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Private Equity Analyst

GPs Navigate The Complex Waters Of Equity Compensation

By Beina Xu
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General partners may obsess about increased regulation over their pay, but more and more they also need to worry about its impact on compensation structures for portfolio company executives.

For years, compensation models have tied investors' and management's interests, usually by emphasizing capital gains. GPs favor awarding profit interests that provide management with equity-based incentives taxable at capital gains rates. But the growing sophistication of management teams, combined with recent and potential changes in tax laws, has pushed compensation packages to increasingly complex structures.

"This is a kaleidoscope," said Paul Weisbrich, senior managing director at McGladrey Capital Markets LLC. "Although the theme is pretty common, the actual techniques being used out there are as varied as shades of gray."

Complicating the process is Section 409A of the Internal Revenue Service tax code, a provision that became fully effective at the end of 2008 and that requires companies to specify the timing of when management may receive their deferred compensation. The provision also sets conditions as to what's permissible as a payment event - a list that can exclude many initial public offerings.

That can make it more difficult for private equity firms to tie management payout to a company's own exit. It has pushed firms to grant property or partnership interests - structures that generally lie outside the grip of 409A - instead of programs like bonus incentive or phantom equity plans that replicate the carry but limit management's role in governance. The provision has been an enormous source of frustration for the private equity world, according to Andrew Oringer, a partner at Ropes & Gray LLP.

Although less of a direct threat with the recent political shift in Congress, changes in potential tax treatment of carried interest still "rattles around on the surface beneath public awareness," said John LeClaire, co-head of the private equity practice at Goodwin Procter LLP. Andrew Bernstein, an employment attorney at Mintz Levin Cohn Ferris Glovsky and Popeo PC, said that the issue caused concern about the potential structure of a buyout for at least one portfolio company client. The portfolio company opted to take restricted stock instead of limited liability company profit interests, enabling them to preserve their capital gains treatment.

Historically, equity compensation packages in the buyout world typically award management 10% to 15% of the company's potential profits at exit, with the chief executive taking 30% of that pool and around 10% going to each his direct reports - positions like chief financial officer or chief operating officer, according to general partners and management alike. One midmarket buyout firm said it would typically distribute options to 75 employees out of a company with a staff of 600. Sponsors often issue options that tie incentive plans to a company's returns, with a home-run option that accelerates management's carry if a company does well. Bernstein estimates that around two-thirds of equity grants are based on performance, with one-third tied to time-vesting.

Portfolio company executives have also become better advised, particularly if they have previously experienced private equity ownership, according to Reeve Waud, founder of midmarket buyout firm Waud Capital Partners LLC. He added that some management teams, more aware of the "bells and whistles" on fee structures, are coming to the table with their own packages.

"You try to align goals," said Weisbrich. "But equity is like toothpaste. When it's out of the tube, it doesn't go back in - at least not easily."

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