MANAGERS AND MANAGEMENT PACKAGES : MAIN TERMS TO NEGOTIATE BEFORE COMMITTING TO AN LBO TRANSACTION

Isabelle Cheradame,
Partner, Scotto & Associés

In the event of an LBO transaction, managers are required to invest alongside the investment fund, their new majority shareholder. In addition to their roles as operating executives of the group, they therefore wear a second « hat », as minority shareholders.

If managers naturally know their group as well as understanding its potential very well, they often are not necessarily experts in private equity and therefore need to be able to make an informed decision before committing to invest their own money in an LBO transaction. It is important to clearly understand and agree – before any commitment is made - on the terms and conditions of their investment. And as for any agreement, the devil is of course in the detail.

First of all are the financial terms and conditions. The investment proposal that is made to managers is usually conditional to certain IRR and/or multiple targets being achieved for the investment fund on eventual exit.

There are different mechanisms that can be used to structure a management investment programme (MIP), either through "sweet equity", "ratchet" and/or "pari passu". With each mechanism there are advantages and disadvantages.

The financial proposal may be presented to managers in different ways, for instance putting forward the percentage of share capital to be held by the managers, or the multiple they may achieve on their investment on the sale of the business. In any event, it is important to break down the proposal, to take into consideration the overall transaction structure and to run various simulations taking into account several circumstances, as various parameters (such as different classes of securities issued, terms of the debt subscribed by the company, or a mere delay in the implementation of the business plan) may have a substantial impact on the management's investment and its outcome.

Once the financial conditions have been clearly set and agreed, it is key to ensure their proper "translation" into

the legal agreement. Lawyers and financial advisers need to make sure they speak the same language in order for the financial proposal to be properly reflected in the documentation.

Financial terms alone are not in themselves sufficient to achieve a "good" management package. It is necessary to anticipate the various events that may occur during the course of the LBO transaction, following a decision by the majority shareholder, and that may have a dilutive effect. This may be the case in the event of a new injection of capital, a contribution of assets, etc. It is therefore important to anticipate the impact such events may have on the minority shareholders and to ensure contractual mechanisms for their protection. The circumstances may vary widely depending on the size of the envisaged transactions, the economic situation of the group and the financial ability of managers.

The rights and obligations of managers with respect to an "exit" should also be discussed and agreed in detail, especially as the position of different investment funds for an exit may greatly differ. Various events need to be considered, such as the transfer by the investment fund of a minority stake, a majority stake or its entire stake. What are the rights of managers regarding their stake in these circumstances? Given that majority and minority shareholders do not benefit from the same powers of decision in respect of the triggering event, and since they usually hold different classes of securities and benefit from a different tax structure, it is key to clearly ascertain the potential consequences of those events for the managers in their capacity as minority shareholders, notably with respect to their liquidity, exit rights and obligations such as "tag-along" and "drag-along" provisions, representations and warranties, etc.

The same applies in the event of a listing: numerous subjects need to be discussed and detailed, whether it relates to the change of the legal structure upon listing, "lock-up" periods, liquidity rights upon listing or subsequently, etc.

Another key subject for MIPs relates to the case of departure of a manager before an exit ("leaver provisions"). The reasons for a departure of a manager are various (resignation, dismissal, retirement, long-term sickness, …) and are not necessarily the result of the choice or fault of the manager. These leaver events may occur quickly after the new majority shareholder has taken over or on the contrary, just prior to an exit. The position of the majority shareholder with respect to the consequences of such leaver events may be very different between investment funds. Some funds will agree that the departing manager benefits from a portion of the added value during the ownership period, some other funds may only permit the manager to recover their original investment amount, and some will even try to request the leaver bears a loss in certain cases. Financial consequences will furthermore vary depending on the economic situation of the group at the time of the departure.

There are therefore many circumstances to discuss and clarify in order to reach a good balance between the parties.

Managers should also discuss governance with their future shareholder, in order to avoid any misunderstanding as to what type of governance, communication and cooperation is expected by the investment fund. Here again, investment funds' practice may differ largely. Some funds will grant the management team a large independence and request updates and discussions during a monthly board meeting, others will want to be closely involved and impose more restrictive thresholds on key decision matters above which their approval will be required. Other funds may involve various consulting companies alongside the management team. Each practice has pros and cons. Management needs to clearly understand the investment fund's modus operandi before committing to this common project, in order to avoid any future frustration or disagreement, which ultimately could lead to a leaver scenario for the manager. The same applies with respect to the group's strategy and development: discussing and agreeing strategic direction ahead of the transaction will enable both majority and minority shareholders to ensure they are aligned, thus avoiding misunderstandings and disagreements.

Last but not least, it is important to analyse the management's investment structure, and more globally the transaction's structuring, from a tax point of view and this well ahead of the transaction in order to ascertain the tax efficiency and robustness of the investment scheme for managers. Tax authorities keep a close eye on LBO investments and if not properly structured, the management's investment conditions are the most likely to lead to a tax control or even a tax reassessment. Furthermore, once the investment has been implemented and finalised, it is usually very difficult to rectify or change the structuring and a "faulty" scheme may consequently be very costly for managers.

MIP matters are more numerous and complex than one might think, and as a result, managers should not agree on mere principles before committing to invest but discuss those matters in detail in order to avoid any misunderstandings and disappointments.