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Nuts and Bolts on a Management Buyout (Part 4 of 7) [Podcast]

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In this episode of The Proskauer Benefits Brief, partners Michael Album and Josh Miller return to discuss how management can use a “template” to have a bidder identify the way compensation issues will be addressed in an MBO. They also discuss the “rollover” by management of their equity in an MBO. Be sure to tune in and listen for the latest insights and perspective on management buyouts in this fourth of a seven part series.

Mike Album: Hello. Welcome to the Proskauer Benefits Brief. We’re presenting on the nuts and bolts of a management buyout, what management needs to know. I’m Mike Album, and I’m joined by my partner, Josh Miller. And on today’s episode, we’ll be discussing certain ways to get bidders on companies to identify in relevant terms their compensation packages, and we’re also going to address the rollover of equity. Josh, in our earlier pod cast, we’ve talked about the situation management faces about the timing and sensitivity of raising its own situation, and how a prospective buyer will be treating them on the range of compensation, and other issues they need to be comfortable with to go forward with the deal. Can you talk a little bit about a process you use, which is a straw man template or chart, in these situations, and how it can be helpful to management?

Josh Miller: Absolutely. Michael, this is something that you and I have used particularly where there’s a very competitive auction, multiple bidders expressing a lot of interest, seeking exclusivity, really favorable price, and a very hot market. In the typical MBO, bidders would submit an indication of interest that addresses broadly their intentions with respect to employees and management, rollover, and equity compensation, and employment severance protections. These can be very general statements of intent, without a lot of specifics, or they can be very detailed. It really depends on the bidders. So one thing that management counsel can help the team develop is a straw man template or a chart, something that can be provided as part of the bid materials, or to include later in the bid to signal to the bidders the key features that management and its counsel expect to be addressed, and it also facilitates assessment and comparison among bidders. So if you have three bidders, and each address a certain feature, to have those lined up and to compare and contrast, can really help management assess the bids as far as they relate to their own individual compensation, as well as other terms, key terms of their equity and liquidity and so forth.

Mike Album: Right. Before we get into the key terms, Josh, I just want to be very granular here for the audience. What we are talking about is a chart with columns and with rows, and the rows will have designated topics. And what it does, is it forces the bidders or the perspective buyers of the company to address the issues that are important to management in a very efficient way. Management as we've said earlier, is very busy, doesn't have a lot of time, and these charts can be lined up against each other so you can see really material differences between bidder one, bidder two, and bidder three, by putting the charts out on the table. It may be old fashioned, but it's a very helpful process, and again, I think if we turn now to the topics that we would put on the chart, you can get a sense for how helpful they'll be. Josh, why don't you take us through the topics?

Josh Miller: Sure. The key topics that you would expect to see; one is the rollover in investment, your common equity, the proportion that it represents of the sponsor class going forward in the form of rollover is a common interest. Is there a strip of common and preferred equity? It really depends on the transaction and the structure. Can the rollover be tax free, what's the value in terms of dollar amounts, or the percentage of net proceeds in the transaction that will be rolled over? And rollover, it might be structured as an individual commitment, it could be structured as a team commitment, there could be a commitment from one individual, and a bucket for the rest of the team. So there's a lot of different ways to structure that. And often management, in a very successful exit from one sponsor, will want to invest more; find the business to be a good investment, and they have no problem keeping substantial skin in the game.

Mike Album: Right. So I think again, the term sheet has in the left hand column, each row is identified with a various topic, whether it's management rollover, then the incentive equity package, tax distribution, employment agreements, governance, preemptive rights. There are a whole list of things that can go in the left hand columns that will then be addressed by the buyers. So I think the most difficult thing here that Josh and I have wrestled with is the right time to bring this up, and the context in which to distribute these. And that's something that you have to work closely with management to find the right time. Because the seller may view this, if it's brought up too early, as a way that would interfere with buyers reaching the right price level, and view it as an unfavorable action by management. So the timing on when to introduce the straw man template is critical, and that's going to depend on each individual deal.

We have time, Josh, to move to one of the hallmarks of a management buyout from the buyer's perspective, which is the management rollover. And why don't you give us a sort of general overview of what it means to rollover equity. Because from management's perspective, this is money that is based on the deal value of the company they're selling. It is money they could have put in their pocket. Instead, they're keeping their skin in the game by rolling over money that they could have otherwise taken out, hopefully on a tax-free basis, into the new company. And that money is very different from option awards or profits interest going forward because from their perspective, that's really earned money that is now at risk, under the new sponsor. And so talk a little bit about how that money deserves different types of protection than profits interests or options going forward.

Josh Miller: Right. The economic rights and privileges of this type of equity, as opposed to some new incentive equity for the go forward business, as you said, is earned. It's something that the people have, and absent the rollover, would be cashing out, realizing liquidity in the transaction. The sponsors are going to demand rollover for a few reasons. It keeps management's interests aligned with the sponsor, by having skin in the game, by having management actual invest, and have a stake in the business going forward. It also tends to reduce the amount of money that the investing sponsor, the new private equity sponsor, buyer, would need to go out on the market to finance, so it reduces the need to increase debt, amend its credit agreement, any amounts that are funded by management won't have to be funded by the buyer.

Mike Album: Right, and just to jump in here. Management of course wants to see a cap table, or a pro forma cap table, as quickly as possible. Well, when you look at that cap table, you're going to see as part the equity that's being set forth, the sponsor's equity, and then you'll see maybe co investment equity, and then you'll also see management's rollover equity. You know, real equity that management will always want to be treated at the same price and in the same manner as the equity that the sponsor's is putting in the deal.

I just want to make another point before I forget because sometimes it's overlooked. In these deals, there's money that goes out to the sellers at closing, and there's money that's put into escrow, to go out to the sellers at closing later, if certain reps, and warranties, and identification obligations are satisfied. You don't want to lose sight of how that escrowed money or that deferred money is treated with respect to rollover amounts. It's a technical area, but you should make sure that from management's perspective, you're not being shortchanged. And we've dealt with this, where people have to focus on how that deferred money's being handled, so management isn't being shortchanged somehow, with respect to amounts that should have been attributable to rolled over shares, and to which they deserve.

Josh Miller: And then that's particularly an issue when the earn out component of a transaction is sizable. The larger the escrow, the larger the earn out, ensuring that the per unit amounts paid to the sellers are based on the pre-rollover equity ownership, as opposed to only the ownership that's being cashed out on the transaction.

Mike Album: Right. So I think at this point, we're going to wrap up this segment of the pod cast. Thank you for joining us on the Proskauer Benefits Brief. Stay tuned for more insights on the nuts and bolts of a management buyout, and executive compensation, and of course be sure to follow us on iTunes. Thank you.

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