CREATING AN OWNERSHIP OPPORTUNITY FOR A CURRENT W-2 ADVISOR/EMPLOYEE

The following steps are recommended for creating an ownership opportunity for an existing Advisor/Employee who has not independently built a book of business.

KEY POINTS

1. *Avoid using a revenue-splitting or commission-splitting approach for Advisor/Employees who do not have their own book of business.*
2. *Value the Company annually to provide a record of growing equity value over time, and to provide the Advisor/Investor a means by which to track the value of their investment.*
3. *Restructure the compensation system at the ownership level to "flatten" wages paid for work performed; rely on profit distributions for the variable and motivational component.*

1) Upon initial hire, utilize formal, W-2-based employment arrangements that make it clear in writing that the hiring Company owns all client relationships developed during the term of the agreement. Avoid using a revenue-splitting or commission-splitting approach for Advisor/Employees who do not have their own books of business. (See FP Transitions' white paper entitled Building a Business of Enduring and Transferable Value for more information.)

2) Recapitalize the Company with sufficient shares (if a corporate entity) or units of ownership (if a Limited Liability Company) to create a reasonable price per share (a price of $5 to $50/share or unit is a common starting point). During recapitalization, authorize additional treasury shares or units for possible use in the future should the Company need to grant shares or units to key staff members to augment the ownership opportunity and initial purchase of shares.

3) Use a multiple tranche approach in which ownership can be sold gradually over an extended period of time, providing an opportunity for the seller to evaluate the Advisor/Investor as an owner and to allow sufficient time to pay for the stock (or units) largely from future profit distributions. Consider these steps to finance the individual transaction(s):

a) Provide for seller financing over a longer term than might initially seem necessary, reducing the risk of default and taking some of the pressure off of the buyer and seller, and the Company's cash flow. A 7 to 10 year term is common, though most repayment periods are easily accomplished in 4 to 6 years;

b) Value the Company annually to track the growth of its equity value over time, and to show the Advisor/Investor the rising value of their investment, which can encourage the Advisor/Investor to pay it off sooner. Second, apply a valuation matrix that adjusts per share value based on actual payment terms, ranging from a no cash investment (or down payment) to payment in full for the ownership acquired;

c) Use a non-recourse promissory note with no monthly payment terms during the first tranche only, relying instead on "re-investment" of profit distributions after taxes, which will shift the Advisor/Investors' focus to sustained growth and improved profitability for the business;

d) Restructure the compensation system at the ownership level to "flatten" wages paid for work performed, creating a budgetable and predictable wage-base and simultaneously transferring the variable component of the compensation package to the profit distributions, which should be paid at least quarterly;

e) Provide for an incremental grant of treasury stock/units as an incentive for paying off the initial purchase or tranche. This step supports the longer tenure requirement for this actively owned investment opportunity;

f) Use a stock or unit pledge agreement to provide at least a minimal level of collateral in any such transaction. Continuing ownership should be tied to continuing employment, and repurchase of shares or units during the first tranche may be limited.

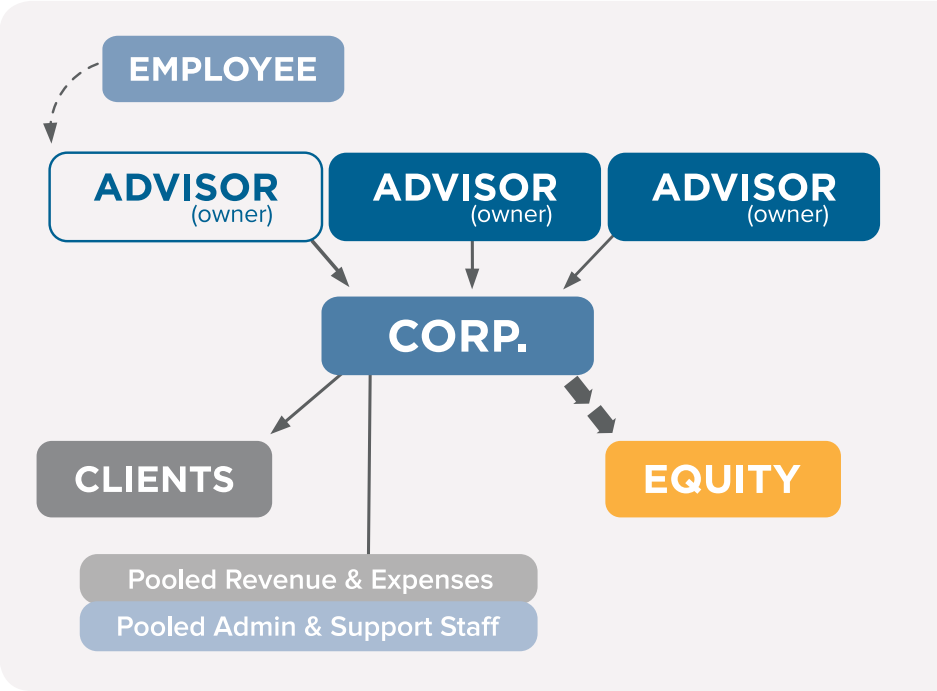
4) Update a Buy-Sell Agreement annually (this may be part of the Shareholders' or Operating Agreement) as new owners are added, stock is transferred, or as business value substantially changes. Ensure that the payment terms of any such emergency purchase not funded by life insurance are feasible given the Company's cash flow situation, taking into account the tax impact of the payments by the Company (in the event of redemption) or by one or more owners. Repurchase of ownership conveyed in tranche one may be limited prior to completion and full payment of the Note.

5) Present the annual valuation inputs (questionnaire and financial statements) and the results to all owners of the Company.

6) Provide for the use of "tag-along" and "drag-along" rights in the Shareholders' Agreement to provide the founder with maximum flexibility should the ownership track not produce a qualified successor or successor-team.

7) Additional tranches or sales beyond the first tranche should be at the discretion of the founding owner. Future sales of stock should use either the Average Deal Structure value or a more appropriate value from the valuation matrix based on the actual deal terms and financing provisions at the time of the transaction. The Company should obtain life insurance and a lump-sum disability insurance policy on all G-1 and G-2 owners if possible, and later on all G-3 owners (assuming there are three owners or more – if less, a cross-purchase arrangement may be more advantageous).

8) Leverage the "sweat equity" of G-2 and G-3 advisors over the course of the Company's formal succession plan to decrease the founding owner's work hours while maintaining and even increasing the profits generated by the Company.



Equity-Centric Business Model

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Since opening its doors in 1999, FP Transitions has completed more financial service transactions than any investment banker or business-broker in the country. FP Transitions' expertise also includes continuity planning, practice benchmarking, compensation studies, entity formation, mergers and acquisitions, and equity compensation strategies.

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