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Nuts and Bolts on a Management Buyout (Part 5 of 7) [Podcast]

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In this episode of The Proskauer Benefits Brief, partners Michael Album and Josh Miller are back to continue their discussion of the rights that management gets when it “rolls” old equity into new equity in the buyout vehicle and then introduce incentive equity awards for management. Be sure to tune in and listen for the latest on management buyouts in this fifth of a seven part series.

Mike Album: Hello, welcome to the Proskauer Benefits Brief, podcast on 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’re going to discuss the rollover of equity by management, management incentive equity, and the structure and operation of a management incentive pool, going forward post-closing.

Josh, the last podcast dealt a little bit with the rollover aspects of management’s investment in the buyer going forward, and how they’ll be expected to keep some skin in the game by taking money that they otherwise could have taken off the table, and roll it over as equity. Those economic interests that management has, management always views as Pari Passu with the sponsor’s equity, same rights. But we all know that as much as they’re putting in, they’re still putting in far less than the sponsor. Can you give a little bit of sense about rights they can expect to have with respect to rollover equity? In particular, can they expect to have any ability to get liquid? Because they may leave the company a year or two after closing, but will their skin in the game be a perpetual investment in the company, or can they get some liquidity when they leave?

Josh Miller: Thanks Mike. Among the various rights that management’s going to want to negotiate for in the various documents are governance rights; management’s participation on the board, or board committees. Often there’ll be a special seat for the CEO, but not always. And it’s important to understand the COO or other management member’s right to participate, right to vote, either as a director or as an equity holder, as well as observation rights, the rules around quorum and notices of meetings. So really the ability to be involved in the management of the company, information rights and access is another very important point: Rights to financials, audited, unaudited, rights to inspect the books. These are very necessary, particularly to the extent that valuation of interests, whether in connection with a buyout, or otherwise, is an issue. Management's going to need that access to be able to make determinations as to whether the value is reasonable and supported. There's other types of protections, often called minority holder protections. These would be protecting individuals against adverse, disproportionate, and material amendments that would impact their rights or economics. This could be on an individual basis, or on a class basis. For example, you can't disproportionately impact the series B, without the consent of the holders of the series B, or a majority of interest of such holders, or the chief executive officer, or management member. There's no right approach, but it's important to understand what ability the majority sponsor has to make changes in the agreements, and the extent to which the minority holders, the management team, will have the right to consent or consult on those actions.

Mike Album: Right. And I'm just, again, going back to the economics of this. These are new investments by management that reflect the appreciated value of what they would have realized on the deal. So management wants to stand side by side with the sponsor's equity. Management is going to want to have tag along rights. If the sponsor sells its equity, management's going to want to tag along to realize a pro rata share of the sale proceeds. The sponsors of course are going to want to have drag along rights, so they can force management to sell, if they want to flip the company to a new buyer.

Management's going to want to have some preemptive rights to maintain their interest in the company. It may not be practical because they may not be able to come up with the dollar amount that's necessary to protect themselves against full dilution, but it's something that we see. And then the last thing is, you want to make sure that you as a rollover equity holder are standing next to the sponsor's equity in the waterfall going forward. You don't want to be subordinate in any way. The operative legal documents here can be quite complicated, LLC agreements with very technical provisions about what happens in connection with proceeds from a sale of the company, or dividend recap, or another type of liquidity event, post-closing. So that's another reason why management needs its own counsel, frankly, to go through and make sure that the interest that it rolls is in fact practically under the documents standing next to the equity of the sponsor.

Josh Miller: Right. And another area where liquidity comes up is termination of employment, as well as to some degree, breach of restrictive covenants. Often a sponsor will not want to let former employees continue to have an ownership stake in the business. They might want to limit the number of holders for securities purposes, for administrative purposes, particularly in a partnership, limiting the number of K-1 partners. As a result, you often see call rights, whereby the company, or if not exercised by the company, its sponsor, can exercise the right and require a terminated management member to sell the interest they have back to the company or the sponsor, usually for a formulaic price. It can be fair market value, as defined in the agreement, which we can get into, in a second. It can be a multiple of EBITDA, or earnings, or it could be some other formulaic price, a bad lever, is someone who has a termination for cause, somebody who breaches a restrictive covenant. Or in some cases, someone who merely quits without notice or without good reason. In those cases, the repurchase price on a call option could be punitive. It could be the lower of cost or fair market value, or it could be a nominal amount, as a way to incentivize good behavior and punish bad actors.

Mike Album: Right. I just want to mention quickly the 280-G issues. Because remember the rollover equity is being funded out of cash proceeds, or the equivalent of cash proceeds, that they would have realized, had there been a sale. It's money that's going into the new company. Other money that people get when there's a sale of the company could be 280-G money, in the sense that it's change of control money with very unfavorable tax treatment. Most of the time in a private company setting, this can be avoided through a shareholder approval process. We haven't really talked about that in our previous pod casts, but the issues involved in cleansing any amounts that would otherwise be payable to management under 280-G is very technical, but very important, and management to be working with its counsel on what would be necessary in terms of disclosure. Because disclosure issues associated with getting a good shareholder vote to protect against the 280-G golden parachute tax are tricky, and management may want to be very careful about the exact way things are disclosed. So the 280-G point is sort of an ancillary point here, but I don’t want to lose it.

I think at this point, we’re going to end this podcast. Thank you for joining us on the Proskauer Benefits Brief. Stay tuned for more insights on the nuts and bolts of management buyouts on our subsequent podcasts, and be sure to follow us on iTunes. Thank you.

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