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[Podcast]: Nuts and Bolts on a Management Buyout (Part 6 of 7)

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In this episode of The Proskauer Benefits Brief, partners Michael Album and Josh Miller discuss the incentive equity package that management will be offered in the buyout, including the structure of the incentive pool, vesting, and favorable tax treatment of incentive grants. Tune in and listen for the latest insights and perspective on management buyouts in this sixth of a seven part series.

Mike Album: Hello, welcome to the Proskauer Benefits Brief, nuts and bolts of a management buyout, what management needs to know. I'm Mike Album, and on today's episode I'm joined by my partner, Josh Miller, and we're going to discuss management's incentive equity packages and pools, in the context of a management buyout.

In our prior podcast, we spoke a little bit about rollover equity, so-called direct equity that the management team is putting into the new company, going forward. The management incentive equity is a little different, Josh. It's sometimes referenced as options or profits interest. Can you explain a little bit why it's different from the actual investment that's being made with a rollover equity?

Josh Miller: The management incentive equity, the sweat equity, whether in profits interest or another form, is really incentive equity. It's granted, not sold. It's not something that was preexisting. This is your new incentive award that's subject to vesting, based on continued service, performance, and other criteria. It generally provides upside, as opposed to immediate value. So for example, a capital interest in a partnership has an immediate right to participation, typically, in distributions from the partnership. Whereas a profits interest only has value to the extent that the company appreciates in value, to participate in distributions above the liquidation value of the company on the date of grant. So they're a partnership analog of options, in that an option in a corporation only has real value to the extent that the trading price exceeds the exercise price of the option.

The form of interest is very important, Mike, as you know because of income tax recognition. Profits interest, if properly structured, will have a value for tax purposes of zero on the date of grant, and will constitute property, subject to code section 83, and as a result enable a section 83 B election, the effect of which is that a profits interest can be granted, even if subject to risk of forfeiture, vesting conditions, forfeiture conditions. It can be granted and the participant can make an 83 B election on the date of grant, to take into his or her income the value of those interests on the date of grant. That value, if structured properly is zero, so you're left with a equity incentive form that results in no taxable income to the holder, and a potential for capital gains on distributions and subsequent transfers.

Mike Album: Right, so if I'm a senior management executive, there are two aspects to the incentive equity that I really care about. One is I'm not paying anything for it. Unlike my rollover equity, this is an award that I don't pay for. The second is if it's in the form of a profits interest, it could be structured properly so I can make a technical tax election called an 83 B election, that has no immediate tax impact to me, no cash tax impact to me because I'm not getting any baked in value with this award. But it allows me, if I hold the profits interest long enough, to have capital gains associated with any payments I receive with respect to that interest. So it's a two part play, if you will. It's a grant that I receive, that gives me upside in the company at no cost, and it may well give me preferred tax treatment on the appreciation. So it's a very good arrangement. The only wrinkle of course is there's got to be appreciation in the company going forward, but of course I'm part of senior management, and I'm being paid to do that post closing, so I'm fully confident that it's going to have that value. Josh, talk a little bit about the size of the equity pool. Because we know that there are a lot of market aspects to what is the right size of the pool.

Josh Miller: The size of the pool varies. You typically will look at the total fully diluted common interest, and come up with a percentage. The percentage does vary, quite a bit, depending on the business. For example, a health care managerial services organization might have a larger pool because they're compensating not only the management team and the directors, but also individual physicians, whether it's physician owners or associate physicians. Whereas a purely operational company might have a slightly smaller pool, but still something substantial, something that gives management real upside and alignment to share in the appreciation of the company.

Mike Album: Right. Also the size of the deal will have an impact on the size of the incentive equity pool, huge multi-billion dollar deals will have a smaller equity pool than a smaller deal because the value of the pool is worth a lot more because of the size of the deal. Josh, can you talk a little bit about vesting and acceleration events associated with these awards?

Josh Miller: Sure. The award as incentive compensation, are generally subject to vesting. Those vesting terms can be a combination of time and performance conditions. The time typically will be anywhere from 40 to 60% of the pool, although it varies. Vesting over time, based on continued service. So this could be over a period of three, four, five years. It could be of ratable vesting, where vesting occurs every year, every quarter, or even every month. Or it could be a cliff vesting, where at the end of a specified period, 100% of the time vesting units become vested. On the other hand, you have performance vesting. The performance vesting units can be based on financial performance on a year to year basis, things like revenues or EBITDA or sales, or they could be tied to an exit: The IRR or the “money on money” return at the time of an exit, measured based on the sponsor’s capital investment in the business. Or a combination. For example, you could have a portion subject to only service over time, a portion that vests based on EBITDA on a year to year basis, but with full acceleration of the entire reward, both time and performance, to the extent that certain returns are met in a liquidity event, such as a sale or change of control event.

Mike Album: Right, we can't cover all the aspects of the incentive pool arrangement, but a couple of take home points that you should at least be thinking about. One is, whatever the size of the equity pool, some of it's not going to be allocated at the time of closing. There'll be a hold back reserve. Senior management should try to have as much control over that reserve allocation as possible, and they should also try to have as much control over any forfeited units that come back into the pool. Because those could have real value, if there were to be a deal done, and they haven't been previously allocated. The second thing to think about is to make sure you get whatever distribution units might take place on unvested units, that they are somehow put aside or held, so that when the units do vest, they can receive the distributions that were made when they were previously unvested. And the last thing to be thinking about is, Josh mentioned various acceleration events, change of control, multiple on invested capital, IRR returns, that would somehow trigger a full vesting of any unvested units at the time of the transaction. Also make sure you try to get yourself a tail. Management should be thinking about a tail, so that if they're terminated, but one of these trigger events were to happen within six months, nine months of their termination, they would get the same economics, had they been there. Now that won't apply to a pure resignation, but that type of tail protection could apply in a good leaver situation, where they'd been forced out without cause, or perhaps had good reason to leave.

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