

Performance Vesting — Great For Alignment, But Trickier Than You Think

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Incentive equity awards based on performance vesting have long been present in growth company capital structures. Increasingly, these structures are used in U.S. middle market buyouts as a complement to time-based vesting. Yet while widely used, performance vesting is sometimes only partially understood.

Performance Vesting – Structure and Theory

Performance vesting can take a variety of forms. Most commonly, performance vesting terms provide that an incentive equity award will vest when a financial sponsor achieves one or more specified levels of return, calculated most often as a multiple of invested cash, or MOIC.

Performance vesting awards are typically issued in tranches. These often begin at hurdle rates of 1.5x to 2x MOIC and have one or more ascending vesting benchmarks above the initial level (e.g., 2.5x, 3x, 3.5x), usually topping out around 4x but sometimes higher. If the "tracking" investor achieves the specified return outcome(s), the grantees of the awards become entitled to their fruits.

This contrasts with time-based awards, which vest if the grantee simply remains employed, regardless of the level of equity value appreciation. Performance vesting is agnostic with respect to different types of incentive equity awards and works across the full range of them (e.g., profits, interests, options, restricted stock and phantom equity), albeit with different mechanics and dramatically different tax consequences.

Performance vesting schemes sometimes involve additional or alternative vesting metrics, such as internal rate of return when the timing of the investment return and not just the absolute amount of the return is important. But MOIC is generally viewed as the most straightforward metric for measuring success and aligning the interests of investors and management.

The foundational principle of performance vesting is that management should do better and better when and as investors do better and better. Offering an ever-increasing share of the equity value pie as equity value increases is thus designed to motivate management to deliver superior results.



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In effect, an owner offering an incentive equity award based on performance vesting says to the grantee

We would be happy to have you own X% of the company and realize \$Y from this venture if we could be assured of Z outcome(s). So we will devise a scheme that will put you in the \$Y position but only if and to the extent outcome Z actually happens. And if Z occurs (assuming the arrangement involves a "catch-up" described below), it will be as if you had owned X% above your buy-in price after preferences are paid, as long as there are sufficient proceeds overall to achieve that.

Performance Vesting — In Practice

Despite the general ubiquity of performance-based vesting in the capital structures of post-buyout and other growth companies, relatively little attention is often paid to how performance vesting actually works. Also, there is little conformity of language and approach in this area.

This is a somewhat surprising state of affairs in an environment where a strong desire for smooth transaction processes and clarity of rights, coupled with the work of trade groups such as the National Venture Capital Association and American Bar Association to move market participants to a certain uniformity of "market terms," have resulted in a general convergence of terms in other areas such as mergers and acquisitions and investment agreements.

Picking from a file (a pile, actually) of recently observed performance vesting provisions, a typical performance vesting provision would require vesting if an identified sponsor "realizes proceeds of [specified levels of MOIC] in cash or liquid securities on a Company Sale (including dividends prior to the Sale), on a fully diluted basis." Straightforward and simple, right?

Performance vesting provisions such as the example above can be applied with reasonable clarity when the liquidity outcome is a sale of a company for cash, paid entirely at a closing and with all MOIC hurdles clearly satisfied after giving effect to full vesting. But what if:

- The currency of a sale transaction is equity that is not publicly traded such as a rollover equity interest;
- The sponsor gains liquidity through a series of sales of minority interests and/or dividend recaps;
- There are escrows and/or deferred or contingent payments, so that achievement of vesting targets based on MOIC otherwise occurs serially over time, not in one fell swoop at a closing, a situation that is often compounded by the fact that incentive equity interests in the seller may no longer exist after closing;
- After closing the sponsor invests additional capital in a deal with MOIC-based performance vesting targets, either before or after the original performance targets have been achieved; or
- The issuer goes public and the sponsor gains liquidity over time through a series of market sales and/or in-kind distributions to limited partnerships?

Each of these hypotheticals may represent an outcome that is not the likely exit event envisioned when a deal comes together. But in most situations at least some of these alternative scenarios are plausible or even reasonably likely.

From the sponsor's perspective, "fair" performance vesting terms should provide for a larger cut of equity for management only if and when the target return is locked in and cannot shrink.

From a grantee's perspective, "fair" vesting terms would provide that vesting may be delayed until the sponsor's return is known and secure, but should give the grantee his or her full rightful proportion of the aggregate proceeds from the venture as and when that occurs.

Between these two perspectives, there are notable gaps in terms of practical implementation, and multiple opportunities for disputes at the time of exit. The lack of clarity across various outcomes can be particularly acute in option-based schemes and schemes involving restricted stock, which typically lack detailed "waterfall" provisions describing how aggregate proceeds of liquidity events are to be apportioned, especially as compared with the LLC context.

There is no "correct" approach to performance vesting. Addressing every one of the "what if" scenarios noted above (and more) may cover the angles but result in a more cumbersome set of agreement terms than is useful. On the other hand, failing to anticipate and consider these issues at all, if only briefly, may result in outcomes that are quite different from what is hoped for by one or more parties.

To avoid such outcomes and the possible disputes that they may provoke, a list of key planning ideas for performance vesting award programs would include the following.

Incrementalism

To get incentive vesting right, it is useful to think of liquidity of investments and related operating company waterfall provisions as a sequential, incremental process, even if liquidity may actually occur all at once. This borrows from the concept of waterfalls in fund investment agreements, where liquidity is by definition sequential as separate investments are sold.

In this regard, it is useful to think of investment returns as a first dollar to last dollar sequence, with each incremental dollar having a "code" directing how it is to be allocated, embedded in the waterfall.

Catch-Ups

Catch-up provisions are a key element of performance vesting waterfalls, closely tied to the concept of incrementalism. Like all equity grants, performance awards will typically have a strike price in some form.

Below the level of the strike price there is no sharing of equity value. Above the strike price, sharing typically begins, at least after capital preferences are satisfied. For performance awards, however, the level of equity value at which performance hurdles are met and sharing begins is usually much higher than the strike price of the award.

As proceeds of liquidity events are distributed to equity owners incrementally, there will come a point when the sponsor's cash return exactly reaches the specified performance hurdle level, say 2x.

What should happen then, provided the objective is to give the award recipient his or her share of equity value above the strike price of the award, is to give the newly vested units all (or most, depending on the dilution structure with respect to ungranted incentive pool interests) of the next incremental proceeds until the award holder has realized the share of aggregate proceeds he or she would have had

if he or she had participated pro rata from the first dollar above the relevant strike price level.

At this point the waterfall "code" for distribution of the next incremental dollars is again reset, with the newly vested performance-based units, their catch-up complete, commencing to receive their pro rata shares.

Catch-ups don't just automatically happen, however. Relevant transaction agreements need to explicitly provide for them or grantees will risk sharing equity proceeds only above their vesting hurdle levels and not above their (usually lower) strike price levels. Limited liability company waterfall provisions are thus explicit with respect to the presence (or absence) of catch-ups, and in a number of ways LLCs provide the best organizational format for performance vesting schemes.

Notably, incentive equity programs in U.S. deals involving performance vesting generally include catch-up provisions for management, while some U.K. deals involving such vesting (referred to in U.K. parlance as "ratchets") do not and thus provide only for a share of value above the relevant hurdle level for the grantee.

While incentive schemes utilizing options or restricted stock have not typically been accompanied by detailed waterfall provisions, as noted, that circumstance may be beginning to change to some degree through the development of waterfall provisions in corporate charters and option grants that reflect performance vesting terms and in particular include catch-up provisions.

"Proceeds" and "Crystallization"

"Crystallization" refers to the point at which a return to a sponsor "counts" for purposes of determining performance vesting, and what type of transaction proceeds are required to cause crystallization to occur.

From the sponsor's perspective, cash received without risk of recapture is the most certain measuring stick for crystallization, although sometimes "liquid securities" will also count. This simple concept can be complex in practical application, however, especially in situations involving noncash payments such as rollover equity.

Assume, for example, a sponsor receives privately held stock valued at 6x MOIC at the time of sale but cannot then liquidate it. Sadly, the value of the stock subsequently falls to 1x and is monetized at that level. It would be unfair to the sponsor if performance-based incentive equity had vested at the initial closing based on the assumption of a 6x return, assuming the business deal involves tracking the sponsor's return until the second liquidity event.

Conversely, if the sponsor and other investors receive private, restricted stock valued at 1.5x MOIC in a transaction in which no more proceeds will be paid after the closing, hold the stock for a time, and then finally monetize the investment in a second sale at a 6x return, the holders/former holders of the incentive equity awards will not receive their specified cut of the aggregate proceeds from their deal with the sponsor absent a clawback, again assuming the business deal is intended to remain in place through the second monetization.

Post-closing reallocation of proceeds may be problematic in a deal with a single sponsor, and can be very difficult if not practicably impossible to implement in a situation with many investors, each of whom holds a piece of the 6x liquidity event.

Comparable but different complexities can attend efforts to carry forward performance vesting in a post-IPO context, whereby the vesting of performance awards is held open as the tracking sponsor monetizes shares in the market (or in some cases distributes shares in kind to LPs) and hurdles are attained in sequence. Such an arrangement effectively extends the compact between the sponsor and grantees out beyond the IPO and results in public investors sharing dilution.

An alternative approach is to mark all equity awards to market at the time of the IPO, settle up pre-IPO performance awards based on the mark, and re-up key employees with typical public company awards. Some performance vesting schemes do likewise at time of sale.

These are not the only considerations, of course. Ancillary issues can include what should not count as part of the sponsor's return (tax distributions? management fees? in-kind distributions to limited partners with carry taken?), the effect of new capital infused before performance-based awards vest (which generally requires an increased amount of equity value appreciation to meet the specified hurdles), or after vesting (which generally does not "unvest" previously vested awards), and whether capital investors who come in after an initial closing share in built-in appreciation to that point.

Moving Forward

At some point it is necessary to decide what matters, and how many side cases are to be addressed, in order to create a fair but functional deal for investors and management alike. There is no single "correct" template. However, a sound performance vesting scheme in any case will include express catch-up provisions if sharing of equity value above strike price is intended once vesting occurs. "Proceeds" that count toward crystallization generally take account of the tracking sponsor's investment return from all sources and not just proceeds from a company sale, but require cash (and sometimes cash equivalents) to trigger vesting.

Particularly if multiple capital investors are involved, catch-ups requiring reallocation of crystallized proceeds previously received are much more workable if they relate only to incremental proceeds paid by a buyer, or an LLC or other similar entity remains in place after closing on the sellers' side to allocate additional or newly monetized proceeds among capital and management investors. Sponsors may also retain flexibility to adjust how the performance scheme will work to adapt to unforeseen circumstances.

In all cases, prudent parties include an excel spreadsheet with a numerical example or examples illustrating how the performance vesting terms and related waterfall provisions work with real numbers. Such a picture is often worth a thousand words.

In practice, such illustrations have often been used but not until the last minute, filed as preclosing charter amendment in situations involving complex economic waterfalls but simplistic document provisions that don't anticipate or clearly provide how proceeds are to be allocated in the transaction at hand. This approach risks triggering a dispute the time of closing, and providing clarity well in advance of a liquidity event or events is the more prudent approach.

Conclusion

The growth economy is powered by well-constructed, effective partnerships between investors and management teams. In a well-constructed deal between management and capital, everyone does well together, and the better the outcome becomes, the better everyone does. Performance vesting is a

mechanism at the heart of this linkage. But it can be complex in its application, and failure at least to know the issues and angles can subvert even the best of partnerships.

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