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Negotiating executive arrangements in private equity

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Unlike a public company, Private Equity (PE) portfolio company executives will be negotiating terms and conditions of employment that are driven by time and performance and achieving growth and liquidity. The concept of an "exit" and liquidity upon an exit are the driving forces in a management team's compensation structure.

Other key legal definitions such as "cause" and "good reason," restrictions and dispute resolution provisions, for example, may be similar to any executive employment agreement and should be fully negotiated on market terms. This article will examine the specific terms that are commonly found in executive compensation packages in PE.

Incentive compensation: success measurements

In addition to co-investment, portfolio company senior executives will often receive an up-front grant of incentive compensation to further align their interests with those of the company and the PE. Such grants are usually large upon joining, rather than smaller annual grants during employment (additional grants should not be expected unless there are additional transactions throughout the executive's employment).

Together with the co-investment, the initial equity compensation grant should bring the CEO's ownership stake to a meaningful 1-5% (or more) of the portfolio company and will trickle down for the rest of the management team.

Types of equity

Incentive compensation in the private sphere can take many different forms. Executives coming from public companies may be accustomed to incentive compensation in the form of restricted stock units (RSUs), which track the value of the publicly traded stock and are settled in either stock or cash. RSUs are atypical in the PE world, where there is a limited market for such equity (restricted stock is sometimes doled out for early-stage employees and founders).

Instead, stock options, profits interests, phantom equity or other similar forms of deferred compensation grants, depending on the corporate form of the company, are the usual form of incentive compensation. While these types of equity grants may have more favorable tax treatment (with PE sponsors often wanting to ensure that the proceeds from the equity grants ultimately qualify for capital gains treatment) than RSUs (which are taxed as ordinary income), payments are typically triggered only upon a change of control or another corporate transaction.

At the stage where the executive and her counsel are advised about the form of equity and the size of the grant that will be made, it is important to include the executive's accountant and/or tax counsel in review of certain documents and negotiations so that the tax consequences of any grant are fully considered and negotiated, if needed.

Vesting terms and performance metrics

No matter what type of grant an executive will receive in connection with the new role, their incentive equity grants will likely be tied to the performance of the portfolio company, and the ultimate 'pay-off' will come when the sponsors have received their expected return on investment.

While a portion of the executive's incentive equity grant may vest over time, often a significant portion of the grant will vest upon achievement of specified performance metrics, usually measured at the liquidity event. These metrics are generally based on the measurements of either the internal rate of return (IRR) or multiple of invested capital (MOIC), or both. Because the latter is not measured in respect of time, it is a more forgiving metric for companies that may take time to grow or turn around.

Treatment upon exits and liquidity event(s)

Executives should also negotiate how equity is treated upon both their own exits from the portfolio company as well as that of the investors.

The former is based on typical termination protections, such as acceleration or continued vesting upon termination without cause or for good reason, which allows the executive to terminate the agreement and be treated as if she had terminated without cause in certain circumstances. The latter is based on the definition of a liquidity event and whether that event will result in an acceleration of vesting, or will simply allow vesting to continue, based on a converted performance metric.

Establishing a fair repurchase mechanism based on different termination of employment scenarios is similarly important here as it is with the co-investment equity discussed above.

Restrictive covenants

There will often be restrictive covenants, such as non-compete and non-solicitation provisions, tied to an executive's equity compensation grant and, in some circumstances, the executive's

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rollover equity (in addition to employment related restrictive covenants).

Courts are more inclined to enforce restrictions in these contexts since they relate to the sale of a company or another corporate transaction. The executive and her counsel should keep in mind that the restrictions should be limited to the portfolio company, and not any successor or affiliated entity, which may have far broader application and scope.

Cash compensation and perquisites

The cash portion of executive compensation packages in PE-backed portfolio companies has often been slightly lower than that of executives of public companies. Further, salary will vary on industry and size of the portfolio company, and bonus opportunity will generally be expressed as a percentage of base salary. Much of this is often dictated by the pattern and practice of the specific PE sponsor involved in the deal.

Bonuses may be tied to specific performance metrics, such as EBIDTA, or meeting growth-based goals. Executives transitioning from larger public companies should also be cognizant that PE-backed companies are less inclined to offer expensive perquisites and benefits, because PE companies want to preserve cash during the investment.

Employment agreement terms

A comprehensive agreement for an executive will not only address all the compensation issues described above but will also create rights and obligations associated with being a senior executive of a company. Wendi S. Lazar and Katherine Blostein, "Executive Employment Agreements," Executive Compensation Library on the Web, XCLW, 06/06/2011, originally published as "Changing Economy Impacts Executive Pay," BNA Pension & Benefits Daily, 172 PBD, Sept. 09, 2009.

This should include specific and articulated duties and authorities. Likewise, in addition to protections of the long-term compensation and equity investment upon termination, the executive should have a severance entitlement. Depending on the strategy and structure of the deal, the executive and her counsel may want to negotiate a change in control severance, given the fact that a change in control occurrence may not automatically result in a full vesting of all equity but the executive's position could be changed or eliminated through the transaction.

Finally, there may be post-employment restrictions and confidentiality obligations that should be subject to legal review, particularly if those restrictions can be broadened upon a sale to a larger successor entity.

Conclusion

It is important to be informed of the details and pitfalls of these types of negotiations but also to be aware of the fact that each transaction and negotiation could be different because of the PE or the target company involved.

Whether one is a seasoned PE executive or a public company employee looking to switch to the private sphere, having experienced advisers that can opine on the legal documents and the dynamics of the deal is necessary. The executive should look to retain experienced counsel and tax advisers once the job prospect is solidified and preferably before any term sheet is signed — those individuals can become the executive's trusted advocates and advisers in the negotiation and potentially through the life of the deal.

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