

M&A ACADEMY

Management Teams in the Context of M&A Transactions

Speakers:

Austin Lilling and Patrick Rehfield

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Presenters



Austin S. Lilling



Patrick Rehfield

The Morgan Lewis Executive Compensation and Employee Benefits Team

- The Morgan Lewis Executive Compensation and Employee Benefits team consists of approximately 75 lawyers and professionals governing various benefit and compensation concerns and clients of all shapes and sizes, including plan sponsors, executives, plan fiduciaries, and transaction parties.
- Our Executive Compensation team represents buyers, sellers, management teams, and senior executives inside and outside the transactional context with employee benefit and executive compensation matters.
- A number of our Executive Compensation professionals are dedicated to management and senior executive representations, and the particularized concerns they have, including those relating to onboarding with a new entity, separating, or in the transactional arena.

The Management Team Client

- Being engaged by the Management Team, versus a single executive, requires specificity in the engagement letter and discussions with counsel to ensure privilege, scope, and process.
- Who is included in the management team ***being represented?***
- Who negotiates?
 - “Negotiating Committee,” generally led by CEO
- Attorney-Client Privilege: None **among** the team, but privilege is intended **for** the team.
- Interests may vary.
- Withdrawing: What if there is a conflict among the group? If interests diverge, counsel may withdraw from representing one or more members and may continue representing the others.
- Confidential Information: Generally may share info **among the group**, unless the group agrees to keep certain items confidential.
- Working together with other management member’s counsel. Play nicely in sandbox.
- Is the company paying? If so, it should sign the engagement letter but **not** as the client.

Summary of Key Considerations for Management

- What kind of transaction is contemplated? Target type (e.g., public company going private, or PE buyer of private company) and type of transaction (stock or asset sale) may dictate the management compensation process and considerations.
- What does the management team have currently?
 - E.g., Employment agreements, covenants, equity, equity participation, transaction bonuses, retention bonuses, change in control agreements, annual bonuses, and LTIP
 - How are these required to be treated in a transaction pursuant to arrangement terms in effect? Will there be modifications to this default treatment?
 - Equity Rollover/Cashout?
- What will management get in the transaction?
 - New equity arrangements
 - New employment arrangements
 - New covenants (employment and closing-related)
- Deal Considerations: 280G, releases, indemnity/D&O tail protection
- Will management be staying on with the post-closing company? Severance?

Transaction Type and Related Considerations

- Equity Financing (e.g., from angel, venture capital, or PE firm)
- LBO: Public company going private
- Private to Private: Private target being acquired by private equity or other private buyer (e.g., family-held business selling to PE)
- Practice Note re: timing: Fiduciary duties to **public company target**, together with disclosure considerations, will dictate timing of negotiation of management compensation, likely after the shareholder vote. May put pressure on ability to rollover on a tax-deferred basis...

Inventory

- **What does the management team have currently, and will we know what life will look like at and following closing (e.g., roles, structure, compensation opportunities, etc.)?**
 - Employment Agreements:
 - Good reason provisions: role changes (including going private), breaches, and/or relocations
 - Severance/enhanced severance: Pre-CIC and post-CIC severance period and potential enhancements
 - Restrictive covenants:
 - In employment agreement
 - From prior sale transaction
 - Equity award covenants
 - Equity awards and treatment under plans/award agreements
 - Equity/phantom
 - Vesting, CIC treatment
 - Performance measurement
 - CIC Compensation: transaction bonuses, retention bonuses
 - Change in control agreements: May provide for special good reason, enhancements to severance, time periods, and/or equity treatment
 - LTIP (multiyear measurement period)
 - AIP (annual bonus measurement period)

Rollover

- A “rollover” is the amount of value (generally proceeds) that individual managers and/or the management team as a whole are being asked to **invest in the company** effective as of closing. This is normally **in addition to incentive equity**, but sometimes this depends on the size of the rollover investment.
- A rollover accompanies the investors’ investment(s). Rolling equity proceeds into “investor” class of shares with economic rights, *pari passu*, and with institutional investor(s), including any preference. Non-economic rights, such as preemptive and tag along rights, liquidity rights, and provisions for affiliate transactions, decision making, amendments and information rights are also key and ripe for negotiation (LLC/LPA terms are key).
- Again, inventory comes into play as to what **could** be rolled over. For example, if profits interests vs. options, the rollover is different because the options may be “adjusted” into new options in target vs. profits interests being “adjusted” into new investor class of units in target.
- Sometimes a rollover is **mandated**. Further, management **may wish** to roll over because they believe in themselves and their PE partners to grow the business.

Rollover (cont'd)

- The terms of the rollover and how the rollover is effectuated are generally considered pre-closing. If intending to be tax “free” (i.e., “deferred”), then action and structure will need to be undertaken **pre-closing** (e.g., contribution arrangement).
- **How much** is required to be rolled over? **By whom?**
- For longer hold investments, will there be a liquidity opportunity to put rollover equity for cash in the future?
- What happens to the rollover equity if there is a termination without cause/good reason/death/disability?
- Is the rollover significant enough to warrant a board seat, and for how long does that right last? What about observer rights? While a board seat or consent right may not be a veto, it will keep the rollover investor(s) informed about company matters through quorum and meeting notice requirements.

Option/Derivative Securities Rollover

- Could effectuate rollover of derivative securities too, such as options.
 - Considerations here include tax rules, such as Code Section 409A and the ISO rules (e.g., adjustments and/or delaying payout of, for example, RSUs).
 - What is the spread/intrinsic value at closing?
 - Leverage using pricing of investor equity; other tax-driven structures with catch up.
 - Potential expiration of the awards being rolled over (e.g., 10 year term). Consider post-termination exercisability (e.g., for the **full-year** term on rolled options).
 - Will have to understand liquidity opportunities and requirements to sign shareholders/operating agreement.
 - Equity plans need to be studied, which should be done sufficiently in advance of purchase agreement being signed.

Equity Treatment

- If **not being rolled over**, what happens to equity upon sale?
 - Vesting up?
 - Single/double trigger?
 - Required or discretionary?
 - Performance measurement:
 - If the closing is in the middle of a performance period, how are awards to be treated?
 - What if performance is hard to measure, or performance for closing year is back-end heavy?
 - Cashout?
 - Convert into unvested cash?
 - **Practice Note: Consider 280G.** The treatment of equity in the transaction either by the terms of the award agreement/plan or discretionarily by the company board may result in parachute payments.

Incentive Equity

- Incentive equity is the incentive for **go-forward** performance and is generally an upside/appreciation award that participants share in upside from the investors cost basis.
- Structures:
 - Stock options in C corp.
 - Profits Interest in partnership or LLCs taxed as partnership.
 - **Practice Note:** Options on partnership interests are complicated and should be carefully analyzed.
- The most common structure includes a partnership Holdco and/or a management Holdco with back- to-back equity participation (i.e., employees remain W-2 employed down below at operating company and K-1 partner/member at management Holdco).
 - Protective 83(b) election in light of Rev. Proc. 93-27 and its progeny
 - Tax detriments of being a “partner” responsible for self employment taxes (i.e., both employer and employee side), estimated taxes, no flex/cafeteria plan eligibility (so paying premiums AFTER tax), multiple state tax returns—loss of company deduction.
 - Possibility for above-the-line deductions for part of the self-employment taxes and healthcare premiums

Incentive Equity

- **Understand the Structure:**
 - Will incentive equity participants be participating in the **acquired company only** (i.e., equity in the target) or also participating more broadly **in the platform** (i.e., equity in the parent)?
- **True Equity or Phantom:** True equity, such as profits interests or stock options could differ in flexibility of timing and treatment from phantom equity (which is compensatory in nature (e.g., W-2 income)).
- **Tax Treatment:** Ordinary income or capital gains
- **Type and Size of Pool:**
 - Will all employees participate in same pool?
 - Fixed pool size dilution considerations
 - Did the sponsor provide illustrations? Were they realistic?

Incentive Equity

- **Vesting:**
 - **Time:**
 - Length: Three to seven years
 - Frequency: Cliff, annual, quarterly, or monthly
 - **Performance:**
 - MOIC, IRR, mixture, and financial goals
 - Interpolated between rungs?
 - Mechanics and definitions are critical here, particularly on an IPO or deSPAC when value is not immediately realized
 - **Effects of Change in Control (CIC):**
 - Double trigger/single trigger. CIC **then** termination without cause/for good reason
 - Protections for a CIC **after** a without cause/for good reason
 - **Termination Treatment:** Proration, additional vest upon event, and post-termination exercise period for options/SARs

Incentive Equity

- **Waterfall Considerations:**

- Is the holder participating **from threshold value** and beyond or **only in value above** waterfall rungs? For example, do you have 5% of value above \$100M and an additional 2.5% above \$250M, or do you have 7.5% above \$100M.
- Is the holder participating after preferred return? Is there an opportunity to catch up?

- **Allocations of Equity Pool:**

- Who is included in the team for eligibility (e.g., are non-executive directors included or is the pool just for executive employees?)
- Who determines allocations among the team, including reserving dry powder?
- How much is granted at or proximate to close?
- Is the **unused** equity pool value to be **ring-fenced** for management upon the next exit?
 - For example, if 10% pool is fully allocated, but 2% is forfeited upon terminations by participants and not reallocated prior to next close, how is that 2% treated at the next close? Does that value get allocated pro rata among remaining participants? Does it go back to the equity holders?

- **Repurchase Rights:**

- Call rights on incentive equity are not uncommon. This gives the company/PE sponsor the right to repurchase equity held by participants following termination. In effect, this caps upside and allows for regrant of same equity to a replacement employee.

- **Taxation:** Do the awards (e.g., options) permit **net withholding**?

- **Exercise:** For options, does the award allow for **net exercise**?

Additional Equity Terms: Rollover and Incentive

- **Call (Repurchase) Rights:**

- By when must the company/sponsor make the election to repurchase?
- What is the repurchase price?
 - Valuation date: The longer the repurchase period, closer to the election date is when the valuation should be occurring
 - Rollover vs. incentive equity: For cause?
 - Payment timing/close
 - Payment Consideration: Cash or **promissory note**?
 - What if the parties do not agree on value? Is there an appraisal right? Is it for any awardee or just senior management? Who pays for the appraiser?

- **Put right:** On rollover equity, is there a right to put shares, either at an agreed-upon liquidity window(s) or following a good leaver termination?

- **Transferability:**

- Estate planning transfers
- **Drag and Tag Rights:**
 - Covenants and Releases
- Required Rerollover? May not be ripe to handle at grant unless executives desires regarding “staying on” are clear. “Last Hurrah!”

Additional Equity Terms

- IPO:
 - Registration rights
 - Release from transfer restrictions following lockup
 - Equitable Adjustments
 - Pro rata Dilution
 - Minority Protections:
 - Prohibition on disproportionate amendments, affiliate transactions, information rights, notice, and consent rights
- Note:** C Suite should understand sponsor's fees (e.g., monitoring, investment banking, advisory, etc.). This is often not factored into sponsor return for performance vesting.

Employment Agreements

- Will new employment agreements be implemented? Are amendments to current agreements contemplated?
- Does current employment agreement or CIC/severance agreement get implicated, for example good reason, in connection with the transaction (e.g., no longer being CFO of a *public company*)?
- Terms to negotiate:
 - Base salary (e.g., no decreases)
 - Bonus (including for transaction year)
 - Equity entitlements (if not one-time)
 - Perks
 - Severance protection: Base severance, bonus element, prorated bonus, completed year bonus, COBRA subsidy, equity treatment, and outplacement
 - Definitions: Cause/Good Reason/Disability
 - 280G protections (e.g., best net after tax)
 - Post-termination restrictive covenants, in addition to those in place or put in place relating to closing
 - Indemnification and D&O
 - Employment conditions (role, location, and reporting)
 - Post-closing structure (Who are the parties to, or guarantors of, the employment agreement obligations of the Company?)
 - Dispute resolution and attorneys' fees
 - Releases

Restrictive Covenants

- Restrictive covenants include noncompetes, nonsolicitation restrictions, confidentiality, intellectual property, cooperation and nondisparagement.
- They show up in various places;
 - Employment Agreement: Applies during service and following termination
 - Covenants Agreement: Applies for a fixed period following closing
 - Equity Documentation: Variable. Could apply for fixed period or for entirety of equity holdings
 - **These may continue beyond the other covenant periods because equity need not be repurchased following termination.**
- Executives often assume that they are **not enforceable**. Understand what you are signing
- Scope and length: What is the business and for how long are the covenants applicable?
- Carveouts?
- Remedies: Injunctive relief, damages, and/or loss of awards
- Cooperation:
 - Scope of cooperation: Does it include “transition” or is it limited to assisting in disputes/audits, etc.?
 - Compensation for executive’s time?
- Consistency across various covenant sets

Internal Revenue Code Sections 280G/4999

- Sections 280G and 4999 concern golden parachute payments to disqualified individuals, which could include top officers, top highly compensated employees, and >1% shareholders that are also service providers.
- Need a **corporation** in the mix.
- Parachute payments can include transaction compensation (e.g., bonuses), vest ups, severance, etc.
- There is a statutory parachute payment limit of 3x the historic five-year compensation (prior to the closing year). If parachute payments equal or exceed this 3x amount, then any amounts over **1x such average** are subject to potential excise taxes to the individual and loss of deduction to the company.
- **These issues are addressed in the transaction, and there is a process for targets, which are not public companies, to “cleanse” any 280G exposure.**
- **This may require individuals to waive excess amounts, and submit them for shareholder approval. Education for management is key here, as well as understanding target’s cap table and the sophistication of target’s voting equity holders.**
- **Public company disqualified individuals are not eligible for this cleanse.** Other mitigation factors (such as noncompetes and income planning) are revisited in those instances, prior to closing.

Questions?

Austin S. Lilling



Austin S. Lilling

New York

+1.212.309.6822

austin.lilling@morganlewis.com

Austin focuses on issues relating to executive compensation arrangements and employee benefit plans. He regularly provides comprehensive counsel to senior executives, management teams, boards, key stakeholders, and employers on the design, negotiation, implementation, and administration of employment agreements; severance agreements; change in control arrangements; corporate and partnership equity and phantom equity compensation arrangements; qualified and nonqualified deferred compensation plans; welfare plans; retention; incentive; and other compensation and benefits arrangements. He has been listed in *Chambers USA: America's Leading Lawyers for Business* since 2021.

Austin S. Lilling



Patrick Rehfield

Washington, D.C.

+1.202.739.5640

patrick.rehfield@morganlewis.com

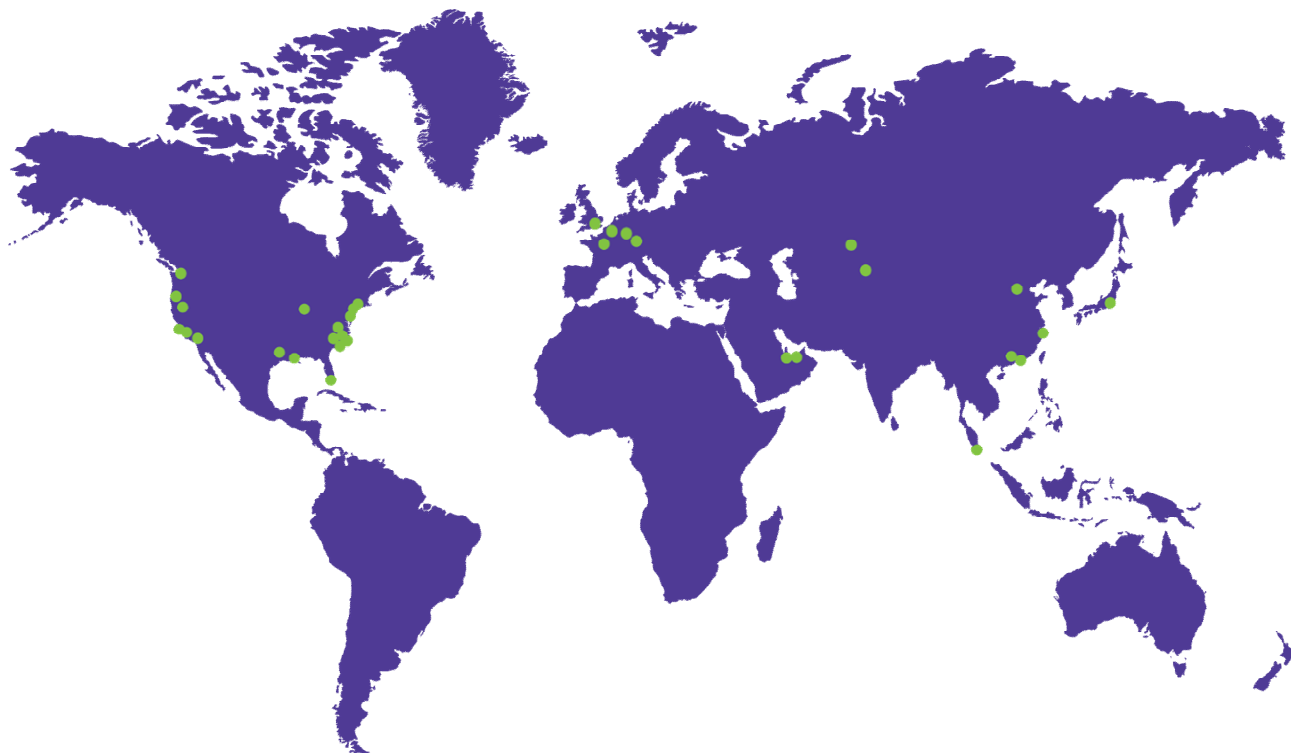
Patrick focuses on matters related to executive compensation, payroll tax, and employee fringe benefits. He advises private and public companies on designing and implementing nonqualified retirement plans, equity compensation plans, and executive compensation arrangements. He also counsels publicly traded companies on reporting and compliance matters involving the SEC, with a focus on proxy and disclosure issues, executive compensation, and corporate governance. He advises public and private companies on employee benefit issues in mergers and acquisitions, including executive compensation matters for senior management.

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Hartford
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