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Management Incentives May Be Revisited After PE Investment

By **Austin Lilling and Nida Javaid** (April 10, 2024, 6:04 PM EDT)


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When private equity investment transactions close, management and private equity investors are off to the races — generally aligned on strategic and financial objectives.

However, as market conditions and the economic climate shift, key parties may become misaligned, and management incentive plans could become underwater or ineffective.

To illustrate, in today's climate, while valuations may have grown, the near-term potential of a liquidity event may be less certain as prospective buyers are waiting for interest rate relief.

Longer, and perhaps unexpected, holds by investors may put pressure on internal rate of return hurdles, place management incentive plans behind larger accruing preferred returns, or push out management's expected timing of realization of value, on both rolled and incentive equity.

As such, thoughtful and attentive boards at portfolio companies may wish to caucus with management to evaluate continued alignment and revisit their management incentive plan and management equity.

While boards may desire to focus on continued retention and incentivizing management toward successful exits, boards may also wish to address explicit concerns of management such as those regarding liquidity, vesting or returns on equity — or sweat equity — which may appear less certain as time horizons become prolonged.

Not All Is Possible

That said, boards revisiting management equity should be aware that not all things are possible, and the nuances of incentive plans and rollover structures may dictate what indeed is feasible.

Understanding such structures and existing terms, the parties' original assumptions and desired outcomes, and the effects of the market on the foregoing are critical to maintaining and enhancing management's focus during uncertain times.

As it relates to incentives, award type matters. For example, profits interests in partnerships — or limited liability companies taxed as partnerships — and stock options are appreciation-style awards that have threshold values or exercise prices intended to comply with or result in exemption from tricky tax rules.

It may not be easy, or even desirable from a dilution standpoint, to reprice or repaper appreciation awards, and doing so may come with tax risk. What's more, phantom awards may not be able to be modified if Section 409A of the Internal Revenue Code is implicated.

Where limitations or undesirables are present, boards may wish to look at additional equity awards or supplemental retention opportunities tied to continued service coupled with strategic or financial short-term goals.

To ensure the intended tax treatment of the original awards, it is crucial to consider the tax regime governing such awards before making any changes or complementing those existing awards with new ones of the sort described, and it is equally critical to consider cash considerations and the dilutive effects of these special awards to the company and on current equity holders.

Performance to Date

Where incentives appear to be working, but market forces are delaying expected exit timing — and thus realization of incentives and rolled equity value — the prospect of change here may be possible. For example, private equity firms may feel it necessary to reward management's interim performance prior to exit.

As horizons for exit become longer, private equity firms may also be asked to consider partial future liquidity opportunities — e.g., put rights — for fully vested awards or rolled equity at more near-term intervals if management continues in service.

Mitigating factors here could be, among others, the availability of cash, the anti-retentive effect that may result from having a substantial windfall of cash in hand or measuring performance prior to an exit — and the realization of an investment for the fund and its investors — each of which renders such opportunities rare.

Bolster Opportunities With New Nonequity Incentives

Setting aside any inclination to modify established incentives, boards may instead wish to craft, or adjust, short-term — e.g., annual bonus — and cash long-term incentive plan opportunities, or offer fixed transaction bonus opportunities tied to continued service through any such closing.

These opportunities could be most relevant if portfolio companies are losing talent, particularly to public companies where both liquidity and equity realization are more readily present.

Perspectives and Precedent

Management and private equity sponsors are likely to have differing perspectives on making midstream changes to incentives or equity participation.

On the one hand, management may wish for its private equity partners to address performance to date and projections that have not yet come to fruition, given that management does not control when businesses sell.

Private equity sponsors, on the other hand, may wish to point to the parties' alignment and agreements as of closing, continued trust in the process, their mutual expectations in the near and longer term, and sensitivity to setting precedent with one but not all investments within the portfolio.

While each portfolio investment is unique, and thus has its own set of potential challenges and opportunities, it would be wise for private equity firms to think carefully about what is appropriate from both an optics and precedential standpoint, and further how fund investors will view enhancements or modifications for management's benefit.

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