Management Incentive Equity: Rights and Restrictions

A Practical Guidance® Article by Sarah McLean, Shearman & Sterling LLP

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This practice note outlines the key features of, and considerations relating to, incentive equity. Equity-based incentives are an integral part of compensation packages used by private equity-backed companies to attract, retain and incentivize executives (the management team) and other employees. For additional information on management equity incentives, see Management Incentive Equity in Private Equity Transactions, Conversion to Partnership Tax Status: Tax Risks Associated with Management Equity Incentives, and Restricted Stock, Stock Options, and Equity Incentive Compensation Plans for Start-Ups.

Private equity-backed companies are risky investments, including for the employees managing them. As a result, equity-based incentives are vital to such companies and employees and are attractive because they allow the parties to shape and mold them to meet their collective goals. Although there are many ways to structure equity-based incentives, this practice note outlines some of the common features of them and the considerations of all parties when negotiating them (but does not include a discussion of all possible features and permutations).

Overview and Structure

Although there are many ways to structure an equity incentive for management, and structuring decisions are often driven by tax considerations (which are outside the scope of this practice note), a common feature of incentive equity is that the ultimate value received by the holder of the incentive equity award will be derived from the value of the underlying company or business, and often directly tied to the ultimate value received by the equity investors with respect to their capital in the underlying company or business. In this practice note, the term "equity investors" refers to those equity holders who contributed capital to purchase their equity interests and "incentive equity holders" or "holders of incentive equity" refers to those equity holders who were granted their equity interests.

The value of the underlying company or business is typically based on the equity investors' return on their investment (ROI, sometimes also referred to as multiple on invested capital or MOIC) and/or internal rate of return on their investment (IRR). ROI is calculated by looking at, for each dollar of capital contributed, how many dollars were returned. If an investor "gets their money back," that is a 1.0 ROI. There are no considerations given to how much time passed between contributing the capital to the company and receiving the distributions from the company. IRR is not as straightforward a concept but simplistically, equals the discount rate (e.g., 10%) that makes the net present value of distributions received, with respect to an equity investor's capital, equal to the capital contributions made to the company by the equity investors.

Less typically, the value of the underlying company or business used in calculating the value of an incentive equity award may be based on other financial metrics such as earnings before interest, taxes, depreciation, and amortization (EBITDA) or annual distributions equity investors.

The rights to distributions with respect to an incentive equity award are often referred to as a "waterfall" and written as a tiered process that works progressively. So, of course, the higher the value of the underlying company or business, the higher the value of the incentive equity award. But, because of the progressive nature of the waterfall, the last dollars of value of the underlying company or business are more valuable to the holder of the incentive equity award than the first dollars. For example, if an incentive equity award gives the holder the right to receive 5% after a 1.25 ROI, 10% after a 2.0 ROI, and 20% after a 3.0 ROI, and the aggregate invested capital is $100 and the aggregate distributions are $400, the incentive equity award will have a right to $33.75, but $20 of that is attributable to the additional value in excess of $300.

Practice Tip

If you are evaluating an incentive equity proposal (or competing proposals), be sure to take note of the following:

- If management also has a capital interest in the company, whether the incentive equity is paid by reducing the distributions received by all equity investors or is paid by reducing the distributions received only by the nonmanagement equity investors (or a hybrid). If management also has a capital interest (and is thus also an equity investor) and its distributions with respect to such capital are being reduced to "pay for" the incentive equity, the incentive equity is less valuable to management.
- If there is an IRR component, how the IRR is calculated, (including how the discounting works (monthly, quarterly, etc.)). It is a good idea to put together a model to visualize the waterfall math, especially if comparing different offers or options.

Control and Other Restrictions

Individual holders of incentive equity will typically not have any control or minority rights, other than with respect to provisions personal to them (e.g., amending restrictive covenants). A minority of equity investors view the incentive equity pool as being for the benefit of the management team and employees as a group and, as long as they follow certain parameters (e.g., diversification and caps on awarded amounts), they allow the management team to make decisions regarding who the incentive equity is granted to, how much is granted to each person, whether to exercise repurchase rights, etc. More typically, though, the equity investors will control the incentive equity, including decisions regarding grants, repurchases and even fundamental changes such as increasing the overall size of the incentive equity pool (thus diluting the value of the incentive equity of all holders). On its face, this seems counterintuitive since the management team is managing the company, its business and its people, and has more firsthand knowledge of employee performance and incentive needs. However, this is in line with the equity investors' desire to control the company completely.

With respect to amendments to the incentive equity (including through an amendment to the underlying governing documents of the company), the right to consent to such amendment is typically given to the holders of the incentive equity as a whole (e.g., approval by 50% in interest) rather than to each individual holder. And it is typical that the holders of incentive equity only have the right to consent to amendments or changes that both disproportionately and adversely impact the incentive equity. So, if the equity investors and the holders of the incentive equity are equally adversely impacted, then there is no consent right for the holders of the incentive equity.

While control or any affirmative rights for incentive equity holders are unusual, restrictive covenants, and transfer restrictions are typical. Depending on the relevant state, restrictive covenants can include non-compete covenants, nonsolicit agreements, confidentiality agreements, no-hire covenants, and similar restrictions, not only while an incentive equity holder is an employee, but also extending beyond the period of employment. Transfers of incentive equity are prohibited, other than certain transfers for estate planning purposes that comply with specified guidelines.

Practice Tips

- When thinking about the rights of incentive equity holders, even if you represent the interests of the management team rather than the equity investors (unless you represent just one individual receiving incentive equity), you should negotiate both through the lens of an individual receiving incentive equity and through the lens of the company, because if there is an issue with one holder (whether while they still are employed or after a termination), in most cases all the other incentive equity holders' interests will be aligned with the interests of the company.

- From an incentive equity holder's standpoint, focus on eliminating the ability to fundamentally change the incentive (potential value) represented by the incentive equity. If the equity investors can increase the number of "units" available to incentive equity holders without consent of any incentive equity holder, there is potential for significant dilution of the value of a holder's incentive equity. In addition, if the economics of how the incentive equity is calculated can be changed by the equity investors without the consent of the incentive equity holders, there is potential for a change in value of a holder's incentive equity.

Vesting and Forfeiture

Since the primary purpose of incentive equity is to incentivize employees, awards of incentive equity are subject to vesting and forfeiture based on the holder's employment status. Vesting can be time-based, value-based (or a combination of time-based and value-based), or cliff.

Time-based vesting is vesting spaced over time. For example, 25% of the incentive equity award vests on the first, second, and third anniversary of the grant date. Value-based vesting is vesting that occurs as capital is contributed to the company. For example, if investors have a $500 commitment to a company, vesting may be such that 25% vests when the first $100 is contributed, 25% vests when the second $100 is contributed, and so on. Value-based vesting is typically combined with time-based (so to vest, both the period has to have passed and the contribution threshold has to have been reached). With both time-based vesting and value-based vesting, it is common for the equity award to vest in full upon the occurrence of a monetization of the company (often called an exit). Cliff vesting occurs when none of the incentive equity vests until an exit, at which time all the incentive equity vests.

Subject to special negotiated circumstances (such as a known or planned retirement) when a holder ceases to be an employee of the company, the incentive equity vesting ceases and the unvested incentive equity is forfeited back to the company for no consideration. Sometimes, such as a termination by the company for cause or a resignation by the holder without certain reasons, a holder will also forfeit the vested portion of its incentive equity for no consideration.

One negotiated issue that varies from deal to deal is who gets the "windfall" that arises if some of the incentive equity is forfeited by a holder but not regranted to another employee. If, for example, (1) the company has four holders of its incentive equity and each has a 25% interest in the incentive equity pool with cliff vesting on a monetization or exit and (2) one ceases to be an employee, forfeits his or her incentive equity, and the equity is not regranted to a replacement employee or anyone else, who gets the distributions with respect to that 25%? Do the other three get 33% of the distributions? Does the incentive pool shrink and thus while the other two get 33% of the distributions, the amount distributed to the incentive pool is reduced by 25% (meaning that each still gets what they would have but for the forfeiture)? Or do the employees and management team share the 25% in another way?

Practice Tip

How a monetization or exit event is defined can be important. Is an initial public offering (IPO) included? What about a partial monetization by the investors (with or without a change in control of the board or management of the company)? If an IPO is not included as a monetization event, would the way an IPO is defined preclude a sale that is structured as a backdoor IPO from being a monetization event (e.g., a merger into a public shell or an acquisition by a special purpose acquisition company (SPAC))?

Distributions

Incentive equity is actual equity in the company, and the holders of incentive equity are entitled to distributions from the company as described in Overview and Structure above. However, the timing and amounts of such distributions may be limited by the organizational documents of the company. The common limitations relate to (1) distributions to holders of incentive equity prior to the committed capital having been completely funded, (2) distributions to holders of incentive equity with respect to their unvested incentive equity, and (3) tax distributions.

Since the "value" of incentive equity is directly related to the returns received by the equity investors, if the equity investors have made commitments to fund capital to a company but have not yet funded all of the committed capital, there may be a holdback of distributions attributable to the incentive equity until the time in which it is clear that by making such distributions, the incentive equity will not be receiving excess distributions (which, if received, would be required to be returned). For example, if (1) the capital commitment of the investors is $200 and they've funded $100, (2) the incentive equity waterfall provides that the incentive equity receives 20% of distributions after a 2.0 ROI, and (3) the company sells a portion of its business and generates distributable proceeds equal to $250, then looking just at the waterfall, the incentive equity would have the right to distributions equal to 20% of $50, or \$10. However, if after the distribution the company calls the remaining \$100 of capital and it generates only a 1.0 ROI, then the cumulative ROI (\$350 on \$200 of capital) does not meet the 20% hurdle. So, if the incentive equity had received the \$10 of distributions initially, the holders would need to "repay" the company the overdistributed amount. Since investors do not want to collect money back from the holders of incentive equity, provisions may be included that provide that the distributions that would otherwise be made to holders of incentive equity are held in escrow or retained by the company until the minimum ultimate return of the equity investors is certain. There is not typically any interest earned on the withheld amount.

In certain circumstances, investors will require that holders of unvested incentive equity should not participate in distributions with respect to the unvested incentive equity. This can either mean it doesn't participate at all—that is, all distributions go only to vested incentive equity, or that the distributions attributable to unvested incentive equity are held by the company either directly or in escrow until the unvested incentive equity either becomes vested (at which time the holder would receive such distributions) or is forfeited (at which time either the holders of vested incentive equity, the equity investors, or a combination, would receive such distributions). There is not typically any interest earned on the withheld amount.

In a pass-through LLC or partnership structure, a holder of incentive equity could be allocated taxable income in a year in which the holder did not receive any other distributions. Thus, without tax distributions, a holder would be required to pay the taxes on the allocated income with funds from other sources.

There are other less common limitations on distributions, including, in circumstances in which the capital contributed will be significant, a cap on the total amount of distributions the incentive equity can receive, regardless of the return, and what the waterfall would otherwise provide.

Practice Tips

- With respect to tax distributions, think about (1) the rate for which the distributions are calculated (if you or your client is an individual in New York, receiving tax distributions at Texas rates will be insufficient), (2) whether the distributions are made annually or quarterly, and (3) how the amount of the distributions are calculated (i.e., whether operating distributions in a previous year are netted out of current year tax distributions).
- With respect to any distributions being withheld by the company either directly or in escrow, think about bankruptcy and creditor risk.

Repurchase Rights

Upon termination of employment, typically the vested portion of a holder's incentive equity (that was not forfeited upon termination) will be subject to repurchase by the company or the other holders of incentive equity. Oftentimes, the purchase price for such repurchase is paid by promissory note with a nominal interest rate that is payable on a monetization or exit event. Factors that may be considered in structuring the repurchase right include (1) the reason for termination, (2) the stage of the company (e.g., if a company expects a monetization or exit event within a relatively short period of time, the repurchase provisions may give the holder additional rights in connection with such monetization or exit), and (3) whether the equity investors view the incentive equity as belonging to management as a group or belonging to management as individuals (if the equity investors view the incentive equity as belonging to management as a group, the repurchase right is often held by the other holders of incentive equity).

The relationship between the reason for termination and repurchase right has several facets. A termination in which the holder is not a "bad actor," for example, death, disability, and a resignation for a defined good reason, may either not include a repurchase right (although this would be unusual) or include the repurchase right, but with a better price for the holder or better terms (cash rather than a promissory note or an ability to object to the company's proposed repurchase value) or include the repurchase right and a reciprocal put right if the company does not exercise its repurchase right.

Practice Tip

With respect to repurchases of vested incentive equity, focus on (1) who has the right to repurchase and how long do they have to make an election to repurchase, (2) the mechanics of how the purchase price is determined (who makes the determination, whether there is an option to object and how a dispute on value is resolved), and (3) how the purchase price is paid (cash or promissory note and if a promissory note, the terms thereof).

Monetization Events

In almost all cases, holders of incentive equity will be required to participate in a monetization of the company pursuant to the terms negotiated by the company. If the monetization is structured as an asset sale (including the sale of subsidiaries of the company), the holders of incentive equity will receive distributions from the sale pursuant to the waterfall and are typically not required, with respect to their incentive equity interests, to participate in the sale or sign agreements associated with the sale. If the sale is a merger and it is approved as required by state law, the holders of incentive equity receive merger consideration as provided in the merger agreement (which should be in line with the waterfall) and are typically not required, with respect to their incentive equity interests, to sign agreements associated with the merger.

However, if the sale is a sale of the equity of the company, then the holders of incentive equity are required to actively participate in the sale and execute the sale agreement and various closing agreements, without any input (or very limited input) into the terms of those agreements. This is accomplished, if not willingly by the holders of incentive equity, by a drag-along provision in the company's governing documents. The drag-along provision provides that if certain equity holders desire to sell the company as an equity sale, the other equity holders (including incentive equity holders) must participate in the sale on the same terms and conditions. The drag-along provision usually outlines that all representations and warranties and indemnities must be made pro rata in accordance with the percentage of the company a seller is selling and what additional covenants a seller may be required to be bound by (including restrictive covenants). The drag-along provision further provides that if an equity holder does not willingly participate in the sale, a designated individual or entity will have a power of attorney to sign relevant documents and bind the reluctant holder.

To counter the mandate of the drag-along provision, holders of incentive equity are often given a tag-along right. This right provides that if there is a sale of the equity of the company and the specified equity holders do not elect to enforce the drag-along right and include the incentive equity in the sale, they can opt in to the sale by virtue of the tag-along right. The tag-along right works like the drag-along but without the power of attorney (which is not needed since the holder is making the election and thus has indicated it wants to be an active participant).

But what if the equity investors sell some, but not all, of their equity in the company? Should the holders of incentive equity have a right to participate in that sale? If so, on what terms? While it seems fair that if the equity investors are selling a significant portion of their capital interest, the incentive equity should participate, it is challenging because the incentive equity value is calculated based on the distributions the equity investors receive for their entire capital interest. Thus, to make an equity sale of less than all of the company work such that the incentive equity gets full value for their proportionate amount, either the valuation for a portion of the company has to be grossed up to a presumed valuation of the entire company, the waterfall has to be calculated by looking just at the capital being sold, or another pro forma valuation method has to be used. Investors are wary of this because the value of their remaining equity in the company may ultimately be less.

Another issue that arises in connection with monetization events occurs is when a buyer wants the management team to stay with the business after the sale. In such case, a buyer will often want management to "roll" a portion of the proceeds from their incentive equity into the business as a capital interest. If this rollover amount is distributed to the holders of incentive equity at the time of the sale (or received directly by them in the case of a direct equity sale) and then contributed back to the company as capital, that is not tax efficient. Thus, management will want to keep a portion of their equity in the company rather than selling it. Structuring rollovers in a way that is tax efficient is challenging and, in such instances, the interests of management and the other equity holders of the company are not aligned.

Practice Tip

In reviewing a drag-along provision, carefully determine whether there are potential requirements for additional restrictive covenants in connection with the sale and what the parameters of those requirements are. Also make sure the drag-along provision preserves the waterfall mechanics when allocating the purchase price among the various equity interests of the company.

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