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Structuring Management Incentive Equity Arrangements in Private Equity Acquisitions

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Structuring Management Incentive Equity Arrangements in Private Equity Acquisitions

INTRODUCTION

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General

- Private Equity vs. strategic investor
  - 3-5 year ownership window
- Equity Owner vs. Non-equity Executive
- Anchor investment vs. tag-on portfolio investment

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Private Equity Objectives

- Retention of management
  - PE more dependent on acquired management teams
- Step-Up Tax Basis in Target
- Control
- Unconditional Right to Exit
- Equity rollover will bridge valuation gaps

Management Objectives

- Tax Free Treatment of equity rollover
- Capital Gain Treatment on exit
- Anti-dilution - preemptive rights
- Liquidity – Management exit with PE
- Waterfall – pro rata with PE or preferred return

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Benefits of Equity Rollover

- Participation in future appreciation
- Aligns management with PE fund
  - Aside – Use Rep and Warranty Insurance to further align parties' interests
- Bridges financing and valuation gaps

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Acquisition Targets

- S Corp.
- C Corp.
- Pass-through vehicle
  - Partnership or llc

IRC §338(h)(10) Election

- Available to S corp or C corp exiting a consolidated tax group
- But Buyer must acquire 80%
  - All assets deemed sold
- S. Corp taxable gain Allocated to Selling Shareholders » rolling shareholders will be taxable.
- Therefore, use "F" reorganization structure
  - Achieve step up and tax deferral for rolling shareholders

Typical Structure Of Equity Rollover Transaction for S corp.

F reorg target merged into an llc

- Minority shareholder become llc holders
- PE buyer gets step-up in basis and no tax to minority holders

C corp. acquisition

- No IRS §338(h)(10) election available
- Equity rollover difficult to achieve
  - PE fund can buy portion of target shares
    - No step-up
  - PE fund buys x % of assets, double tax to minority shareholders

Pass-through acquisitions (partnerships and LLCs)

- Ideal structure
  - PE fund secures step up in acquired interests under IRC §754 and §743
  - Shareholders retain their shares without tax event

Management does not own equity at Inception (excluding rollover)

- NQSO - corporate
- SAR’s - corporate
- Profits interests – pass throughs
- ISO’s - corporate

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Types of Incentives

- Cash retention bonuses (non-equity)
- Equity rollover, when available
- Appreciation awards
- Stock Options
  - Non-qualified stock options
  - ISO’s
- Profits interests
- Phantom stock

Structuring Management Incentive Equity Arrangements

Decision Points and Market Terms

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Private Equity Management Equity Incentive Programs Overview

- A Management Equity Incentive Program ("MEIP") is a central component of a Private Equity Sponsor's compensation philosophy:
  - Pay for performance
  - Retain management through a liquidity event
  - Align management with the Sponsor
- MEIPs are specifically designed to provide an incentive for management to:
  - Increase value
  - Create liquidity
- Management (mgmt) = executives and key employees tasked with managing the portfolio company

Private Equity Management Equity Incentive Programs
Key Decision Points

- Amount of Equity (Reserve Pool)
- Form of Equity
- Participation Requirements
- Vesting Conditions
- Termination Provisions
- Ancillary Equityholder Terms

Private Equity Management Equity Incentive Programs
Amount of Equity

- Reserve pool = amount of equity reserved for mgmt
- Common starting point is 8-12% pool (10% likely the mode)
- Size of pool can vary (up/down) based upon:
  - form of equity award
  - size of the company
  - amount of mgmt equity investment
  - number of participants
- Some Sponsors split the pool into a base "performance" pool and a separate, related "superperformance" pool (e.g., 10% pool based upon anticipated/desired performance and an additional 5% based upon outsized returns to Sponsor)

Private Equity Management Equity Incentive Programs
Form of Award

- Appreciation awards are the prevailing form of MEIP award
  - Appreciation awards only provide mgmt with value if the company increases in value
  - A full value award (e.g., restricted stock or RSUs) has value even if company value decreases
  - Appreciation awards more typical because of alignment with Sponsor philosophy
- Different tax treatment for different forms of appreciation awards
  - Stock Options – ordinary income for mgmt (company deduction)
  - Profits Interests – capital gains for mgmt (no company deduction)

Private Equity Management Equity Incentive Programs Participation

- Some Sponsors grant MEIP awards irrespective of rollover or co-investment (likely the prevailing practice)
- Other Sponsors condition incentive equity grants upon investment or matching investment with incentive equity
- CEO often dictates "depth" of grants
  - MEIP awards typically reserved only for senior executives
  - Other types of long-term incentive programs often utilized for lower tier executives and rank and file employees

Private Equity Management Equity Incentive Programs
Vesting Conditions

- Vesting conditions are a critical design element for determining if/when mgmt is able to realize any value created
- Two primary types of vesting conditions:
  - Time-Based Vesting
  - Performance-Based Vesting

Private Equity Management Equity Incentive Programs Vesting Conditions

- Range of 1/3 – 2/3 split between Time-Based and Performance-Based Vesting tranches most common
- Time Vesting:
  - 3-5 year vesting schedule typical range (5 years likely most common)
  - Annual cliff vesting for first portion of the award to vest is common
  - After initial cliff any of annual, quarterly or monthly used
- Performance Vesting:
  - Annual Performance Vesting tied to achievement of annual financial performance metrics
  - Exit Vesting usually tied to ROIC (IRR used but less common)
  - Superperformance pool usually tied to Exit Vesting Awards

Private Equity Management Equity Incentive Programs Vesting Conditions

- Time-Based Vesting rewards mgmt for continuing to provide services to the company (retention incentive)
- Note that because appreciation awards only have value if the company increases in value, even Time-Based Vesting has a built-in performance feature
- Preferred returns can also create an underlying performance incentive as mgmt must clear the preferred return in order to realize value

Private Equity Management Equity Incentive Programs Vesting Conditions

- Performance-Based Vesting rewards mgmt for achieving specified performance criteria
- In the Private Equity Sponsor context, Performance-Based Vesting is typically based upon:
  - Annual financial performance targets (e.g., achievement of budgeted EBITDA)
  - Return or Exit targets, (e.g., Sponsor achievement of specified return on invested capital (ROIC) hurdles)

Private Equity Management Equity Incentive Programs Vesting Conditions – CIC

- Time-Based Vesting awards often fully accelerate upon a CIC
- Accelerated vesting of Performance-Based Vesting awards varies among Sponsors:
  - Annual performance vesting may awards accelerate upon a CIC if an overriding performance goal is satisfied (e.g., achievement of specified ROIC hurdle)
  - Exit vesting awards accelerate on a liquidity event if performance goals are achieved
  - Variable treatment of Exit vesting awards upon less than 100% sale

Private Equity Management Equity Incentive Programs
Vesting Conditions – Termination of Employment

- Disparity in treatment of equity awards upon termination of employment
- Time-Based Vesting award alternatives:
  - No additional vesting upon termination of employment
  - Pro rated vesting for year of termination
  - Vesting commensurate with severance duration
  - Full vesting
- Performance-Based Vesting awards:
  - Lookback for terminations shortly before CIC
  - Abbreviated "deemed" measurement

Private Equity Management Equity Incentive Programs
Termination of Employment

- Call (repurchase) provisions are customary in the Private Equity Sponsor context
- Sponsors want to limit upside for terminated participants (but do not want to treat terminated participants better than participants continuing to work to drive value)
- Call often exercised through cash or use of a Note
- Determination of FMV upon a call event can be an area of tension

Private Equity Management Equity Incentive Programs
Termination of Employment

- "Punitive" repurchase price (i.e., lower of cost or FMV):
  - Terminations for Cause
  - Violation of Restrictive Covenants
  - A few Sponsors also include a punitive repurchase upon a voluntary termination of employment
- Put rights are less common in the PE Sponsor context
- Restrictive Covenants related to the equity award typically survive termination of employment

Private Equity Management Equity Incentive Programs
Ancillary Considerations

- Net (aka "cashless") exercise feature for options
  - Exercise Price
  - Tax Withholding
- Transfer restrictions
- Drag-along rights
- Tag-along rights
- Preemptive rights
- Fiduciary Duty Waivers (LLCs)

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Structuring Management Incentive Equity Arrangements in Private Equity Acquisitions

IMPACT OF RECENT U.S. TAX REFORM

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FORM OF PORTFOLIO ENTITY IMPACTS TAX TREATMENT

- The type of equity interest which may be granted to an executive will be defined by the legal form of the portfolio entity.
- For example, stock options can be granted by a corporation but not by a partnership (or an LLC that is treated as a partnership for tax purposes).
- On the other hand a "profits interest” can only be granted by a partnership.
- However, phantom equity interests can be granted by both corporations and partnerships.

IMPACT OF TAX REFORM - C CORPORATIONS

New Law: Review the Marginal Tax Rates on Equity Based Compensation

Executive:

- Phantom stock, SARs, RSUs, Income on exercise of NQOs-compensation (ordinary income)-37% plus Medicare tax , payable 1.45% by the employer in 2.35% by the executive (3.8% combined), or
- Capital gain 20% plus Medicare tax (3.8%) upon sale of shares

Employer

- C Corporation will deduct the compensation at a federal marginal rate of 21%.
- But no deduction for income executive recognizes as capital gain and not compensation.

Observation: The executive’s Federal tax rate is 16% higher than the employer’s tax rate.

IMPACT OF TAX REFORM - C CORPORATIONS (Cont'd)

Prior Law – Example:

Executive:

- $100 of compensation is paid to the executive. Executive included the income at 45% (includes Federal tax at 39.6% plus 9% state and local tax ("SALT") of about 5.4% after federal benefit). The C Corporation deducted this $100 compensation against income taxable at 40% (35% federal plus, let's say 8% SALT, net about 5% after federal benefit.

Employer:

- The C Corporation deducted this $100 compensation against income taxable at 40% (35% federal plus, let's say 8% SALT, net about 5% after federal benefit.

<u>Observation:</u> The executive's Federal tax rate is 5% higher than the employer's tax rate.

After taxes, the executive had $55 which cost the corporation after tax savings $60.

IMPACT OF TAX REFORM - C CORPORATIONS (Cont'd)

- After tax reform, the executive will be subject to tax at 46% (37% federal plus 9% SALT which is generally not deductible). The employer, a C Corporation (assume 21% federal and 7% SALT after federal benefit will deduct this $100 against 28% income.
  - The executive will have $54 after taxes on the $100 payment (almost the same as prior law) but this payment will have a net after tax cost to the C Corporation of $72 instead of $60, or $12 more than before.
  - Observation: After taxes, ordinary compensation paid to executives will "cost" a C corporation more than under prior law. This compensation will include not only base salary plus bonus but also ordinary income from the exercise of NQOs and SARs.

IMPACT OF TAX REFORM - C CORPORATIONS SUMMARY

- For the executive, the best tax treatment is capital gain (23.8%). The worst is straight compensation (39.35%, or 40.8% if the corporation's 1.45% tax is included).
- From a deduction point of view, the loss of the deduction where capital gain is recognized by executive will be less costly since the marginal tax rate for the employer corporation will be only 21% instead of 35%.
- If the Target is a C corp., consider granting "incentive stock options" ("ISO"s). ISOs provide total capital gain but must satisfy certain statutory requirements. An ISO also provides tax deferral of the entire appreciation
- NQOs provide capital gain only on post exercise appreciation and no deferral of appreciation to the point of exercise.
- For a stock option to qualify as an ISO, the option and optionee must meet certain requirements when the option is granted.

INCENTIVE STOCK OPTIONS

- On the date the option is granted, the optionee must be an employee of the C corporation (or its subsidiary)
- Option must be granted pursuant to a written plan approved by the shareholders
- The maximum aggregate number of shares that may be issued under the plan through ISOs must be fixed when the plan is adopted
- Ten-year duration of the plan. The plan cannot have a duration that exceeds 10 years from the earlier of the date the plan is adopted or the date the plan is approved by the stockholders.
- Option terms are exercisable up to a 10-year period.

INCENTIVE STOCK OPTIONS (Cont'd)

- Options are not treated as ISOs (but instead are treated as NSOs) to the extent that the aggregate fair market value of stock with respect to which ISOs are exercisable for the first time by any individual during any calendar year (under all plans of the individual's employer corporation and its parent and subsidiary corporations) exceeds $100,000. Fair market value of the stock is determined as of the date of grant of the ISO.
- An option is considered to be first exercisable during a calendar year if the option will become exercisable at any time during that year, assuming that any condition on the optionee's ability to exercise the option related to the performance of services is satisfied.

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INCENTIVE STOCK OPTIONS (Cont’d)

- Option exercise price must be not less than 100% of the fair market value of the stock that is subject to the ISO, as measured on the date the option is granted. In the case of 10% owners, the option exercise price must be not less than 110% of such fair market.
- At first glance, this may seem to be the toughest task in adopting an ISO Plan for executives of a closely held company.
- However, while the shares are not publicly traded, the valuation solution is normally handled by a “nonlapse restriction”. (See “Valuation of Shares” below).

INCENTIVE STOCK OPTIONS (Cont'd)

An ISO plan or the ISO agreement may contain provisions other than those discussed above, as long as they are not inconsistent with the above restrictions. Such provisions could include for example:

- option vesting,
- the right to pay the exercise price with corporation stock or promissory notes, same-day-sale arrangements (sometimes referred to as "cashless" exercise arrangements),
- stock appreciation rights (including a tandem ISO/SAR in certain circumstances),
- rights of first refusal in favor of the corporation,
- a right in favor of the corporation to redeem the stock on termination of employment, or acceleration of vesting upon a change of control of the corporation.
- Although qualifying ISO dispositions can be reported as long-term capital gains, the bargain element at exercise is also a preference item for the alternative minimum tax.

VALUATION OF SHARES

Treasury Regulations under Sec. 83 provide reliable guidance on determining closely held shares acquired in an employment context. Treas. Reg. Sec 1.83-5(a) provides:

- Valuation. — For purposes of section 83 and the regulations thereunder, in the case of property subject to a nonlapse restriction (as defined in § 1.83-3(h)), the price determined under the formula price will [generally] be considered to be the fair market value of the property unless established to the contrary by the Commissioner, and the burden of proof shall be on the commissioner with respect to such value. If stock in a corporation is subject to a nonlapse restriction which requires the transferee to sell such stock only at a formula price based on book value, a reasonable multiple of earnings or a reasonable combination thereof, the price so determined will ordinarily be regarded as determinative of the fair market value of such property for purposes of IRC section 83.

VALUATION OF SHARES (Cont'd)

A nonlapse restriction is defined as:

- Treas. Reg. § 1.83-3(h) **Nonlapse Restriction.** — For purposes of section 83 and the regulations thereunder, a restriction which by its terms will never lapse (also referred to as a "nonlapse restriction") is a permanent limitation on the transferability of property [w]hich will require the transferee of the property to sell, or offer to sell, such property at a price determined under a formula, and [w]hich will continue to apply to and be enforced against the transferee or any subsequent holder (other than the transferor).
- A limitation subjecting the property to a permanent right of first refusal in a particular person at a price determined under a formula is a permanent nonlapse restriction. Limitations imposed by registration requirements of State or Federal security laws or similar laws imposed with respect to sales or other dispositions of stock or securities are not nonlapse restrictions. An obligation to resell or to offer to sell property transferred in connection with the performance of services to a specific person or persons at its fair market value at the time of such sale is not a nonlapse restriction.

IMPACT OF TAX REFORM – S CORPORATIONS

- If an executive owns shares in an S corporation, ordinary income allocated to the executive (in excess of salary and bonus) is generally taxable at 37% but may be reduced to 29.6% to the extent that a portion of such income constitutes "qualified business income" eligible for the 20% deduction.
- In a typical acquisition of an S corporation by a private equity fund (generally a partnership for tax purposes), the S corporation converts to a C Corporation which would not permit an executive to claim this 20% deduction
- Thus, where an S corporation is the target of a private equity fund, the executive, depending on bargaining power, may require the fund to structure the acquisition in a way in which the S corporation continues its status. A simple example would be for the S corporation to transfer its assets to an LLC or partnership followed by a sale of, for example, 70% of the LLC interests to the fund. The executive would continue to participate as a shareholder of the S corporation in the same pool of profits as the fund.
- See discussion on "20% deduction for qualified business income" below.
- Typically this situation arises where shares are already owned by the executive at the acquisition date. If after, then share grant is more difficult because it is compensation to the executive. Alternatively, if the executive does not own shares in the S corporation target at the time of the acquisition, structuring the acquisition as a partnership (or LLC) as described in the third bullet point above may be preferable since a profits interest in a partnership would permit eligibility for the 20% deduction without a tax on the executive at grant of the profits interest.

IMPACT OF TAX REFORM – PARTNERSHIPS AND LLCS

If the target is a partnership or an LLC treated as a partnership for tax purposes, having it continue in partnership form will enable executives to

- Be granted profits interests without incurring tax on the receipt of such interests, and
- Be eligible for the 20% deduction for qualifying business income.
- Under certain circumstances, it may be able to structure the redemption of the profits interest as being at least in part eligible for capital gains.

20% DEDUCTION FOR QUALIFYING BUSINESS INCOME ("QBI")

- Individuals who are S corporation shareholders or partners in a partnership (or members of an LLC treated as a partnership) or owners of a sole proprietorship, are subject to tax at the individual owner or shareholder, partner or owner level rather than the entity level. Net income earned by such holders of interests in these entities report their share on their respective income tax returns and are subject to ordinary income tax rates, up to the top individual marginal rate (37% under the Act).
- Generally, for years beginning after 2017 and before 2026, the Act allows a deduction equal to 20% of "qualified business income" ("QBI") derived by such interest holders. Individuals may benefit meaningfully from this proposal, since QBI income that would otherwise be subject to a 37% maximum rate may be eligible for a maximum effective rate of 29.6%. However, the QBI deduction is limited to the greater of the owner's share of (i) 50% of the amount of W-2 wages paid to employees by the qualified business during the tax year, or (ii) the sum of 25% of W-2 wages plus 2.5% of the cost of qualified property.

SECTION 409A PITFALLS TO AVOID

- Section 409A generally provides that "non-qualified deferred compensation" must comply with various rules regarding the timing of deferrals and distributions. Section 409A applies whenever there is a "deferral of compensation" payable in a later taxable year than the year the employee acquires a legally binding right to such compensation.
- Section 409A imposes restrictions with respect to:
  - the time of distributions
  - prohibitions against the acceleration of benefits
  - restrictions on the timing of deferral elections.
- Distributions under a nonqualified deferred compensation plan can only be payable in the following situations:
  - separation from service
  - disability
  - death
  - a fixed time or schedule specified under the plan
  - a change in ownership or effective control of the corporation, or a change in the ownership of a substantial portion of the assets of the corporation
  - the occurrence of an unforeseeable emergency

SECTION 409A PITFALLS TO AVOID (Cont'd)

- 409A specifically does not apply to incentive stock options (ISOs) and non-qualified stock options (NSOs) granted at fair market value. However, if a company issues options to a service provider at a valuation below fair market value, section 409A will apply. The fair market value of an option on common stock is defined as the fair market value of the common stock (the underlying security) on the date of issuance. Therefore, the valuation of common stock is critical.
- Section 409A applies to any nonqualified deferred compensation arrangement between a service provider (whether an executive or employee of the Corporation or a partner or member of a partnership or limited liability company). A violation of the statute can result in severe penalties being imposed on the executive.