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[Podcast]: Nuts and Bolts on a Management Buyout - Part 3

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In this episode of The Proskauer Benefits Brief, partners Michael Album and Josh Miller return to discuss the nuts and bolts of a management buyout, and in particular, how management deals with the selling sponsor and the bidder, and starts to develop their own compensation packages post-closing and consider deal bonuses from the selling sponsor. Be sure to tune in and listen for the latest insights and perspective on management buyouts in this third of a seven part series.

Mike Album: Hello, welcome to the Proskauer Benefits Brief. This is nuts and bolts of a management buyout, what management needs to know. It's part of a series of a Proskauer podcast. I'm Mike Album, and on today's episode and throughout the series, I'm being joined by Josh Miller. This picks up on our earlier podcast on iTunes, and today we'll be addressing some distinct executive compensation matters in an MBO and that senior management has to review and deal with.

Josh, let's talk a little bit about the beginning of the process, which is what we'll call the self-inventory process, when our clients have to figure out what their existing documentation is, what their existing compensation arrangements are. And it might sound funny to even say that because you think sometimes people would have an absolutely encyclopedic knowledge of what they have. But they're busy running the business, often then haven't focused on the whole array of compensation they have, so why don't you take us through the kind of things they should be looking for, as they build their self-inventory.

Josh Miller: Sure. The number one thing certainly is going to be their equity ownership, and that would include fully vested equity, common stock or capital interests, as well as incentive equity, such as profits interest, restricted stock, RSU's. What they're going to need to really understand are the terms and conditions of those equity awards, in connection with a sale. Will the sale accelerate vesting, or result in adjustments, or payments, or measurement of performance in connection with incentive equity? Are there "drag alongs" or forced sale provisions that require equity holders to participate in the transaction, and if so, on what terms? Also, it's the non-equity compensation, annual bonuses, deferred compensation, rights to carried interest, employment agreements.

It's a good idea for management to review salary levels, bonus targets, and structure, not only to understand how they relate on an absolute basis, but where they are relative to the market. And for that, might be worth hiring or retaining counsel or a consultant to study trends and survey data, to look at precedent transactions involving companies in the same industry or transactions between the same sponsors. Public filings are a great place to look, particularly for businesses that have started out public and taken private, or strategic acquisitions by a public company. As I said, outside management counsel, compensation consultants, and various news sources will have a lot of data here. The management can work with its advisors, and make sure that their existing package is up to par with market.

Mike Album: Yes. I want to step back for a minute because in one of our earlier pod casts, again which you can find on iTunes, you spoke a little bit about the due diligence process the buyers are going to undergo in order to figure out and understand the legal and executive comp landscape of the company they want to buy. So they will be focusing on the existing current state. In other words, your self-inventory is sort of parallel tracking their due diligence process. So they're looking at the current state, to figure out the sort of minimum amount they have to offer you, and perhaps argue that you shouldn't get any more, once the deal closes going forward, than what you've had in the past. I mean we've seen this a lot in the area, Josh. In employment agreements, for example. Whereas a buyer, a PE firm behind the business may have its own approach to an equity pool, and how the equity grants work. Often when it comes to the employment agreements, they'll piggy back of what we call the legacy agreements, and not want to change things, particularly if the legacy agreements are pro employer.

Josh Miller: Sure.

Mike Album: So severance terms may not be particularly generous, or there are no change and control provisions, or acceleration provisions. So the legacy documents are playing two key roles. One is for the buyer, to use to set up its new proposal, and for the management team to realize what they have, and what they may have to bargain up from.

Josh Miller: Right. And then management, generally is going to be unwilling to accept anything less favorable, or that exposes them more than what they had pre-deal. They're going to want to improve their alignment with market, and they're going to want to create programs that bolster their retention and their motivation from and after the closing. So it is very important to understand your existing severance formula, your triggers, how deep it goes in the population of the management team, as well as the restrictive covenants. It's another area where what management has lived with through the transaction can really set the stage for what they're willing to accept post-transaction.

Mike Album: Yes, and then just to jump in here. It's a very delicate negotiation because if your legacy restrictive covenants are highly restrictive, you're going to send a very difficult message to a buyer, if you're trying to loosen them in a situation where they're paying a lot of money for the company, and think they're buying management talent. So of course counsel's always thinking of worse case scenarios. How can I provide an easy exit for my clients, if this acquisition doesn't go well? But that's running head up against the buyer's economic motive, which is to buy a management team that's been so successful, and keep it, and make sure it doesn't walk away.

So Josh, I just want to say one thing because we're a little short on time on this segment, but I do want to talk a little bit about bonuses, such as extraordinary bonuses, deal bonuses, because the management team has to realize, notwithstanding what the legacy framework is for their comp arrangements, if they've done a very good job, it's not unusual to try to seek some sort of transaction bonus in connection with the sale that's coming up.

Josh Miller: That's right, and where those could be particularly important, when the buyer is demanding a significant roll over or post tax investment from management, requiring a large percentage of their total proceeds to be invested in the transaction. In that case, management often will go back to the seller and recognize that in return for this premium price and a favorable exit for the seller, seller can help fund management's rollover investment. So a transaction bonus not only can help do that, but also provide a very valuable retention element, and also make management in some cases more neutral to the transaction.

Mike Album: Right, and I think just to jump in here, as Josh and I have worked closely with our tax experts in structuring all types of compensation arrangements. So one of the things not to lose sight of is if management is lucky enough to be able to get a transaction bonus. Start to think about ways that maybe tie to pre-existing profits interests, or changing an LLC arrangement, so there may be an opportunity for capital gains. In other words, more favored tax treatment for that particular transaction bonus than would otherwise be the case, if it was just an "ordinary income" bonus.

So I think at this point we're going to end this segment. Thank you for joining us on the Proskauer Benefits Brief. Stay tuned for more insights on the nuts and bolts of management buyouts, as we will be setting up another pod cast shortly, and be sure to follow us on iTunes. Thank you very much.

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