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Private Equity Update

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The Use of LLC Profits Interests as Management Incentives in Buyouts

As private equity-sponsored buyouts proliferate and valuations continue to escalate, the demand for strong management teams continues to grow. In this context, savvy management teams and sponsors focus on ways to deliver equity-based incentives taxable at capital gains rates in order to deliver more after-tax dollars to management, often with less dilution to sponsors.

Management teams and sponsors in buyouts often seek to achieve these objectives by using so-called profits interests. Structurally this generally involves using a limited liability company (LLC) as the top company (the entity in which the private equity sponsor and management hold equity) in a buyout transaction structure. This is true even when the target is a C corporation whose equity will be held by the LLC. What is driving this structuring decision?

A profits interest in an LLC is an interest in the increase in the value of the LLC. Like a fair market value option, it has no value if the LLC does not increase in value, creates no downside risk to the holder if the LLC decreases in value, and has no taxable value at the date of grant. Unlike what usually happens with options, however, upon the disposition of a profits interest, the holder always realizes capital gain (taxable at long-term rates if the interest is held for at least a year).

Profits interests have several advantages over more traditional equity incentive arrangements such as incentive stock options (ISOs), nonqualified stock options (nonquals) and restricted stock. These advantages are summarized in the attached table. From the employee's perspective, the holding periods for ISOs are rarely satisfied in a buyout context, and a holder of ISOs therefore usually recognizes ordinary income on the value of the ISOs. Nonquals always result in ordinary income upon exercise. Restricted stock can be an attractive alternative to options for management in a buy-out, but management must either pay fair market value for the restricted stock at the time of grant (in cash or an at least partial recourse note) and risk losing the investment if the buyout fails, or pay tax on the value of a grant of "free equity." When equity values are high, as in a large buyout, these features usually make restricted stock impractical.

For a profitable company, granting nonquals is the most tax-efficient way to incentivize management because of the non-cash tax deduction the company receives when the nonquals are exercised. The tax cost to the recipient of ordinary income tax treatment can be mitigated by granting more nonquals or paying a bonus to cover the tax on exercise, sometimes on a grossed-up basis. However, while the noncash tax deduction the company receives when the nonquals are exercised provides a cash benefit for profitable public companies that experience relatively consistent exercises of nonquals by holders over time, the benefit is less clear for a privately-held buyout portfolio company.

Without a public market for a company's equity, options are typically exercised only upon a sale or after an IPO. In the case of a sale of the company, all outstanding options are typically cashed out at closing. Thus, all of management's option gains are typically realized at once, as ordinary income. Although technically deductible by the portfolio company, this one-time gain often exceeds the portfolio company's taxable income in the year of sale and can only be carried back to the two prior tax years. While sellers often seek additional consideration from the buyer of a portfolio company for unused deductions generated in the sale transaction by the exercise of nonquals and disqualifying dispositions of ISOs, buyers often decline to give full value for these deductions given the uncertainty surrounding whether and when the often highly-leveraged surviving company will be able to take advantage of them.

Similarly, options that are exercised following an IPO are usually sold promptly upon exercise, in part to generate proceeds to pay the tax that is due. Most option holders are unwilling to put capital at risk by exercising options when the equity value of a share of stock is close to the option strike price and the value of the option is uncertain. But once the company's equity value has appreciated substantially, making the capital outlay for exercise a safer bet, the tax that results almost always forces an immediate sale. As a result, optionholders rarely realize capital gains from options.

In contrast, the sale of a profits interest always results in capital gain, is not subject to any holding period requirements beyond the one-year long-term capital gain holding period and does not require the holder to put capital at risk. However, the portfolio company does not receive a deduction in connection with the grant or sale of a profits interest.

The grant of a profits interest, like the grant of an option, is not a taxable event.

A simple example of the use of profits interests is as follows:

- Sponsor and management agree to acquire Target, a C corporation, through Newco LLC.
- Sponsor and management agree that all profits from the buyout will be split 90/10, subject to the sponsor getting its money back first as a priority, not a preference (i.e., non-participating preferred-type economics).
- The CEO of Newco LLC is to receive 40% of the management equity (i.e., 4% of Newco LLC). The rest is to be distributed to the other members of management.
- Newco LLC buys Target for $540 million, with half of the purchase price financed with debt.
- Sponsor invests $270 million in equity of Newco LLC and receives 270 million Class A Units of Newco LLC. These are membership interests, but not profits interests.
- Management is granted 30 million Class B Units of Newco LLC, of which the CEO receives 12 million. These are profits interests.

- Newco LLC's operating agreement provides that all distributions, including cash distributions out of operating earnings, distributions resulting from a sale of Newco LLC, and distributions resulting from a sale of the underlying equity Newco LLC owns in Target, are to be made as follows:
    - 100% to the holders of Class A Units until they receive their money back, and then
    - 100% to the (vested) Class B Units until the aggregate distributions to the Class B Units are such that the Class A Units have received 90% and the Class B Units have received 10% of all distributions, and then
    - 90/10 to the holders of Class A Units and Class B Units pro rata.
- If the liquidity event is an IPO, Newco LLC would typically be liquidated (on a tax-free basis) at the closing of the IPO and the shares of Target held by Newco LLC would be distributed to the Sponsor and management based on the IPO valuation and the "waterfall" described above.

If Newco had been structured as a C corporation (or if the investment had been made directly in Target), the $100,000/year ISO vesting limitations would have prevented the CEO from receiving a meaningful portion of his 4% of the equity of Newco LLC in the form of ISOs. This is due to the fact that, even if the common stock underlying the ISOs was valued at one half of the value of the preferred stock issued to the sponsor (and valuation firms these days generally do not view such a discount as supportable), the 12 million shares of common stock issued to the CEO would be worth $6 million. The CEO would therefore have to receive a portion of his stock either in the form of nonqualified options taxable at ordinary income rates on exercise or in the form of restricted stock. Issuing restricted stock to the CEO would require the CEO either to make a substantial investment to buy the stock (in cash or in the form of an at least partial recourse note), or to pay tax at ordinary income rates on the value of the free stock granted to him.

Note that the foregoing example includes a "catch up" for the Class B units. This replicates the economics of a non-participating preferred / common stock structure, in which the common stock granted to management (through ISOs, noquals or restricted stock) is valued at zero. Profits interests can also be structured to replicate participating preferred-type economics (<u>i.e.</u>, distributions are split 90/10 only <u>after</u> the capital partner has received a return of its investment (and sometimes a preferred return)).

The permissible terms of profits interests are not spelled out in a statute; profits interests are effectively created by contract. As such, they can be structured in any way the sponsor and management wish. For example, they can be structured to have value only after the holders of invested capital (Class A Units in the example above) have realized a preferred return, whether a fixed annual percentage rate, a target internal rate of return or otherwise. One can create multiple classes of profits interests in order to deliver extraordinary returns to management if management delivers extraordinary value. Profits interests can have any vesting terms the parties desire (such as tying the vesting of one or more classes or profits interests to a liquidity event), however, performance-based vesting may result in variable accounting. Profits interests can participate in distributions of current earnings, but such participation is usually limited to vested interests.

Unrelated business taxable income (UBTI) and effectively connected income (ECI) are generally not an issue if the LLC sits on top of a C corporation. If the operating company below the LLC is also a flow-through entity, these issues will be a concern for many sponsors. A variety of structures, including blocker corporations and variable interest notes, are available to mitigate these concerns.

	Advantages	**Disadvantages**
Incentive Stock Options (ISOs)	To the holder: • Holder realizes capital gains on sale taxable at long-term rates if holding period requirements are satisfied. • No downside risk.	To the holder: • $100,000/year vesting limit. • Holding period requirements: to receive long term capital gain treatment, holder cannot sell until at least one year after exercise and at least two years after grant. • Potential AMT on exercise. To the company: • Not deductible unless disqualifying disposition. • Accounting charge based on Black Scholes value at grant.
Nonqualified Stock Options (nonquals)	To the holder: • No downside risk. To the company: • Taxable income realized by holder is deductible to the extent of the granting company's taxable income.[1]	To the holder: • Holder realizes taxable ordinary income upon exercise equal to difference between option price and fair market value of stock upon exercise. • IRC 409A effectively precludes grant price below FMV. To the company: • Accounting charge based on Black Scholes value at grant.
Restricted Stock	To the holder: • Holder realizes capital gains on sale taxable at long-term rates if holding period is satisfied. To the company: • Traditional accounting (i.e., based on spread at grant). • Potentially better incentive than options.	To the holder: • If the recipient buys shares, he risks losing his capital if the value of the stock goes to zero. • If the restricted stock is granted for less than fair market value, the recipient taxable ordinary income on that value at time of grant, either out of pocket, via a company loan or via a (possibly grossed up) bonus. • If purchase is financed with a note, SOX requires executive recipients to repay the note before the IPO filing. To the company: • Not deductible except to the extent that the stock is granted for less than FMV.

[1] It is worth noting that nonquals are the most tax-efficient means of delivering equity incentives to management. This is because the tax benefit a company realizes upon the exercise of a nonqual is substantially equivalent to the tax burden borne by the optionholder. As a result, there is no net "leakage" to the IRS. A profitable company can afford to give optionholders additional compensation (in the form of additional equity incentives or cash) to offset the tax cost to the optionholder resulting from the exercise of a nonqual. In contrast, the capital gains tax paid in connection with any of the other equity incentives discussed here (ISOs, restricted stock and profits interests) generate no corresponding deduction for the company and thus constitutes net leakage to the IRS.

Profits Interests	To the holder: • Holder realizes capital gains on sale taxable at long-term rates if holding period is satisfied. • No downside risk.	To the company: • Not deductible. • Accounting charge typically based on a binomial model and other complexities. To the company and the holder: • Issues such as self-employment taxes will need to be addressed if the holder of a profits interest is also employed by the LLC.

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