, to truly create golden handcuffs (that is, to truly encourage executives to stay long-term), various forms of equity compensation should be considered. With equity, the employer promises to pay executives generously in the future (with financial value they help to create), and makes it very expensive for them to leave the firm. The combination of performance-based pay, a stake in the future of the business, and a forfeit of benefits for leaving the firm creates a powerful incentive for an executive to stay.

### *Phantom stock*

Phantom stock may be viewed as one example of a golden handcuffs arrangement. Unlike real stock, phantom stock does not convey any actual ownership in the business. Rather, executives are rewarded for superior performance with a "phantom" share or credit in an employee account for an amount equal to the value of the company's real shares of stock. As time goes on, this account is credited with changes in share value and with the value of dividends. Note that there is generally no taxable income for the holders of phantom shares until the employee redeems the phantom shares at a later date.

The advantage of this arrangement to the employer is that ownership and control of the corporation will not be diluted. Also, phantom stock works well if the employer is an S corporation and can't exceed the maximum allowable number of shareholders. To employ golden handcuffs, a vesting period is established for the phantom shares. In other words, the phantom shares are granted--but require a minimum holding period. If the executive leaves the company before the holding period has expired, he or she will forfeit the value of the shares.

### *Nonqualified stock options*

Nonqualified stock options are another effective tool for retaining executives. As an option-holder, the employee has the right to purchase shares in the company at the grant price (which is typically the current share value). As the business grows in value, the value of the stock option rises. Options are generally subject to a vesting period before they can be exercised to purchase shares. This requires employees to remain with the company.

To truly encourage executives to stay, the employer might wish to consider using a "stair-step" approach to vesting.

***Example(s):*** *An executive, Jim, has options to purchase 100 shares of his company's stock at $10 per share. The company can mandate that up to 50 percent of the options may be exercised at the end of Jim's second year of employment and that the remaining 50 percent can be exercised only upon completion of the fourth year.*

### *Incentive stock options*

An incentive stock option is a right or option granted by a corporation to key employees to purchase shares of company stock at a certain price that may be no less than fair market value at date of grant, for a specified period of time, and notwithstanding an increase in the value of the stock after the option is granted. These options are sometimes referred to as qualified or statutory stock options (as opposed to the nonqualified stock options mentioned previously) because they must comply with numerous requirements imposed by Internal Revenue Code Section 422.

This statute requires, among other requirements, that the grant price of the incentive stock option equal or exceed the fair market value of the stock at the time of the grant and that the employee meets certain holding period requirements. Specifically, the stock acquired under the option must be held for at least two years from the time it is granted and one year from the time it is exercised, unless the employee who receives the ISO owns more than 10 percent of the employer, in which case the option price must be at least 110 percent of the fair market value of the stock and the option is not exercisable after five years from the date of grant. However, an employer can create more strict requirements with respective incentive stock options or the nonqualified stock options mentioned previously. If an option qualifies as an incentive stock option instead of a nonstatutory stock option, the employee exercising such an option will not be taxed upon exercise of the option, but will instead be taxed at capital gains rates when the stock is ultimately sold.

***Caution:*** *IRC Section 409A contains complex rules that govern NQDC plan deferral elections, distributions, funding, and reporting. If a NQDC plan fails to satisfy Section 409A's requirements participants may be subject to current income tax, as well as an interest charge and 20 percent penalty tax. In some cases phantom stock plans and nonqualified stock options may be subject to Section 409A's requirements. Incentive stock option plans are exempt from Section 409A.*

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