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MANAGEMENT COMPENSATION IN LBOS: ANSWERING THE QUESTIONS OF WHAT AND WHY

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Although the pace of leveraged buyouts has slowed a bit in 2016, there are still lots of LBOs being done (as evidenced by Apollo's $7 billion acquisition of ADT). The compensation of senior management in LBOs is absolutely critical. This article attempts to walk through the primary issues relating to how private equity buyers typically incentivize senior management in a question and answer format, with emphasis on structural elements and deal points that will be of particular interest to M&A professionals.

Guiding Principles and Timing of Management Negotiations

What is the PE mantra for management compensation? Management makes money if and when sponsors make money, management needs to have skin in the game (typically through new equity arrangements and rollover investments) and management participates in the upside only so long as they remain employed (although there are exceptions to all of these points).

When you do typically negotiate? Equity compensation arrangements are negotiated either (i) before signing the acquisition agreement after the deal price and other key terms are set or (ii) between signing and closing. For public-to-private transactions, negotiations usually occur after the stockholder vote but before closing of the transaction.

Why not negotiate at the same time the deal is being negotiated? If management starts negotiations too early in the sale process (*e.g.*, before a handshake exists on deal price), plaintiffs' lawyers may claim that management selected the bidder who offered the best terms to management instead of the bidder that offered the best value to stockholders.

Are there instances where management does negotiate before the deal price is final? Yes, if the sponsor insists on this (and will not proceed with merger negotiations otherwise), then an early negotiation may occur. This is most common when a particular executive is critical to the future of the investment, such as a founding CEO. A sponsor may be unwilling to commit resources to a transaction without knowing management is committed to remaining with the company for many years.

What other factors influence the negotiation timing? For public-to-private transactions, the company must disclose arrangements between the sponsor and senior management in the merger proxy. As a result, negotiations should be finalized before the proxy is finalized or delayed until after the stockholder vote to avoid supplements to the proxy.

Why not wait until after closing? Delaying negotiations until after closing could send a signal to management that the sponsor intends to make changes or does not value the team. Also, if management is reinvesting in the company, there often are tax advantages to management making its commitments prior to closing. This provides incentive for management to finalize rollover terms before closing, but executives generally will not want to do so until they know the economic terms of their new equity incentives (the "promote") and their other post-transaction compensation and employment terms.

New Equity Compensation Arrangements: Types of Awards

What type of awards are typically granted and why? Sponsors almost always use awards that only share in the "upside" value in the company, such as stock options and profits interests. Public companies traditionally offer a mix of "full-share" and "upside" awards to balance incentives to grow the company's stock price (options) against incentives to mitigate downside risk (RSUs). Sponsors do not try to balance incentives—they want to encourage appropriate risk-taking in a leveraged environment to achieve outsized returns. Sponsors firmly believe that if the investment doesn't increase in value, management should not receive any value whatsoever, other than base salary and annual bonuses (if earned).

What are the primary tax differences between stock options and profits interests? Stock options give rise to compensation "wage" income to the employee when exercised and a corresponding tax deduction to the company at the same time. Profits interests, which are partnership or LLC interests that are subordinated to the Sponsor's invested capital, generally give rise to capital gains income to management upon a sale of the company's equity or assets. As a result, management typically prefers profits interests. Unfortunately, profits interests do give rise to a corresponding entity-level tax deductions (although the profits interests will still result in less taxable income being allocated to the investors, to the extent the investors are taxpayers).

If profits interests produce a better tax result to management, why use stock options instead of profits interests? If the company expects to be a net taxpayer, then the value of the stock option exercise deductions to the employer may be greater than the tax benefits to management of using profits interests (*i.e.*, a future buyer may pay more for a company to utilize those stock option deductions). Also, stock options are easier for employees to understand and impose fewer logistical complexities (such as partnership tax reporting, pass-through income, self-employment taxes).

Are there any downsides to profits interests from management's perspective? It may depend on the exit strategy. In the context of an IPO, profits interests often are rolled into a share amount upon dissolution of the partnership, so the enhanced leverage of the profits interests is lost (in some cases this may result in a request

from management for a reload option grant upon the IPO). Also, partners need to report the partnership/LLC's income on their tax returns (via K-1s). Management may have significant phantom income as a result of a profits interest structure (although most partnerships provide for tax distributions/advances to mitigate this issue). Moreover, being a partner may cause management to lose other tax benefits associated with employment (*e.g.*, self-employment taxes, inability to participate in certain benefit plans and taxability of medical benefits).

New Equity Compensation Arrangements: Pool Size, Allocations and Vesting Terms

What size should the pool be and what factors go into deciding the pool size? Typically it's 5%-15% of the fully diluted equity of the company immediately after closing. The number of recipients, prior LTI grants and target exit opportunity if management projections are satisfied. Often, a larger cap company will have a smaller option pool percentage compared to smaller companies, but these "smaller pools" could yield a more significant payout (*i.e.*, 5% of $1 billion of growth is better than 20% of $200 million in growth).

How much of the pool is granted at closing? Often about 75% of the pool is granted at closing, because you are front loading five years of grants into one mega-grant. The remainder of the pool is typically used for new hires and promotions, so if you expect a lot of new hires, the reserve could be larger.

Why is the entire pool granted up front? The only way to grant options or profits interests at the initial deal value is to make the awards before the valuation increases. If the value increases, then management would not share in all of the growth. As a result, most of the awards are made early in the investment, but vesting terms will be more heavily weighted toward the end of the investment life.

What factors are relevant in determining the time vesting versus performance vesting split? Prior sponsor precedents and industry standard of 1/3 to ½ time vest and ½ to 2/3 performance vest. The larger the pool size, the larger the portion likely to vest based on performance, as sponsors are more willing to agree to a larger pool if it is conditioned on a strong exit return (3x or greater).

What is the typical length on the time-vesting period? Four to five years, with five years typical.

What are the common performance vesting conditions? MoM return (or "MOIC"), IRR and annual operating metrics tied to management forecasts (such as EBITDA). Typically, the annual operating metrics will be based on the projections management has made in connection with selling the business to the sponsor. Alternatively, premium priced (or accreting strike price) time vested options may be used.

Why do sponsors prefer MoM or IRR over operating metrics? Because return targets are linked to the Sponsor's actual return, providing for perfect alignment. Sponsors want to focus management on achieving a particular return, and not just annual operating performance.

Why do management often prefer annual operating metrics? Because management can more directly control operating metrics as opposed to when a sponsor exits an investment and what the market is like at that time. Industry multiples, in

particular, are entirely outside of management's control.

How are management fees (and other fees paid to the sponsors) treated in the MoM/IRR calculation? Typically they are not included in the return calculations based on the traditional theory that the fees are paid to the sponsor, not the fund itself.

How are the MoM hurdles calculated (e.g., 50% vesting at 2x and 100% vesting at 3x)? Most sponsors use several tranches of MoM or IRR hurdles to create multiple overlapping incentives, or "steps." Typically, a portion of the equity incentives will vest at the levels of 2.0x / 8% IRR, 2.5x / 10%-12% IRR, 3.0x / 12.5%-15% IRR, but some transactions commonly feature some tranches with multiples in the 4x-5x range.

Why would the hurdle be a step function (all of nothing) instead of a straight line interpolation? "All or nothing" targets help focus management's attention on achieving specific targets. On the other hand, pro-rated or interpolated vesting when returns are "close enough" can lead to a "good enough" attitude from management.

If operating metrics are used as vesting criteria, are there typically catch up provisions? Approximately half of deals have a catch up for the subsequent year and occasionally for all years. For example, if the annual EBITDA targets are $100 million, $110 million and $125 million over three years and the Company reaches $99 million ($1 million shortfall), $108 million ($2 million shortfall), and $130 million ($5 million excess), management can apply the excess in Year 3 against the shortfalls in Years 1-2. Sponsors may put time limits on the catchup, or provide for some penalty since EBITDA growth in Year 3 may not be as attractive to a buyer as steady growth in each year. It is also not uncommon to see a separate MoM catch up if a very good (*e.g.*, 3x) return is achieved by the sponsors, thus negating the effects of having missed the annual operating targets.

New Equity Compensation Arrangements: Special Vesting Terms and Other Terms

What is the typical effect of a CIC on time vested awards? Historically, time vesting awards "single trigger" vest on a CIC. Given the shift to double trigger CIC vesting in public companies, some sponsors occasionally use double trigger CIC vesting provisions, particularly where the sponsor suspects that likely future buyers in an industry will pay a premium for an intact management team.

What is the typical effect of a CIC on performance vested awards? Typically the MoM or IRR is measured and the promote vests or is forfeited, depending on whether the returns are satisfied. If the performance condition is an annual operating metric, (1) the in-cycle year often will vest based on actual pro-rated performance for the year and (2) the periods that have not yet started will vest on a pro-rata basis (*i.e.*, if two of three previously completed annual tranches have vested, then the future tranches will vest on a two-thirds basis).

What is the typical effect of an involuntary termination on time-vesting awards? Typically the unvested portion is forfeited although sponsors sometimes will agree to vest the current year or a pro-rata portion of the current year. Full vesting on an involuntary termination has always been—and continues to be—extraordinarily rare

in LBOs (unlike historic practice at public companies).

What is the typical effect of an involuntary termination on performance-vesting awards? Typically the unvested portion is forfeited although some sponsors will permit (1) in the MoM or IRR context, a 90-180 day "tail" period where the promote will vest if a sale occurs within such period (so called "schmuck insurance") or (2) in the operating metric context, contingent vesting for the year of termination if the operating metrics are satisfied for that year (even after the executive has left).

How is an IPO treated and how is a CIC typically defined? In PE transactions, the IPO is almost never a vesting event. This is consistent with the PE mantra described above—management only makes money if and when sponsors make money (and an IPO typically is not a payment event for the sponsors). A CIC is often defined as either a sale of over 50% of the company to another person (a public company style CIC definition).

What is the typical option term? Typically it's 10 years.

What is the standard option exercise period after termination of employment and why it is shorter than in the public company context? In a good leaver context, it is common to see 90-180 days and in a voluntary resignation it is common to see 30-90 days. Sponsors want to limit the optionality for employees who no longer work for the company, particularly for those who leave voluntarily.

How are extraordinary dividends or dividend recap payments treated? Typically these result in a reduction of the option exercise price by the amount of the dividend, subject to tax principles that limit how low an exercise price may go (generally 20%-25% of the FMV of a share). If the exercise price cannot be reduced by the full amount of the dividend, then any excess is payable in cash to the option holder, although its common to hold back payments on unvested options until the option vests.

Are employees required to actually pay the option exercise price and any associated withholding taxes upon exercise? Most option agreements require employees to pay the exercise price and withholding taxes in cash. However, it is not unusual to waive the cash payment on a case-by-case basis for "good leavers" who exercise options and allow a net exercise at least for the exercise price. The availability of a net exercise to pay withholding tax varies because in this circumstance the company would be required to remit the taxes to the IRS. The company's financing documents need to be review to ensure that the desired outcome in permitted under such agreements.

New Equity Compensation Arrangements: Put/Call Arrangements

Why do sponsors insist on a call right and what are the typical call provisions? They want the right to ensure that company appreciation is only shared with employees and is only shared while they are employed with the company. They want the right to restrict free-riders. Typically a call at lower of cost or FMV on a termination for cause and certain types of resignations (*e.g.*, voluntary resignations that occur within 12-24 months of the grant date or resignations where grounds for a cause termination exist). In other cases, the call price is FMV.

Why would a sponsor ask to have a call on vested equity awards at the lower of cost or FMV on a voluntary resignation? For many years, any voluntary resignation prior to an IPO or CIC would result in a "lower of" (or forfeiture) call right. This was consistent with the theory that management had to be employed at the time the investors earn their profits. Market practice has shifted and, now, most sponsors allow for FMV call rights upon a voluntary resignation as long as the employee has worked some minimum period (12-24 months). Note, in this context it is critical to make a protective IRC Section 83(b) election at the time of option exercise because the underlying shares could remain "unvested" for Section 83 purposes until the "lower of" call provision expires.

How is FMV defined? Generally, FMV is determined by the Board in its good faith discretion, but some management teams insist on a third party appraisal (particularly if the amount in dispute exceeds some pre-agreed threshold). For private equity sponsors that are public, sometimes FMV can be determined by reference to the sponsor's internal valuations used for SEC reporting.

What if there is an IPO or CIC at the higher price shortly after the exercise of a call right? Sometimes, senior executives will have the right to a top up tail (or "schmuck insurance") if there is such an event within a short period of time after a call is exercised (60-120 days).

Why do call rights typically expire after a IPO or CIC? Once the company is public through an IPO, sponsors are no longer concerned with management leaving and continuing to have upside in the stock since the company has many nonemployee stockholders. In most CIC scenarios, management will sell their stock alongside the sponsor and, as a result, the call rights become irrelevant. But if the structure does not result in a sale by management, then the call rights nonetheless expire since management is likely reporting to a new sponsor (or a consortium of sponsors) and may even be working with (or for) another management team. It would be unfair to require management to forfeit future upside in the promote if they are terminated or if they quit because circumstances have materially changed.

What is the typical length of a call right and who should get to exercise the call right? Typically the call runs for six to 12 months after employment terminates, but many deals do not contain a time limit. Because the value of most businesses increase over time, management should consider whether its desirable to force the sponsor's hand by limiting the time period. It typically is preferable to hold the equity for as long as possible. Typically the company gets to exercise the call, but occasionally the sponsors may exercise the right for their own benefit if the Company does not.

Does management typically have a corresponding put right? Typically management either has no put right or only has a limited put right at FMV on death or disability. Occasionally executives will have FMV put rights on other narrow good leaver events.

Are there limitations on the payment of the put/call price? If the company is restricted by applicable law or its financing documents from paying cash, then typically the repurchase can be deferred or a note can be delivered.

Rollover Equity

Why are executives asked or required to rollover investments in the deal and how much is senior management typically asked to rollover? The sponsor wants to know the management has skin in the game that is not going to be cashed out until the sponsor's exit the investment. A rollover of 25%-50% of the after-tax deal proceeds is a very common formulation. In some deals, this is limited to compensation awards that are paid out at closing and in other deals it also includes shares that are owned outright.

Can management rollover more if they want to? Yes, sponsors usually encourage management to invest as much as possible and view larger rollover amounts as a sign of good faith. In some transactions, the size of management's promote is directly related to how much money management reinvests in the company. Moreover, if the CEO makes a very large rollover, it is not unusual that the rollover can be leveraged to get better terms on certain other matters (*e.g.*, no call rights, better vesting terms or more options).

Is the rollover of after-tax proceeds or can you rollover amounts pre-tax? It is typically possible to rollover stock options and shares that are not subject to vesting conditions on a tax-deferred basis, but you typically can't rollover restricted stock or RSUs on a tax free basis.

If I rollover stock options do they just rollover on the same terms? No, typically the exercise price of the option is reduced to 20% (or 25%) of the FMV and the number of options is reduced to preserve the intrinsic spread value. For example, if an executive has 100 options with a $15 strike price per share and a $25 deal value per share, the executive has $1,000 of value (100 x ($25-$15)). In the new company, the $1,000 will be allocated into fewer options with a lower strike price per share—specifically, 50 options with a $5 exercise price (50 x ($25-$5) = $1,000) or 53.33 options with a $6.25 exercise (53.33 x ($25-$6.25) = $1,000). Practitioners have differing views as to whether the exercise price can be reduced as low as 20% (as opposed to 25%).

Why are stock options treated in this manner? The sponsors want to reduce the dilution or leverage of the option to the maximum extent permitted under the tax rules. Fifty options at $5/share will not be as valuable as 100 options at $15/share if the price per share increases from $25 to $100 in the future. If the sponsor could lower the exercise price to a penny, it would do so, but tax principles impose the 20-25% limit.

How many people are required/permitted to rollover amounts? Typically only the CEO and his/her director reports are required to rollover, but a much wider group (subject to securities law limitations, particularly related to being an accredited investor) is often permitted (if not encouraged) to rollover amounts.

Will rollover equity be subject to put/call provisions? Yes, typically the rollover equity will be subject to put/call provision that are similar (but typically more favorable to management) than the put/call provisions applicable to new equity awards.

Employment, Non-Competition and Shareholder Agreements

What happens to existing employment agreements and what if management does not have employment agreements? Typically existing employment agreements are rolled forward as is (or possibly with minor changes to ensure that

the executive does not have "good reason" to resign right after closing and to include appropriate non-compete restrictions). If there are no employment agreements in place, it's common for new employment agreements to be entered into as a signal that the new venture is a partnership between the new sponsor and management.

Does management have to agree to a non-compete? Yes, typically this is included in either the new equity plan or in the employment agreement. One to two years is fairly typical. If management is selling a significant amount in the buyout, then the new owner may also seek a "sale of business" non-compete of two to five years, although this can be highly negotiated and controversial.

What are the typical shareholder agreement terms? Typically there are prohibitions upon management selling shares prior to an IPO or CIC, but there are customary tag along and drag along provisions and, for larger shareholders, piggy back registration rights. Typically management does not get preemptive rights. Typically there are no limits on the sponsors' ability to sell their shares. Typically there are no limits on the sponsors' ability to contribute more money to the company in return for shares (thus diluting management's share of the company), but in circumstances where future investments are likely (or there is a distinct possibility of follow-on investments), management may insist on certain share price valuation protections so that this investment does not unfairly wipe out management's investment.