a few things you should know …

Management Equity Incentives in Private Equity Transactions

In this edition of *A Few Things You Should Know*, we provide practical insights for sellers relating to equity arrangements in private equity buyout transactions.

- **IN A NUTSHELL**
  One of the key advantages of selling to a private equity (PE) fund in an M&A context (relative to a strategic buyer) is the ability to provide greater equity upside to sellers and management. A PE fund will invite (and often require) the target company's management team to roll a portion of their equity stake into the post-closing enterprise (often referred to as rollover equity). In addition to rollover equity, an equity incentive pool may also be set aside for management.

- **EQUITY ROLLOVER BASICS**
  The primary objective of an equity rollover is alignment of incentives between the fund and sellers who will be involved in the post-closing enterprise. Although the size of the actual rollover will vary, the *willingness* to roll a large portion will be a positive factor for the fund. Beyond alignment of interests, equity rollovers can provide many economic benefits to sellers, particularly in a case where the valuation did not meet sellers' expectations (the lower the price…the cheaper the roll). Use of leverage by a PE fund can also increase upside potential for sellers (of course, not without risk). For example, assume that the target company was debt-free at closing and sellers agree to roll 10% of their sale proceeds into buyer equity. Buyer in the transaction is funding 50% of the purchase price with debt and the remaining 50% with equity from the fund. In this simple example, sellers would own 20% of the post-closing equity (not 10%) because the equity value at closing was reduced by the debt.

  Many funds provide that rollover equity will be "*pari passu*" to the fund's equity. References to a *pari passu* rollover typically imply economic equality (i.e., no liquidation preference for the fund). The fund's equity may carry other rights that are not shared equally such as board control and drag along rights.

  In many M&A structures, it is possible to accomplish a rollover on a tax-deferred basis, meaning that any gains on the sale would be deferred (not avoided) until a later sale or exit transaction. Most funds will cooperate with sellers to achieve this result. While a tax deferred rollover is typically preferred, in an LLC/flow-through structure, it can result in disparities in tax treatment for the fund and sellers. The fund will expect to achieve a step-up in basis if possible, but this treatment is often not available to sellers. This disparity can be mitigated through tax distribution provisions, but it is difficult to eliminate unless sellers are reinvesting proceeds on an after tax basis.

- **GOVERNANCE AND MINORITY RIGHTS**
  A fund that acquires a majority interest will expect to maintain control of the board or any similar governing body. Only a large minority holder should expect to have meaningful veto rights attached to their equity, other than those related to self-dealing or other affiliate transactions. In addition, controlling the exit is considered a sacred right of many PE funds. For rollover sellers (even with large percentage ownership), any rights that could disrupt the exit process will be strongly resisted. Holders of rollover equity would typically have preemptive rights to purchase their pro rata share of future equity.

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- **REPURCHASE RIGHTS**
  For a seller that remains employed by the target after the sale, many funds require a repurchase option if employment is terminated for any reason. The purchase price may vary depending on the circumstances of termination (fair market value for "good leaver" or something less for "bad leaver"). For rollover equity, this is often a contentious issue for sellers given that this equity was effectively purchased by them (not granted as an incentive). From the fund's perspective, their goal is to ensure that everyone who owns equity is participating directly in the growth, and no one gets a free ride if they leave the Company. The resolution of this issue varies by fund and by deal, but it is more common than not for rollover equityholders to be subject to repurchase rights in some form. *Most repurchase rights are options for the target/fund to exercise if they wish. It is less common for holders of rollover equity to have a corresponding "put" right to sell their equity upon termination, although this is often a negotiated point.*

- **INCENTIVE EQUITY**
  In addition to rollover equity, a fund will often set aside a "pool" for both existing and new management, with the same goal of aligning incentives. Incentive equity comes in many flavors, depending on the structure of the target and the fund's prior customs. Those can include profits interests, options, phantom equity, restricted stock grants, and equity purchased with a note. Many of these have different tax treatment and different treatment for purposes of receiving dividends. In addition, incentive equity grants are often subject to vesting and performance thresholds, and will typically be subject to repurchase rights on termination of employment. Most funds will have established customs and form documents for equity incentive terms, and may be less likely to alter those terms (relative to rollover equity). *As such, it is important for management to request the details of incentive equity grants as early as possible in a deal process.*

- **THE EXIT**
  Holders of both rollover equity and incentive equity will likely be subject to "drag-along" provisions that require them to cooperate in the sale process. In essence, the fund will have the right to determine and control all elements of the sale process, including who to select as a buyer and any related terms. Sophisticated sell-side counsel may be able to mitigate certain risks for the sellers in a drag-along provision, but it is rare for a fund to eliminate these provisions altogether. The interests of the fund and management in a sale transaction can be aligned in most respects, but management should seek separate counsel to represent their interests, particularly with respect to future equity/employment arrangements with buyer.

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A FEW THINGS YOU SHOULD KNOW is a periodic publication of the Mergers & Acquisitions practice group of Perkins Coie LLP. Each edition covers a discrete topic related to M&A, including identifying key issues to be addressed and related market trends. We also share our experience-based insight into current approaches to resolving common deal issues. *A Few Things You Should Know* is intended as a high-level issue spotting guide and quick-reference resource for buyers, sellers and their professional advisors. Please contact the Perkins Coie LLP attorney listed above for more information.

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