Resetting the equity

Nicholas Plant
Partner, Corporate
SJ Berwin, London
E nicholas.plant@sjberwin.com

Across Europe the equity in a large number of private equity backed portfolio companies is currently underwater. This applies particularly to leveraged buy-outs done between 2005 and 2007. One of the consequences of this is that the management team may no longer be incentivised to create shareholder value for all shareholders and the retentive effect of the equity for them may be lost.

Some private equity houses take the view that if they are feeling the pain, then so should their management team. Some see little point in resetting underwater equity in management's favour if an exit is not imminent in the short or even medium term.

But others take the view that it is an opportune time to consider re-incentivising management using equity, given the relatively low valuations for portfolio companies that can be achieved at present. And for managers based in the UK - where a 50% income tax rate comes into force from April 2010 - having some form of equity incentive that can deliver capital gains tax treatment at 18% is more important than ever before. That equity incentive will have to be above water if it is to incentivise incoming managers charged with turning the fortunes of a company around.

Set out below are some of the ways in which companies across Europe can reset underwater equity. We also highlight some of the taxation consequences for UK portfolio companies and UK management teams. Different taxation consequences may apply in other European jurisdictions (although the principles may be similar). Please contact us for a more detailed analysis.

Cash

The simplest way to deal with the incentivisation/retention question is to agree to pay management a cash bonus on an exit calculated by reference to the exit price or the private equity house's return on investment or even non-financial metrics such as customer satisfaction, as encouraged in the UK by the Financial Services Authority's recently published Remuneration Code. This could be given as a quid pro quo for the management team surrendering their existing equity, although (in the UK at least) it should be clear that it is not "payment" for the surrender so as to ensure there is no upfront tax charge.

The advantages of such an arrangement are that it is simple and has no cost to the portfolio company or the private equity house unless the performance criteria are satisfied. It also does not need to be dependent on the portfolio company's shares having a positive value on exit.

The disadvantages (for UK taxpayers) are that any payment on exit would be taxed in full as employment income, subject to income tax and National Insurance Contributions (NICs) and, in addition, the payment may not be deductible for corporation tax purposes where it is exit related.

Release or capitalisation of existing debt

A release of the obligation to repay a shareholder loan or bank debt may seem counter-intuitive to the holder of the debt instrument, but its effect could be twofold. First, it eases the burden on interest repayments and therefore increases the likelihood that the company will not fail but will be able to repay the remaining debt. Second, it will either bring the equity into the money immediately or more quickly if valuations rise, and so help to incentivise/retain management.

The private equity house and bank can be further incentivised to accept this route by being offered an additional interest in the equity in exchange for the cancellation of the relevant portion of the shareholder loan or bank debt. Private equity houses will tend to want to recover the cost of their investment before the management team receives a return, so the terms of the equity will have to be amended to achieve this. There is, therefore, a balance to be struck in order that the management team's equity does not remain too distant in the waterfall.

The tax considerations on this type of restructuring can be complex and will need specific consideration. For example, one needs to consider whether it can be done in such a way that the borrower company does not suffer tax as a consequence of it being released from the obligation to repay the debt. In addition, consideration needs to be given to whether the management team will suffer an employment income tax and NIC charge if the debt release/capitalisation results in an increase in the value of their shares or is otherwise considered to provide them with a benefit. While there is a reasonable argument under UK law that there should be no tax charge if their shares remain negative in value, the position may not necessarily be as clear cut as it might be thought to be and may depend on the precise reason(s) for the debt release/capitalisation, how far underwater the management's shares were to start with, and how far from "daylight" they end up being after the debt release/capitalisation.

Loan note transfers to a partnership

One idea which is gaining currency in the market is the idea of putting a shareholder loan (or institutional strip) into a partnership and then giving the management team an interest in the partnership. In this way, management can receive a new incentive on virtually any terms that can be negotiated without the need to adjust any of the underlying instruments. For example, the partnership profit sharing clause could reserve to the private equity fund all of the proceeds resulting from the loan notes placed in the new partnership up to an amount equal to their initial investment, and then scale up the amount of proceeds paid to management over that hurdle - thereby in effect creating a "ratchet" in relation to the loan notes but without actually amending or converting any of the underlying instruments.

While there are questions about what the value of the partnership interest is and whether it has been acquired by managers at an undervalue (thus potentially giving rise to income tax and NIC on that undervalue), we understand that share valuers have had greater success in arguing a lower value with HMRC (the UK tax authority) for an interest in a partnership that holds loan notes than for the grant of a direct interest over a loan note. Obviously, every case will need to be determined on its own facts in terms of what the value of such a partnership interest might be.

Changing the terms of management's equity

This is a relatively simple process of amending the terms attaching to management's equity to make it more likely that they will receive value on an exit by moving them up the waterfall or increasing their proportionate return on an exit.

In the UK, to the extent that such a change increases the value of their equity, this may give rise to an employment income tax and NIC charge for management. However, if the management's equity still remains negative in value then, as with debt releases and debt capitalisations, there is a reasonable argument that there should be no taxable benefit. Equally, whether a taxable benefit arises or not may again depend on how far underwater the management's shares were to start with and how far from "daylight" they end up being after the variation of their equity terms. Each case will need to be considered on its own facts with the aim (at least!) being to achieve a nil tax result whilst ensuring that the management team are effectively incentivised.

Swapping management equity for other instruments

Various other methods can be used to move management up the waterfall by exchanging some or all of their equity for interests in shareholder debt, third party debt and/or preferred equity, in order to increase the likelihood that management will receive payment on an exit.

Whilst the detailed terms of any proposal would have to be considered, particular thought should be given to whether what management receive is worth more than they have given up, as in such a case employment income tax and NIC liabilities might arise. So the same value issue arises again.

If the new securities acquired by management are debt and the intention is that management are not to be subject to tax on any redemption or repayment of the debt on the basis that what they receive is a repayment of the principal amount, there is a risk that the redemption or repayment may be sought to be treated as employment income or a taxable benefit.

Spread bet

Far more esoteric, a spread bet would broadly involve the management team paying a premium for a bet on the increase in the value of the company's shares, the value of its debt or some other measure. If the bet is won, management receive a payment by reference to the amount of the value increase, debt value, etc. If it is lost, management lose the money they paid upfront. The aim of this arrangement is that any return for management should be tax free on the basis that it is the proceeds from winning a bet rather than a payment relating to employment or a capital receipt on sale of an asset - such as an employment related security. While such an arrangement may be entered into with a third party counterparty, there is a risk that the UK tax authority may seek to treat this type of structure as employment income if it pays out or as an employment related security on the basis that it is "a contract similar to a contract for differences" on the basis that it seeks "to secure a profit...by reference to fluctuations in the value...of property...or other factor" - in which case there could be employment income tax and NIC charges at the outset and potential capital gains tax charges on payout.

Conclusion

Whilst this is, and is only intended to be, a brief overview of some of the potential ways for, and issues relating to, resetting the equity, the key questions for private equity houses across Europe remain: should they do this at all; if so, when and how should they do this; and finally what will the tax consequences be. With the current economic outlook remaining uncertain and tax authorities focused on increasing tax revenues, this is likely to remain a "hot topic" for some time.

THE PRIVATE EQUITY INTERNATIONAL
AWARDS 2008
Best law firm (fund formation) in Europe
SJ Berwin

Private Equity International 2008 Awards
European Law Firm of the Year - Fund Formation

ACQAWARDS2008

ACQ Finance Awards 2008
LBO Law Firm of the Year

PEI
THE PRIVATE EQUITY INTERNATIONAL
AWARDS 2007
Best law firm (fund formation) in Europe
SJ Berwin

Private Equity International 2007 Awards
European Law Firm of the Year - Fund Formation

We are pleased to have been shortlisted in the forthcoming Private Equity News Awards for Excellence in Advisory Services, and in the British Private Equity Awards. Watch this space!