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The Biggest Mistakes in Management Participation Programs

Management participations are standard in MBO/LBO transactions by financial investors. The aim of financial investors is to combine their interests with those of management. Employees shall become entrepreneurs. The implementation of management participation has become continually more professional during the past 20 years. Nevertheless, in practice one still sees mistakes made in both the process and the actual structuring that can lead to the lack or even negation of the positive effectiveness of management participation.

Tax issues

In the German Federal Fiscal Court's decision of 4 October 2016 (IX R 43/15, Federal Tax Gazette (BStBl.) II 2017, 790), taxation of management participations as capital assets was finally confirmed, thereby putting a stop to the increasing tendency of the fiscal authorities to qualify such income as salary.

For the Federal Fiscal Courts, the most important criteria for the qualification of management participations as capital assets are as follows:

- Purchase and sale of management participations at market price.
- Participation with effective risk of loss.

This judgment should cover many typical management participations. However, if the management participation has divergent elements, which, if applicable, manifest an additional connection to the employment relationship, one should be cautious. The question of demarcation of salary and investment income will continue to be determined by an overall assessment of the facts of the case. This overall assessment can still lead to a qualification as salary.

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In structuring management participations, a careful drawing up of agreements is therefore essential in order to avoid negative tax consequences.

Management participation should be strictly separated from the employment relationship. In particular, a commitment to granting management participation should not be included in the employment agreement. Employment and management participation issues should also be regulated in two separate term sheets. One should always avoid the impression that management participation is a component of compensation according to the employment agreement.

Since the fiscal authorities now also require presentations on the proffered management participation from private equity investors, these should be carefully examined with regard to representation and the language used. One should avoid terms such as “compensation”, “incentives” and “sweet equity”, so as not to create the impression that management participation represents compensation. Ultimately, management participations are capital investments with a risk of loss and therefore not compensation.

Problems arising from IFRS 2

Even when all these aspects are taken into consideration, problems can arise from the other side. A phenomenon that was almost never considered until now – because it is rather new in actual application – is the treatment of management participation programs in international accounting according to IFRS. IFRS 2 regulates the preparation of balance sheets for share-based compensation. Typically real and virtual option or stock option programs are covered by IFRS 2, because companies grant their employees compensation related to share price or TSR (total shareholder return) as long-term incentives.

For those who do not work with IFRS 2 on a daily basis, it can be surprising when the accountants qualify the acquisition of a participation in a company on the same conditions as the majority shareholders (financial investors) as share-based compensation according to IFRS. As previously mentioned, a capital investment with risk of loss that is customary on the market is not compensation, but rather a financial investment. However, this consideration does not play a role for the purposes of IFRS 2. In fact, it is enough that the capital investor is an employee of the company and the participation program provides for a so-called leaver scheme, i.e., purchase options for the financial investor in the case of termination of the manager's employment relationship. Because this is the prevailing opinion of the certified accountants based on experience, the CFO concerned must accept this qualification.

In fact, this point of contention was rather symbolic for many years, because there was no dispute that personnel expenses for a participation program were to be included in the balance sheet according to IFRS 2, if the manager had acquired the participation at market value. If the manager had acquired his participation at the same price as the financial investor close to the time at which the financial investor took part, the participation program would be mentioned as share-based compensation, but with the statement that no personnel costs are to be recorded because the manager acquired the participation at market value. (One who is not knowledgeable about IFRS would thereby conclude that no share-based compensation could exist per se.)

In recent years, the practice has asserted itself in some – primarily the larger – accounting firms according to which, without prior consultation, the accountants interpolate the internal valuation units with a special audit for a fee. In many cases, the assessors would then come to the conclusion that the managers had acquired the shares for less than market value, for which personnel expenses according to IFRS 2 would be included. This is a remarkable assumption, because the structuring of the financial instruments is carefully examined regarding tax matters and is also negotiated between the shareholders. – The problem could be limited by communicating two things to the accountant:

- No compensation for a valuation report as a special project.
- The company will assess the financial instruments itself. The function of the accountant is to examine the valuation of the company for plausibility.

Seniority in management discussions

Discussions of potential management participations are a matter of principle and should be carried out as such. The initial negotiations with management typically take place on the C-level on the management's side. This means that the managing directors or board members negotiate the management participation for "their" managers from the 2nd and 3rd levels. In this respect, it is important that, on the part of the private equity investor, the negotiating partner is on the same level. Therefore, on the part of the private equity investor, (senior) partners should also carry out the discussions. In practice, one often sees negotiations and discussions being delegated to younger colleagues as a bothersome burden.

In this context, it should not be underestimated that for managers who are executing a buy-out for the very first time, such a process contains many uncertainties and unfamiliar situations.

This uncertainty is increased if the management team does not feel valued by their counterparts. The first step in establishing trust is to treat one's counterpart as one himself wishes to be treated. This means that the management should be treated with appreciation and respect as a negotiation partner. In particular, one sign of appreciation is if the partner of the private equity investor leads the discussions with the management. Our experience demonstrates that being on the same level also has something to do with age and experience. This is not absolutely necessary, but a discussion among persons of the same age and with the same amount of experience will be simpler than when there is a significant age difference.

Timing / explaining to management

Within the scope of M&A proceedings with potential private equity investors as acquirers, the management plays an important role. Private equity investors need the management to manage the company to be acquired. The seller needs the management to facilitate a structured sales process and to present the company to be sold as completely and positively as possible. In this respect, the management is often designated the third party in the sales process.

It is even more important for the seller to integrate a management team (particularly one that is inexperienced) and to prepare it for the future. Frequently, there are still anxieties and reservations on the part of the target management regarding a private equity acquirer; it is essential to dispel these. It is also important for the success of the transaction to ensure that the management knows the expectations of a private equity acquirer and his operating method. In practice, it has proven to be advantageous to instruct the managers of the target to be sold beforehand. Such preparation for the managers with regard to the roadshow has long been common practice in IPOs. Even a management team that has no experience with private equity should be professionally instructed, so that they can much more easily have discussions with the private equity bidders because they are speaking the "same" language.

In this day and age, M&A proceedings have become faster and more complex. Today, management participation should typically already be agreed upon before the transaction is signed (at least on the basis of term sheets). Normally, there are multiple bidders involved in negotiations, while the management must also take care of management presentations, Q&A sessions, inclusion of data in the data room, disclosure processes, etc. It should not be forgotten that the management must also keep the company's operations going.

In this respect, the management needs support on a range of topics, such as guarantee undertakings, employment agreements for managing directors and precisely such management participation, all of which affect the managers personally. Therefore, managers should be provided advisors who are well-versed in the subject matter from the beginning. On the one hand, this serves to save management's time and, on the other hand, the managers are much more open and target-oriented, because they have competent sparring partners on their side, who can guide them through this range of topics about which the managers often know very little. Finally, the management advisor is responsible for representing the managers' interests, but also for making a deal possible and explaining the nuances of the market to the managers.

Reps and warranties upon entry

Due to increasing competition, there is currently a sellers' market. This means that the sellers can dictate the conditions. This is also reflected in the guarantees within the scope of a company sale and purchase agreement. Within the scope of a standard transaction, the seller will often put forward a very lean sale and purchase agreement with very few guarantees that transcend legal title guarantees. In order to ensure a competitive advantage within the scope of auction proceedings, the bidders prepare a very "light" markup and often forgo an extensive guarantee catalogue for the bidder. On the one hand, we see a tendency for the seller to "countersign" the guarantees from the company sale and purchase agreement by submitting a so-called directors' certificate or officer's certificate by the management. However, with the proviso that the obligation to submit is not laid down in an existing management participation program or an exit bonus agreement, the management has no obligation in this respect. Generally, there is no obligation to submit guarantees arising from the employment agreement or the position as managing director.

On the other hand, the buyers try to get these guarantees, which they don't want imposed under the company sale and purchase agreement, from the management by way of a so-called warranty agreement. The management is sometimes given very extensive warranty agreements, according to which the managers should ultimately provide guarantees on the operations of the target company, as in a company sale and purchase agreement. Here, the guarantees that the buyer does not get from the seller are effectively shifted to the management. In some instances, in particular with Anglo-American private equity bidders, one sees that they insure these warranty agreements with a reps and warranties insurance policy.

In the meantime, in Great Britain there are special providers that also insure such guarantee catalogues for management teams in order to reduce risk. This has not yet been tried and tested in Germany.

For the managers, guarantees are a highly emotional matter. Ultimately, the managers are liable with their private assets. Often, however, the liability is limited to the exit bonus or the acquired management participation, but these often represent significant sums for a single manager. In this respect, a management team that is unprepared will always react defensively to such a request. Therefore, the management team should be informed of the content and consequences in the preliminary stages of such a transaction. Otherwise, there could be delays and friction between the parties.

Finally, each bidder should carefully consider what he really needs and what are actually optimal expectations on the part of the advisors. In any case, submission of a warranty agreement is a competitive drawback for the bidder, if other bidders only request this within a reasonable scope or do not request one at all. In practice, there were cases in which bidders have withdrawn this demand due to the tight schedule of the proceedings and a defensive management team. Thus, from the manager's point of view, this is proof of trust.

Complexity

One stumbling block in the fast-moving transaction is the complexity of the contractual documentation that is submitted in management participations. In times in which merely the term sheet on the management participation is 20 pages long, contractual documents that are short, succinct, and clearly written can give a private equity investor the edge.

The scope and content of a term sheet certainly also depend on the particular transaction. Sometimes there is an impression that the term sheet is more a document for the advisors of the buyer and that there is certain narcissism in the documents produced by the advisors. Here, the private equity investors should consider whether a three to five page term sheet would be sufficient and what clauses must absolutely be in the term sheet and which ones could possibly be included later in the complete documentation.

In deals that are solely based in Germany, primarily involving SMEs (small and medium-sized enterprises), it is recommended to write both the term sheet and all documentation in German. The material itself is complex enough for the managers and if language barriers are added, this can lead to a defensive stance.

Within the context of a secondary transaction, where applicable, it can be of advantage if the provisions are based on the existing documentation, because the management is already familiar with these documents. Due to the increasing complexity of participation agreements drawn up in English, private equity investors should review the contractual documentation for comprehensibility and readability. Based on experience, we doubt whether many managers actually can or want to understand a (in particular, an Anglo-American) participation agreement that is 120 pages or more in length. Occasionally, one can get the impression that the participation agreements are, in the end, only to be understood by the writer himself, i.e. also not by the financial investor.

Too many participants at too low investment amounts

The motto of many private equity investors is: "We back the jockeys and not the horses." In this respect, the management is a significant factor for a successful buyout. However, management participations must not just be drawn up, but must later also be managed.

Due to a lack of experience, the company's managing directors tend to include a large group of people in the participation program. In this case, the financial investor should bring his experience into play. It is better to include fewer people, but do it properly. Investment amounts under EUR 50,000 are not worthwhile, because time and effort are not commensurate with the return. Exceptions prove the rule, for example regarding participants from emerging economies.

There are programs with over 250 participants that were barely manageable in the exit process and later in the execution. If one nevertheless decides to have a very large group of participants, the agreements must provide for rules that in certain cases do not require a vote by all members and that they must also not expressly act; rather there are representation and power of attorney solutions solely for the execution that take tax provisions into consideration.

It is rather recommended that one should work with bonus or virtual participation models for the third and fourth management levels. This means that these persons do not make an investment and that the proceeds from such models are subject to full income tax liability. However, in case of doubt, one cannot convey an investment to this group of persons whose turnover rate is much higher than in the upper levels of management.

Bonus or virtual participation models have the advantage that everything can be regulated with regard to economics, because topics such as beneficial ownership or overlapping of the capital commitment relationship through the employment relationship do not play a role and the tax treatment as salary is clear-cut.

It must always be determined on a case-by-case basis, whether and how much one can in turn calculate possibly applicable tax payments arising from diffrent bonus programs as business expenses for the employer company. Depending on the particular structuring, hidden distribution of profits cannot be excluded generally.

Economics

The market average of the relevant economic parameters for management participations has barely changed in the last 20 years. However, in recent years there has been observable improvement in the economics for the managers. It remains to be seen whether this is due to the fact that competition between the financial investors has also increased with regard to the management teams, or whether this is just a temporary phenomenon. In any case, diversification of the models offered has increased.

Recently, participation models have appeared on the market that provide for so-called hurdles or performance shares. Hurdles or performance shares are shares that only participate in distributions of dividends or profits when certain total profit thresholds are exceeded. This model is widespread in France and the U.S. It has not yet been much tested in Germany.

Legal issues

Several legal issues should be noted that in practice have caused problems in the course of drawing up, managing and executing management participations in recent times.

When granting financing loans to participating managers, it is often forgotten that managers are frequently considered consumers in legal terms. This means that the loans granted represent so-called consumer loans. Unless the respective reporting requirements and revocation policies are observed, the participating manager has the right of revocation and not only with regard to the loan, but also to the investment made. This may be awkward when the growth of the management participation is negative, because under certain circumstances the manager can then demand the return of his invested capital.

With regard to American management participants, it should be considered that the management participation pooling vehicle, in particular with regard to FATCA (Foreign Account Tax Compliance Act), has duties to cooperate and the participant in the management participation should make provisions to submit the respective documents upon admittance.

In drawing up the pooled management participation vehicle, one should already determine how it will be liquidated after a successful exit. Especially when many managers are no longer available after they have received the exit proceeds, liquidation of the pooled management participation vehicle can be difficult. In this respect, regulations or power of attorney solutions that do not require further action by the managers are welcome.

Communication

Finally, a recurring issue should be pointed out which, alongside all legal, tax and economic issues, may be one of the most important within the scope of a private equity transaction. The parties do not listen well and often talk about each other, but not with each other.

A transaction will be successful only when the parties actively listen to each other. In psychotherapy, there is a method of active listening developed by the American psychotherapist Carl R. Rogers that has long been used. This says that one must empathize with the interlocutor, follow along in the conversation, and should give one's attention and show one's interest to the interlocutor. These things seem understood to all parties, but in practice they are often disregarded and can then lead to misunderstandings, barriers and defensive behavior on the part of management.

This does not mean that understanding automatically means agreement. However, if one feels understood, it is a sign of appreciation and respect, which should be the basis for successful cooperation of the financial investor with the management for the years until exit.

Conclusions

Management participations in the form of equity participation are standard within the scope of private equity transactions. When they are properly structured and drawn up, they are advantageous for all parties. Mistakes can be easily avoided if one takes certain pivotal legal, tax and economic points into consideration. In all legal and economic matters, one should not forget the interpersonal aspects and communication. Otherwise, the advantage can quickly become a disadvantage; no one wants this to happen and it can significantly jeopardize the transaction process.

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