

Compensation of Target Management Teams in Private Equity M&A

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The typical private equity-sponsored buy-out includes the seller's investment in the future growth of the target company's valuation, a bargain for the participant's active participation in the target company and buy-in for success. The customary approach for private equity buyers is to convey equity participation through equity-based incentive plans. There is a lot of appeal for both buyers and sellers to entertain deal structures with an equity-based compensation component to satisfy cash flow requirements, participant commitment and the creation of a common goal in the success of the target company. Both parties should be aware of the complexities associated with equity compensation which can present some disadvantages that are not discovered until after closing.

Common forms of modern equity compensation include stock, stock options or warrants, profit participation and stock appreciation rights (and the limited liability company equivalents thereof). Each type of equity compensation has its own unique advantages to buyers and participants as well as potential negative consequences for both. Many of these structures are chosen over other structures for their total cost considerations and legal features that meet the operative requirements of the buyer. Both buyers and target management should factor these cost considerations and legal features in their offer and acceptance of this compensation. At a high level, here are a few of the considerations applicable to most all equity-based compensation schemes:

With few exceptions, all equity-based compensation schemes have restrictions and conditions imposed on their receipt, retention, exercise and disposition. These limitations serve to align compensation with the long-term company performance requirements with the ability to mitigate against short-term behaviors. The most common restriction is a restriction on a participant's resale of the equity-based compensation, making the opportunity unique only to the participant. A follow-on close-second restriction is the issuer's right to 'claw back' or repurchase the equity compensation at the same or lesser value than its original valuation, a mechanism that aligns equity ownership with a participant's active engagement.

The common 'management rights' conveyed to institutional investors are commonly omitted in private equity-backed equity-compensation plans, including transactions for roll-over equity, to limit participant involvement and visibility of management discussions and information utilized by the company. Statutory rights are the minimum threshold and commonly the norm.

Economic participation can come in the form of quarterly payments, annual payments, one-time payouts upon sale and the allocation of profit and loss. For private-equity sponsored plans, economic participation can have a minimum valuation threshold that the target must achieve and with exception to allocations, they are most-commonly limited until the target company's liquidity event, which can be years later. Liquidity events include IPOs, sales and sometimes recapitalizations.

Tax implications of equity-based incentives can vary between the types of equity-compensation conveyed. Synthetic forms of equity-compensation are typically taxed as income whereas traditional forms of equity ownership have capital gains treatment

upon disposition. These tax consequences can occur at the time of conveyance, at vesting or disposition. For tax purposes, company and participant interests are not always aligned.

Private equity buyers intend to provide value with the implementation of equity compensation plans. Each type of equity compensation has its own features, making it advantageous in some circumstances and not so in others. Firms frequently roll out an enterprise equity compensation plan that utilizes the same type of equity compensation plan throughout their portfolio to allow for a familiar and efficient form of management. Plans can vary greatly between different firms and participants can find distinctive and meaningful differences between plans although much of these distinctions remain unknown to would-be participants and are not discernable during the due diligence phase of a transaction.