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Understanding executive arrangements in private equity

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Private Equity (PE) owned companies are at the height of growth and expansion in the U.S. and abroad. While SPACs and de-SPACs are leading in transactions and melding private and public companies with record numbers throughout 2020 and into 2021, PE management teams are also in demand.

Public company executives are leaving their jobs to go private at an increased rate, so knowing the rules of engagement is critical for an executive and her employment attorney.

This article addresses key aspects of private equity structure and what executives need to know before they enter negotiations. The next article will examine the specific terms that are commonly found in executive compensation packages.

Understanding the deal

When an executive is considering an opportunity at a private equity owned company or even when her employer is considering recapitalization, several issues in the pre-employment and transaction process are important to contemplate before the employment agreement, and ancillary documents are presented. Before any compensation arrangement is discussed, the executive and the company need to get to know each other and the executive needs to understand the sponsor's structure, goals, and its level of involvement in the company's management.

Once there is a negotiation around the business deal, a few issues should be negotiated that are atypical of public company employment arrangements, such as the executive's co-investment or 'rollover' terms and the equity incentive grant that will represent a large portion of the executive's ultimate pay-out at "exit."

Once the employment-related agreements are presented, it is important to negotiate all terms such as the cash compensation, benefits, termination related provisions, restrictive covenants and how the executive's equity grant will be affected in the event of termination. Having counsel and tax advisors who are familiar with each step of the process helps ensure that the deal and terms are fair and equitable in the short and long term.

The structure

Before delving into the details of any executive compensation package, it is critical for the executive to understand the type of industry they are joining, what the structure of their role will be on the management team and what the goal of the company and its investors are toward the return of their investment.

Because little public information is available about PE-backed companies (unlike public companies), it is critical for those looking to lead PE-backed portfolio companies to gather information directly from the sponsors and the company. For this reason, the timeline for negotiating such roles is often a little longer, as the information-gathering and 'interview' stage may take time. The executive should remember that she is not just being considered for a job — she is considering taking on this opportunity, not just as an executive but as an investor.

Because the timelines for investments are significant (usually at least five to seven years) and the ultimate pay-off comes at the investor's liquidity event, the executive must be comfortable with the partners of the sponsor considering the deal as well as with the rest of the management team she would be joining.

Management and governance

One key corporate governance difference for executives of portfolio companies is board involvement and board membership. It is not uncommon for CEOs of public companies and closely held private entities to hold the role of both Chairman of the Board and CEO, allowing the executive to wield control over both the company itself and the directors. In portfolio companies, while the CEO is often a member of the board, the control typically lies with the PE sponsor (depending on percentage of ownership) and the CEO may not be in a position to have control over the board.

The portfolio company's Board of Directors appointed by the PE sponsor (typically comprised of PE's advisors in the specific industry and partners running the deal on behalf of the PE), is often much more involved and exudes far greater oversight over the company's strategy and the CEO's or other executives' performance. As a result, the executive should also get to know the prospective members of the Board and understand whether this will be a hands-on or a hands-off Board. Understanding the general approach of the sponsor and its style of managing the companies through the life of the investment becomes essential.

Investment timeline and goals

In order to effectively negotiate long-term compensation, the executive needs to understand the investors' goals and how to best align her interests with theirs. The two data points a portfolio company executive needs to understand are the PE sponsor's desired timeline of the investment and the exit strategy.

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It is also important to understand where the company is in its growth stage. Investor risk and interests may differ for portfolio companies that represent distressed assets versus those that are in a growth stage going through a second or third round of funding. This can result in varying amounts and types of equity compensation and investment opportunities for the executive. It is key to understand the kind of liquidity event investors are anticipating — whether it be a sale of the company to another PE, an initial public offering or SPAC, or a divestiture of sorts — and what will allow the executive to negotiate vesting terms that appropriately compensate her for reaching those goals.

Therefore, the executive (and/or her counsel) should request the capitalization table which may provide an analysis of the company's percentage of ownership, equity dilution, value of equity in each round of investment by founders, investors and other owners, and timelines/information about liquidity events. Finally, being able to anticipate whether and when future injections of capital are forthcoming may allow an executive to protect her equity interests from significant dilution in later funding rounds.

Executives as owners: co-investment

CEOs (and other senior officers) of portfolio companies are often asked to become co-investors with the sponsor as part of their joining the company. The co-investment requirement will be an additional portion of the employment package that requires negotiation.

While public company executives are often compensated in a mix of cash and equity grants on an annual basis, PE-backed executives are asked to make their co-investments at the outset. Unlike long term incentive compensation (typically granted only at the outset of the initial PE investment or executive's employment and taking many different compensation forms), an executive's co-investment will be in the form of actual stock or membership interests in exchange for a cash payment that the executive will make at the start of employment.

In certain transactions, equity holders in the company being acquired or going through the transaction, including founders and key members of the management team who are staying on post-transaction, may be required to co-invest by rolling over a portion of their ownership stake into the new equity capital structure put in place by the acquiring PE firm in lieu of receiving all of their proceeds from the transaction. This type of co-investment is known as "rollover equity" and is attractive to private equity investors because it reduces their cash outlay and helps align investor and management team objectives.

Transfer restrictions and sale rights

The equity terms of the co-investment should align as much as possible with those of the other investors. An executive should seek *pari passu* treatment with respect to any preferential treatment upon certain corporate events and transactions and certainly with respect to any other management equity holders, such as former executives who have departed the company.

Ideally, management equity holders will hold the same tag-along and drag-along rights as other investors, so they may participate in any sale of the company in full. Similarly, management may press for preemptive rights to invest in upcoming capital raises to prevent dilution of their investment.

Finally, asking for the same piggyback registration rights allows executive equity holders to participate in an IPO on the same terms as majority stakeholders, allowing for quicker and more valuable liquidity of the investment.

Valuation

Equity valuation in private entities presents a greater challenge than those where a public market exists. Because the value of equity will be subject to some interpretation, executives should understand how the company will be valued at certain exit and liquidation points and how such valuation is determined.

It is not uncommon for legal language in the governing documents to allow the Board to make determinations of equity value in good faith. In any case, the executive and her counsel should make sure that the executive has access to the company's books and records and quarterly/periodic financial statements. Additionally, the executive should negotiate to have audit rights so that she may challenge any unfavorable valuation assessments.

Treatment of co-investment upon termination of employment

While an executive is considering the deal going in, they must also understand how her co-investment will be treated upon a separation from employment. If an executive is not allowed to hold on to her co-investment post-separation from service, the equity will likely be subject to a repurchase right which should be valued in an equitable manner, at a minimum price, with the type of protections noted above.

Also, given that the co-investment equity will be illiquid, an executive may seek a put right on this equity so that she may be able to force a sale of her interests upon a separation. While not necessarily common, this can be particularly helpful to allow a clean break for the executive by taking her money out of a company that no longer wants to employ her.

Conclusion

The management team executives are embarking on a new employment relationship. Understanding the deal between themselves and the PE sponsor, the executives will find that the need for information and the importance of alignment and engagement are critical for their success and the success of the business. While PE companies have created a large market for talented executives, a certain level of risk and investment is necessary for this employment relationship to be successful.

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