

Incentivizing management in a seller's market

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There's no question that it's a sellers' market.

With unprecedented levels of dry powder and debt available for investment, sellers are not only able to garner high valuations, they are also more carefully reviewing management incentives being put forth by potential private equity buyers.

PE firms need to ensure they are incentivizing management teams correctly for a number of reasons.

First, they want to keep management interested in pursuing a deal with them. Then they want to keep management incentivized to work hard after the transaction is complete.

To reach the goal of a successful transaction, there are a few steps PE firms should take when it comes to setting compensation.

Understand existing arrangements

During the due diligence phase there's a lot to learn about a company.

Sometimes the task can be so overwhelming that understanding the current management team's incentive plan doesn't become a priority. This is a mistake.

It's crucial for potential PE buyers to understand and consider the following during the due diligence phase:

- What do management's current equity incentive awards look like? Will awards automatically vest on the close of the deal or is acceleration of vesting discretionary?
- What is the level of payout to management that will be triggered by the transaction? If the payouts are too big, management may not be motivated to stick around after the deal is closed, and the buyers may have to find a new management team.
- If there are golden parachute payments that will be made by a U.S. company or be made to a U.S. taxpayer (even from a non-U.S. company), will the amount of the payments trigger the limit on the corporate tax deduction or result in a 20 percent excise tax under sections 280G and/or 4999 of the United States Internal Revenue Code, respectively? (There is no equivalent rule in Canada.)
- Does management hold any equity in the company (in addition to equity incentive awards)? Can any of this equity be rolled over on a tax-deferred basis?

These are important questions that PE buyers should consider and be able to get answers to during the due diligence process and prior to signing.

If there are excess golden parachute payments and the target is a private company, the shareholder approval exemption may be available to avoid negative tax consequences.

And the purchase agreement should contemplate that the target will take the necessary steps to submit the right to receive or retain such payments to shareholders for approval.

Obtain executive “buy-in” prior to signing

After buyers thoroughly understand management’s compensation expectations and have set forth their expectations as well, actual terms need to be agreed to.

Often the key terms of the post-closing management incentives are discussed with the key executives prior to signing the transaction documents so that the buyer has comfort that the key executives are on board.

These key terms may be set out in a term sheet, which is executed at the same time as the purchase agreement. If management will be rolling over a portion of their equity or investing alongside the sponsor, the amount that will be rolled over or invested and the key terms of the shareholders agreement may also be set out in the term sheet.

Often there aren’t any material changes to base salary and annual bonus opportunities unless someone is transitioning to a new role.

The key component will be the long-term equity incentive; portfolio company management teams often receive a large, one-time equity incentive grant that requires them to remain with the (typically through to the buyer’s exit) to realize the full value.

Long-term incentives are most commonly in the form of stock options or profits interests (if the holding company is established as a partnership), which reward management for increasing the equity value.

Full value awards such as restricted stock units or restricted stock are less commonly used because management still realizes some value even if equity doesn’t increase in value.

A portion of the equity incentive may be subject to time vesting conditions (typically four to five years), and a portion (often 50 percent or more) may be subject to performance vesting conditions such as IRR, return on invested capital, Ebitda targets, or an escalating or premium exercise price.

The PE sponsor should determine the size of the equity pool and work with the CEO of the target company to determine appropriate allocation among current management as well as the appropriate level of reserves for future key hires as well as promotions.

The size of the pool will depend of the size of the sponsor’s equity investment and how deep into the organization awards will be made.

The sponsor may model out expected payouts based on various levels of return on investment and use this to determine appropriate allocations.

It’s also important that compensation plans be flexible enough to address different exit

strategies including an IPO or a sale.

If the company is sold, all unvested equity is typically accelerated and management participates in wealth creation. In an IPO, vesting of awards may or may not accelerate but management will have liquidity.

Equity plans should also address any adjustments to reflect special dividends, which may be declared to allow the buyer to realize a return without a full exit.

PE buyers should also consider the treatment of equity awards if management leaves before the next liquidity event.

If someone is terminated with cause, they forfeit all awards, whether vested or unvested and equity that they own may be repurchased at the lesser of cost and fair market value. The gray zone is if someone resigns or is let go without cause.

Sponsors need to decide whether to allow them to exercise their vested awards before a liquidity event or whether such vested awards will remain outstanding until the liquidity event.

If awards remain outstanding until the liquidity event, the former employee will participate in increases in equity value even though they are no longer contributing to the company's growth.

If awards must be exercised within a short window following employment termination or if the employee owns equity, then it is important to consider the company's ability to repurchase those shares. The terms of call rights and whether to grant employees put rights should be negotiated at this stage.

Finalize documents

While the key terms of the management incentives are firmed up prior to signing the purchase agreement, the equity incentive plans, shareholders agreement and employment agreements are often drafted and finalized between signing and closing of the deal.

Having these agreements as buttoned up as possible as early on as possible is best.

PE buyers should want management focused and energized by the transaction, not spending their time worry about their incentive plans.

Additionally, all parties should feel comfortable going in to the transaction. Ideally, the negotiated deals will allow management to have skin in the game and something at risk on a go-forward, long-term basis.

Management should have an opportunity to participate in the upside as well as the downside. Management should be incentivized to want to help the company grow and preserve their investment.

***Note:** *This article originally appeared in The PE Hub Network*