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Getting The Deal Through

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Contributing editors
Will Pearce and Louis L Goldberg
Davis Polk & Wardwell LLP

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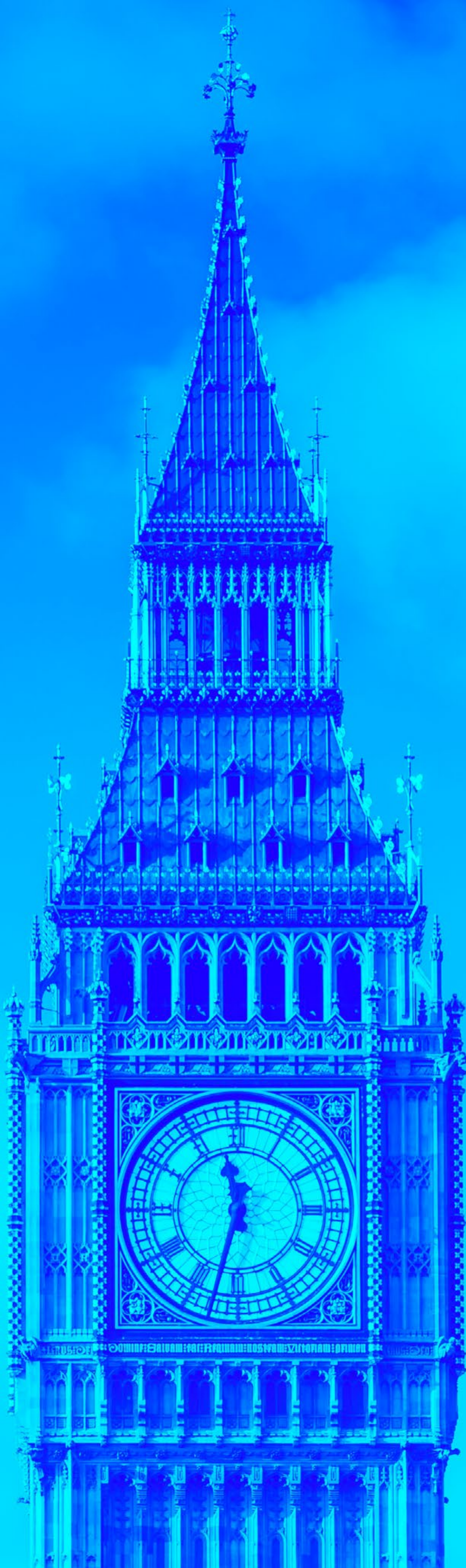

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Incentivising management teams following an acquisition: comparing UK and US practice

Adam Kaminsky and **Neil Sharpe**
Davis Polk & Wardwell LLP

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It is common in the context of a private M&A transaction that the key members of management of the newly acquired business are given an opportunity to participate in the equity of the post-acquisition business. These arrangements are commonly referred to as 'Management Incentive Plans' (MIPs). They are particularly prevalent where private equity funds invest in a business with the intention of exiting on a sale or initial public offering (IPO) after three to five years. Management equity is intended to incentivise key managers to deliver substantial returns for both the investors and themselves over the investment period, with the exit event providing liquidity for the management equity. MIPs are also commonly used where employees already hold equity in the target business, and it is agreed that all or part of those holdings should roll over into the post-acquisition business.

It is usual for the design of the MIP and the allocation of MIP equity to form part of the agreed terms of an acquisition. This means that the members of the proposed management team, whether they are already in place or will take up their roles following the completion of the acquisition, tend to become involved in the negotiation of the MIP at an early stage of the pre-contractual negotiations. The members of the management team are often represented by the proposed CEO, and the management team through the CEO (or just the CEO) will often engage their own outside counsel to negotiate the terms of the MIP (and other employment terms).

The actual implementation of the MIP can often occur quite some time after the acquisition as other transaction-related issues take priority, except in the case of a tax-efficient rollover of existing management equity, which must occur at the time of the completion of the transaction.

While there are a number of similarities in the key considerations for, and terms and structuring of, MIPs in the UK and the US, there are some key differences.

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Delivery of value

MIPs are usually designed to deliver value to participants when the investors in the target business receive a return on their investment in excess of certain thresholds. In the UK, this delivery is usually on a sale or IPO of the business, whereas in the US it is usually restricted to a sale. We refer to these liquidity events as an 'Exit'.

The level of return to participants is usually set by reference to the financial metrics that the investors themselves use to measure the success of their investments. The most common financial metrics used are the internal rate of return (IRR) or the multiple of invested capital (MOIC). The IRR metric measures the annualised rate of return and so incentivises the achievement of an early Exit, whereas MOIC measures the absolute return to the investors and so incentivises overall value maximisation. In the UK, it is usual to use only one or the other of these metrics, while in the US it is a little more common to see both used.

The design of the MIP equity is usually such that relatively small increases in the investment returns result in a disproportionate increase in the value of the returns to participants, thereby incentivising participants to achieve the best possible returns to investors.

It is also common in the US for approximately one-third of the management equity to be subject to time-based vesting rather than investment performance (or another performance metric), so that the longer a participant remains employed by the business, the greater the proportion of the management equity award that vests.

Form of management equity

The form of the MIP equity is determined partly by commercial considerations and partly by the tax treatment.

In UK MIPs, the most common form of equity is 'sweet equity' shares (also known as 'hurdle shares' or 'growth shares') in an appropriate holding company of the post-acquisition corporate group. These are a class of ordinary shares that usually have economic rights based on the investment return metrics referred to above and no voting rights. In the US, the most common form of MIP equity is profits interests in a partnership structure, which generally provide the management equity holder with a portion of the 'upside' over the value of the business at the time that the profits interests are granted.

Both sweet equity and profits interests can be structured so that they attract capital gains tax treatment rather than ordinary income tax treatment in their respective jurisdictions when value is delivered to participants.

Stock options are sometimes used in MIPs in both the UK and US. Restricted stock or restricted stock units are occasionally used in the US, though they are generally less tax efficient (particularly in a private company).

MIP equity pool

The proportion of equity that is allocated for MIPs depends on various factors, including the size of the transaction, the industry, the dynamic between the management team and the

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investors, the policies of the investors, and any previous practice at the target business. The current market practice in the UK is for 10 to 20 per cent of the fully diluted share capital at the time of completion of the acquisition of the target business to be allocated to an MIP. In the US it is around 10 per cent, with the size of the MIP pool often depending on the value of the company. Once this pool of equity has been reserved, it is rare for it to be adjusted for any subsequent dilution, such as for further equity issuances to investors.

Typically, 70 to 80 per cent of the equity pool is allocated at the time of the acquisition (or, as noted above, as soon as practicable thereafter), with the balance reserved for new joiners and promotions. The CEO often receives 20 to 25 per cent of the overall pool and usually recommends to investors the allocations to the other members of the management team.

In the UK, if there is any unallocated equity remaining in the pool at the time of an Exit, then it is common for that balance to be distributed immediately before the Exit – either at the discretion of any remuneration or compensation committee or on a pro rata basis among the existing management holdings. In the US, this practice is less common and only comes up in limited circumstances.

Valuation at grant

In the UK, the sweet equity shares are usually acquired by management at market value. When the initial allocations are made on, or shortly after, the completion of the acquisition of the target, the market value of the shares is usually very low. This is because the shares will not accrue any substantial value unless and until the returns to investors have exceeded certain thresholds on an Exit. A low initial valuation usually means that the participants pay the market value in full using their own funds. If the UK participants pay less than market value for their shares, then they are liable to pay income tax on the discount. Therefore, it is usual for a professional valuation of the shares to be obtained in case His Majesty's Revenue and Customs (HMRC) queries the valuation.

Where shares are acquired sometime after the initial acquisition, such as in the case of the hiring of a new executive or granting equity in connection with a promotion, their market value may be considerably higher than at the time of the initial allocation of shares. In such circumstances, the business may provide a loan to the executive to assist with the acquisition of the shares or create a new class of shares with different economic rights that results in a low initial valuation.

In the US, for profit interests to qualify for favourable tax treatment, they must have a zero liquidation value at the time of grant. This valuation can usually be based on the investors' valuation exercise for the business (which is generally the purchase price when the grants are made at or soon after the closing of the acquisition). Where stock options are granted, the exercise price must not be less than fair market value at the time of grant in order to avoid potential tax penalties in the US.

Treatment of leavers

MIPs usually have leaver provisions, under which participants who leave the business can be required to sell back or forfeit their equity interests within a set period following their departure. The value that such leavers receive usually depends upon the reason for their departure.

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In the UK, it is common for there to be three categories of leavers – good, bad and intermediate leavers – whereas in the US, there are generally only good and bad leavers. Those participants who leave the business for a 'good reason' tend to receive the higher amount of the market value and the initial price paid for their vested equity interests, while those who leave for other reasons get less value, or no value at all, depending on their reason for leaving. To the extent that there is time-vested equity (as described above), the participant will generally lose all of their unvested equity and the vested equity would be subject to repurchase as described below.

The terms of the leaver provisions are often negotiated between the investors and the management team. 'Good leaver' reasons typically include compassionate circumstances such as death or disability and circumstances where the employer has acted unreasonably or in breach of contract. Termination for cause and breach of restrictive covenants will always comprise 'bad leaver' reasons, while resignation without good reason will sometimes be treated as bad depending on the negotiation, with any bad leaver departure generally resulting in participants forfeiting their equity interests for the lower amount of their market value and cost (which, for an equity award that does not require any payment from the participant, is nil).

The repurchase of equity securities in connection with the departure of a participant usually requires a relatively up-to-date valuation of the company's equity interests, to determine the amount to be paid to the participant. Obtaining an independent valuation using an expert valuer can involve considerable administration and expense. An alternative approach (which is fairly common and often part of a negotiation) is to use the last periodic valuation of the business obtained by the investors for the purposes of their internal reporting (or for other reasons) or consider a valuation based on an arm's length transaction, such as a minority investment. In some situations, this approach allows the participants to insist on an alternative valuation by an independent valuer if they believe that the valuation is not accurate but this is generally at the risk of having to pay for the valuation if it is not substantially higher than the investors' valuation. In the US, this right to request an alternative valuation is usually restricted to the CEO and other senior executives, whereas in the UK it is typically available to all participants.

Drag-along, tag-along and put rights

MIPs commonly include drag-along rights, under which investors selling controlling interests in the business can force the MIP participants to sell their interests in the same transaction. Typically, the MIP participants are required to sell the same proportion of their equity interests as the proportion that the investors are selling of their equity interests.

MIP interests are usually also subject to tag-along provisions, under which the participants can elect to sell their interests when investors sell part or all of their interests. The market practice in the UK is for this provision to be triggered regardless of the proportion of investors' holdings that is being sold. In the US, tag-along provisions are common for equity that has been rolled over (see below), rather than for new MIP equity.

A relatively rare feature of MIPs, but one that is often requested by management during the negotiations of an MIP, is a provision that allows participants to sell some or all of their equity to investors if an Exit has not been achieved by a set long-stop date. This most often arises with investors whose investment strategy is to hold investments for a longer period of time and there is a concern among the management team that getting liquidity only upon an Exit would be too long a holding period.

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Equity rollover

Where the management of a target business already holds equity interests in that business, then it is common for those interests to be rolled over in whole or in part when the new investment takes place.

If the target business has distributed equity widely across its employees, then it is usually only the top tier of management who participate in the rollover – less senior employees are often allowed to cash out their equity interests in full when the new investment takes place. Where a proportion of management equity is being rolled over, then it is usually the continuing CEO who rolls over the largest proportion, which is typically a minimum of 20 to 50 per cent with the amount often the subject of significant negotiation.

The terms of the existing equity do not usually prescribe the terms of a rollover, so those terms are usually negotiated between the management team (and sometimes the team's counsel), the new investor and, to generally a lesser degree, the existing business. This means that the management team usually has scope to negotiate more favourable terms than if it was acquiring management equity for the first time, including in relation to leaver treatment, repurchase rights, drag-along and tag-along rights, and dilution protection.

The most common form of rollover is an exchange of the pre-existing equity for the new equity. This approach can usually be structured so that no tax charges are incurred in relation to the exchange.

Where it is not practicable or appropriate to exchange the equity, then the rollover usually requires reinvestment of the cash proceeds received by the management team for their existing equity into new equity in the post-acquisition company. This investment is usually done on an after-tax basis, the executives having been subject to tax on the proceeds they obtained for their existing equity.

Executive participation in investor equity

In the UK, it is not uncommon for the CEO, sometimes with other senior members of the management team, to participate in the same components of equity and debt as the investors acquire the 'institutional strip' comprising preference shares or loan notes, and one or more classes of ordinary shares that are reserved for investors. The executives usually have to make a substantial investment from their own funds in purchasing the institutional strip, further aligning their economic interests with those of the investors. As a result of this investment, the executives' institutional strip is not usually subject to leaver provisions, although annual returns may be reduced for the period after leaving the business. An executive's participation in the institutional strip is in addition to their acquisition of management equity under an MIP.

In the US, to the extent that members of the management team do not have existing equity to roll over (or proceeds from existing equity to immediately invest), they will sometimes be asked to invest along with the investors in the equity of the post-acquisition company on the same terms as the investors. Similar to the investment in the institutional strip, these investments are not usually subject to leaver provisions or punitive repurchase rights.

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Comparison of UK and US market practice

While MIPs are individually negotiated and their terms can vary widely, the table below outlines the broad market practice in the UK and the US in relation to the key features of MIPs.

Market practice in the UK	Key provision	Market practice in the US
Sale or IPO	Exit event	Sale
IRR or MOIC	Common performance metrics	IRR, MOIC, sometimes both Approximately one-third is not subject to performance – time vesting instead
Commonly, ordinary shares (sweet equity) Occasionally, options	Type of equity interest	Commonly, profits interests Occasionally, options, and less frequently, restricted stock units
10 to 20 per cent 70 to 80 per cent allocated initially, 20 to 25 per cent to CEO Unused pool allocated at Exit	Size of equity pool	Generally up to 10 per cent 70 to 80 per cent allocated initially, 20 to 25 per cent to CEO Unused pool generally not allocated at Exit
Good, bad and intermediate leavers	Treatment of leavers	Good and bad leavers
Drag-along and tag-along rights Sometimes, long-stop put right	Put and call rights	Drag-along rights, with tag-along rights common for rollover equity Sometimes, long-stop put right
Typically limited to the most senior executives, with the CEO rolling over a minimum of 20 to 50 per cent of existing equity Usually an equity exchange on a gross (tax-deferred) basis	Equity rollover	Typically limited to the most senior executives, with the CEO rolling over a minimum of 20 to 50 per cent of existing equity Usually an equity exchange on a gross (tax-deferred) basis
Occasionally, for the CEO or most senior executives only	Participation in investor equity	Occasionally, when no equity rollover

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Adam Kaminsky adam.kaminsky@davispolk.com
Neil Sharpe neil.sharpe@davispolk.com

5 Aldermanbury Square, London EC2V 7HR, United Kingdom
Tel: +44 20 7418 1300
www.davispolk.com

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