Proskauer

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

Employee Benefits & Executive Compensation Blog on **October 25, 2018**

In the final episode of a seven-part series for The Proskauer Benefits Brief, partners Michael Album and Josh Miller talk about employment agreements in the context of a management buyout. They go over the key terms and issues that management should focus on when reviewing and negotiating their go-forward employment arrangements, compensation structure, severance protection and restrictive covenants with the buyer following the sale. Tune in and listen for the latest insights on management buyouts.

Mike Album: Hello, welcome to the Proskauer Benefits Brief. This is a Benefits Brief on the Nuts and Bolts of a Management Buyout, What Management Needs to Know. I'm Mike Album, and I'm being joined by my partner, Josh Miller. And we're going to discuss employment agreements in the context of a management buyout.

Josh, we spoke a little earlier about the preexisting employment agreements and how those provisions will be looked at by the buyer of a business to perhaps model the terms of a proposed new employment agreement. So can you go over the sort of key terms of an employment agreement that management should be focusing on as it sits down to try to get a new deal from the buyer of the business?

Josh Miller: Sure. Your typical employment agreement, in addition to defining the positions and duties of the executive, will set forth the basic compensation terms during employment. Those will include base salary, your annual bonus opportunity, and a long-term incentive opportunity, typically equity. For the bonus opportunity, management wants as much specificity as possible in terms of the actual performance targets and metrics, or at least some parameters around the process. They want to know what percentage of base salary or what dollar amounts they can receive at threshold maximum and target performance. They want to know when the targets and goals will be determined and by whom, the board and the committee, the extent to which management such as the CEO is involved, to consult on those goals and targets, or even to consent and develop those jointly.

Mike Album: Josh, just one quick interruption. Before we leave the annual cash incentive targets, this is one area where management's going to have a lot of familiarity with the projected performance of the company. There'll be a three-year plan; there'll be a five-year plan in place. And management will be fully conversant in what they expect the budget to be, what it would mean to beat budget.

So they have in some ways better knowledge than the buyer in this situation or as good a knowledge as the buyer. The key is to make sure that their view on the applicable metrics as Josh said is the view that controls, and that they're not being forced into financial metrics that they're not comfortable with.

Josh Miller: On that note, it's important for management when they're shopping a deal, to be reasonable in their business plan and budget. You can set, stretch targets and goals, but that will make the performance triggers on your annual and long-term incentives that much harder to take. So they should be attainable, but they should be real goals. They should be something that incentivizes the performance that management and the sponsors are looking for. And of course they have to be objective. There shouldn't be any subjective elements. Management should have a very good idea that if we hit performance at this level, this is what we can expect to receive.

And on the other hand, the long-term equity incentives can be a little broader. Generally you'd like to see some eligibility for participation, eligibility for future grants. But you want to document the commitment with respect to closing date incentive awards, particularly to the extent those won't be made on the actual closing date.

And I think when we're representing management, our preference would be to have the award agreements, or at least a form fully baked and attached as an exhibit. But sometimes you're not at that stage. An employment agreement might be updated in connection with a signing and the awards documented between signing and closing or post-closing. So you want to be as specific as you can and reflect the deal.

Mike Album: Yes, just a couple of observations there. You can have annual cash incentive opportunities, and you could have multi-year cash incentive opportunities. The key word there is cash. Multi-year incentive cash opportunities could be tied to various financial metrics, EBITDA on an annual basis, EBITDA on a cumulative basis. As you're trying to plan out your bonus structures, very important for management to have catch-up rights, and to be able to deal with both targets on an annual basis and a cumulative basis, so that if there's a miss in any particular year, that could be made up with subsequent better-than-anticipated performance. And in fact, the notion of catch-up is something to keep in mind when it comes to vesting provisions on the incentive equity that Josh mentioned earlier in the previous broadcast. Again, catch-up is management's friend. Don't lose sight of it.

On the long-term equity awards, there might be a bit of a battle there because the sponsor is going to say well I gave management nice allocations of my incentive pool at the time of closing, I'm not anticipating annual grants going further. The annual grants in the future will be new hires I bring in. So it's not like a public company Josh, where you can anticipate every year the compensation is going to consist of cash and then equity grants reaching a certain number. You'll have to see. You'll have to see how the negotiations go in terms of guaranteeing future equity grants. Talk a little bit Josh, about severance and cause in these new agreements.

Josh Miller: Sure. Before, we talked about the compensation during employment. The severance really deals with compensation or the consequences of a termination of that employment. The typical triggers for termination of employment vary. On an earlier podcast we referred to a good leaver and a bad leaver. Typically the good leaver is a person who is terminated by the company without cause. Or at the senior level, was constructively terminated, as a result has a good reason to terminate employment and receive severance. Those are very important definitions and concepts.

Cause should be very narrow. You want to make sure there's no performance trigger where a failure to hit budget or goals can result in a termination for cause, because the termination for cause often results in forfeiture of unvested equity, no payment of severance, and in some cases punitive rights such as calls in respect of even investment rollover equity. It's important to note that the definitions in the employment agreements for senior management should be consistent with the definitions that apply to their equity vesting and their call rights and other liquidity features in the LLC and other organizational documents. You don't want a situation where particular behavior or a particular act or omission constitutes cause under one scenario for purposes of severance but doesn't constitute cause for purposes of the equity, or vice versa. You can have an employee employed but then lose their equity. Particularly in these private equity deals with profits interest, a lot of the value is in the upside, is in the future growth. So in some cases, severance multiple or continuation of base or base and bonus isn't going to be commensurate with the value of equity after several years of performance and growth. So that's something to keep in mind.

On the cause definition itself, we want it to be very narrow. We want it to be objective and material. We want to see due process protection for management. What that means is you don't want a situation where the employer or the sponsor can terminate you due to a foot fault, due to subjective failure to perform, or due to failure to hit performance goals or budget. You want some real teeth to that.

And the cause triggers that we typically see are serious bad actor triggers, material breach, and material violation of policies, commission of a felony or a misdemeanor involving moral turpitude, fraud, embezzlement, misappropriation, so real bad acts. And they should be subject to notice and cure. Wherein before a termination for cause can be effective, the company gives the executive sufficient notice to contest the termination, to attempt to cure it to the extent curable. And if cured, no longer constitutes cause.

On the flipside, you have good reason protection, which is how an executive terminates as a good leaver and receives severance. These are essentially your constructive termination. Typical triggers will be around protection of base salary, annual bonus opportunity, duties and authorities, protection against relocation, and protection against a material breach. Notably to the extent you have deferred compensation as severance or otherwise in your compensation arrangements, you want to make sure that you understand whether or not good reason is considered a true and voluntary termination under Section 409A of the tax code, whether safe harbor or otherwise, so that you know whether or not that you're subject to 409A, whether or not your severance arguably could be subject to limitations on modifications or other rules impacting the time and form of payment.

Mike Album: Josh, let me just make a couple of observations 'cause we're going to have to bring this to a close. This is a situation we mentioned earlier where the legacy documents could hurt you if they haven't been drafted in a pro-executive way. And frankly, the argument you have to make to the buyer is those are legacy documents under a different regime. I want to make sure I'm protected under a new regime, and I'm entitled to what I view as market conditions. So that would be market conditions on severance, good reason, cause.

The last thing I want to just speak about quickly are the indemnification provisions, making sure that both the old legacy indemnification provisions stay in place and are not wiped out by more restrictive indemnification provisions that might be put in the transaction documentation at the time of the deal.

This is a technical point, but just please realize that there are many different indemnification obligations floating around, and management doesn't want to be in a situation where there's an issue arising from the sale of the business based under the transaction documents, and somehow they've lost indemnification rights that they would've had under the old terms because of the new provisions of the transaction documents. So thank you for joining us on the Proskauer Benefits Brief, and we want to thank you, and be sure to follow us on iTunes.

Listen to The Proskauer Benefits Brief