



Operating Management Incentive Plans (MIPs) globally: key issues

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In the dynamic landscape of global private equity, Management Incentive Plans (**MIPs**) are a crucial tool for attracting, retaining and motivating executive talent. In this article, we highlight key issues and practical tips for companies planning to operate MIPs across different jurisdictions.

General design considerations

IDENTIFYING OBJECTIVES

A MIP is a compensation arrangement used to incentivize the management of a privately owned company, often one backed by private equity investors (a “portfolio company”). MIPs can align the interests of management and investors to help drive profitability and stockholder value. Identify why you want a MIP so that you can structure it to deliver the appropriate outcome. This might include giving management “skin in the game” in anticipation of a future sale or listing, facilitating the recruitment and retention of key talent, or utilizing tax-efficient structures locally.

TYPE OF PLAN

There is no single MIP model. MIPs can be equity plans, cash incentive plans or sometimes a combination of both; commonly they track the portfolio company’s equity. They can provide long-term or short-term incentives for management. However, it is typical for MIPs to be structured as equity plans designed to realize the value for management when private equity investors sell or otherwise realize their investment in the portfolio company.

LOCAL STRUCTURES

A “one size fits all” approach for a global MIP will often not be possible. Local market practice, local laws (see **Regulatory compliance**) and tax treatment (see **Tax considerations**) are among the many factors that will drive the optimal MIP model to choose locally. In Europe and the U.K., for example, “sweet equity” (where a portion of equity is allocated to the management team, often at a nominal cost or at a discount to market value) is a common vehicle, while in the U.S. “profits interest” arrangements are popular as a tax-efficient vehicle.

ADDITIONAL/ALTERNATIVE INCENTIVE TOOLS

MIPs are only one potential tool to incentivize your management team. Other options include annual cash bonus plans, transaction bonuses (instead of exit-based MIPs), phantom equity plans, co-investment programs (enabling management to buy equity in the company at a discount) and carried interest plans (which more commonly arise in the funds of the private equity investors and cover a portfolio of investments rather than a single portfolio company).

Designing a global MIP

WHO WILL PARTICIPATE?

Identify MIP participants and the jurisdictions in which they are based. Typically, participants will include senior management, board members, founders, “early employees” and key employees. Be mindful of local employment laws on fair treatment and non-discrimination when selecting participants and deciding on their award terms.

A SINGLE GLOBAL PLAN OR SUB-PLANS?

Most commonly, a MIP will be negotiated as a single plan for the global management team but modified for local needs. This approach will facilitate plans being tailored for local compliance, allow flexibility to address local market practices and employee expectations, and allow tax efficient structures to be used locally. Align this arrangement with the company’s strategic goals and local requirements.

DOCUMENTATION

Think separately about employment agreements, award letters, plan rules, the shareholders agreement and documents governing any pooling vehicles. Link these carefully, particularly in the context of leaver provisions and vesting rights. Are there mandatory local translation or “wet signature” requirements? Consider translating documents into a participant’s native language anyway to evidence that they have understood and accepted the terms.

COMMUNICATION

Develop clear communication strategies to explain the MIP to local participants and ensure they are aligned with its objectives and their own obligations. Check and fulfill any local information and consultation obligations owed to employees or their representatives before introducing or amending the plan. In countries such as Germany and the Netherlands, it may be necessary to seek works council approval (if a company works council has been established) in respect of MIP terms, or proposed changes to terms, if employees participate in the MIP.

PERFORMANCE/VESTING CONDITIONS

Performance and vesting conditions should tie in with the private equity investors’ objectives. The vesting of awards can be fully or partially time-based and conditional on a participant’s continued employment; vesting can be on a “cliff” basis requiring continued employment at the time of a realization event, or at intervals, such as quarterly or annual dates, or a combination of both. Set clear and measurable financial targets linked to company growth as performance vesting conditions (using metrics such as revenue, EBITDA or gross profit) which participants can easily understand when and if conditions are satisfied.



Tax considerations

GLOBAL APPROACH

Due to different local tax rules, a bespoke approach may be necessary whereby managers in different jurisdictions invest through different instruments and vehicles to receive their MIP proceeds tax-efficiently.

TAX OPTIMIZATION

Identify the optimal local tax treatment for MIP awards. In many jurisdictions, it is preferable for both managers and the company for MIP proceeds to be taxed as capital gains rather than income; usually capital gains are subject to lower tax rates and do not attract social security contributions.

CONSISTENCY ISSUES

While exact alignment will not always be possible, aim for participants to achieve similar tax profiles from their investments to ensure a level playing field and mitigate against claims of detrimental treatment.

LOCAL STRUCTURES

Identify structures that can deliver optimal (usually capital gains) treatment for managers in each jurisdiction. Key considerations will include:

- ♦ which type of equity instruments work best in each jurisdiction (such as “sweet equity”, options or different instruments such as profits interests in the U.S.);
- ♦ whether participants need to pay to acquire their equity (often its market value) and the methodologies for valuing that locally, and whether a third party valuation is needed for tax filing purposes;
- ♦ the return profile of participants’ equity, taking into account the form of proceeds (such as sale proceeds, a return of capital or a distribution) and how they are taxed;
- ♦ whether participants should invest directly in the group or via a pooling vehicle (and how that vehicle is classified for tax purposes); and
- ♦ whether participants and the group need to enter into tax elections to secure the desired tax treatment (as is common practice in the U.K. and the U.S.).



Regulatory compliance

CORPORATE LAW ISSUES

Check the limits on the number and value of awards that can be issued without approval from minority holders or co-investors. Depending on the company structure, you may need to provide for equity to be awarded through an aggregator entity that is separate from the employing entity.

SECURITIES LAW ISSUES

Review whether any local regulatory filings, disclosures or other compliance steps are required, or whether exemptions apply, based on your MIP structure. In the U.S., private companies issuing securities to compensate employees can potentially benefit from a federal exemption from registration under Rule 701 of the Securities Act of 1933; this does not override certain disclosure requirements or state securities law requirements, including potential “blue sky” filings, which must be considered separately. In the EU, there may be exemptions from prospectus requirements for offerings made only to employees, to a limited number of individuals and/or where the overall value of the issuance is low.

REGULATORY REMUNERATION ISSUES

Check that MIPs used to reward staff in financial services firms headquartered or operating in the EU comply with remuneration rules under relevant EU Directives, as implemented locally. These target the “variable pay” (which would include MIPs and potentially carried-interest arrangements) of certain key staff; they include conditions on deferral, performance adjustment via malus and clawback and, in banks, a cap on participants’ total variable pay relative to their fixed pay.

EMPLOYMENT LAW ISSUES

Draft terms carefully to mitigate against the risk of participants being deemed employees through their participation in the MIP and qualifying for employment protection (if not already classed as employees under local law). This is a risk area in countries such as France, Germany and Italy, where managers may not be treated as employees for employment law purposes. Note that a choice of foreign governing law in MIP rules cannot deprive U.K. or EU-based employees of their mandatory local employment law rights.



Restrictions on MIP awards

LEAVER PROVISIONS

These provisions are often heavily negotiated. The commercial drivers behind them and the impact of local laws where participants are based are important starting points when drafting these provisions. Key drafting considerations will include:

- ♦ how “good leavers” and “bad leavers” (or other categories such as “intermediate leavers”) are defined, and the impact of this status on awards – which elements of their awards will they have to forfeit, or will they retain the awards and at what purchase price (for example, the original subscription price, the fair market value or a percentage of fair market value)?;
- ♦ the trigger for becoming a “leaver” and when the company can “pull” this trigger to mitigate the risk of disputes with participants – this trigger is highly dependent on the local law regime(s) in which the MIP operates;
- ♦ whether the provisions operate as a “call option” giving the company or sponsor the right (but no obligation) to buy the equity at the time they leave, rather than a “put option” for the benefit of other participants; and
- ♦ how the equity returned or retained will be valued, and whether the company or sponsor should reserve discretion to determine its value.

FORFEITURE AND CLAWBACK

Leaver cases will often engage provisions for departing participants to lose or forfeit their awards. Provisions may also reserve the company’s rights to claw awards back, for example, if there is an accounting misstatement. Check the enforceability of these provisions under local laws. While careful drafting and application should assist, they can be difficult to enforce in some European countries, particularly in relation to vested awards. Consider treating a departing participant as a “bad leaver” in the event that they breach their restrictive covenants.

RESTRICTIVE COVENANTS

Consider how best to protect the business against harmful competitive activity by departing participants. As well as non-competition, these might target the participant’s solicitation of (or dealings with) customers or suppliers, or their solicitation or employment of key employees. Key considerations are:

- ♦ local enforceability conditions for restrictive covenants, such as reasonableness criteria and payment conditions, and how they should be drafted to comply;
- ♦ whether there is scope to apply broader and longer covenants to a participant who is a shareholder than to an ordinary employee, given local courts often take a more liberal view of commercial covenants; and
- ♦ getting the right interplay between employment and shareholder restraints for participants in a dual capacity, to assist your chances of enforcement.



Events in a MIP's lifecycle

FUNDING FOR PARTICIPANT INVESTMENT

Consider how participants will fund MIP shares, and the regulatory and tax considerations if the company is providing loans to participants.

CORPORATE EVENTS

The most common corporate events impacting MIPs are liquidity events, which are typically in the form of a sale of a majority of the company or an IPO, or pursuant to a deSPAC transaction. Plan for the impact of such events on MIP awards to ensure that such impact is consistent with the private equity investor's expectations and goals. Will vesting be accelerated? Will they be converted into the currency of the relevant transaction (for example, into cash in an all-cash acquisition)?

UNDERPERFORMANCE

Consider the consequences of the company's underperformance for MIP awards. This will often lead to performance-based awards not being earned, but will it also undermine the retention value of awards?

RESETS

MIP resets are a way of realigning participant and investor interests and re-incentivizing participants where their equity is "underwater". There is no "one size fits all" approach to MIP resets. Consider the appropriate approach in the circumstances, taking into account local laws, tax issues, commercial objectives, exit strategy, the number of participants involved and any corporate restrictions. In practice, amending MIP terms (for example, by resetting targets) may be complicated and issuing new equity may be the preferred solution.



A&O SHEARMAN

If you would like to discuss how these issues will affect your own MIP or are considering creating a MIP, please contact one of us.



Brian Jebb
Partner

Tel +1 212 610 6354
Mob +1 646 531 0070
brian.jebb@allenoververy.com



Alain Dermarkar
Partner

Tel +1 214 2715658
Mob +1 214 4601711
Alain.Dermarkar@shearman.com



Jai Garg
Partner

Tel +1 212 8484960
Mob +1 917 8932330
Jai.Garg@Shearman.com



Tim Harrop
Partner

Tel +44 20 3088 3983
Mob +44 7917 187070
tim.harrop@allenoververy.com



Gilles Dall'Agnol
Partner

Tel +352 44 44 5 5104
Mob +352 621 290 528
gilles.dallagnol@allenoververy.com



Arnold Keizer
Partner

Tel +31 20 674 1359
Mob +31 653 388 620
arnold.keizer@allenoververy.com



Kate Pumfrey
Partner

Tel +44 20 3088 1329
Mob +44 78674 46866
kate.pumfrey@allenoververy.com



Sebastian Schulz
Partner

Tel +49 69 2648 5915
Mob +49 172 6862873
sebastian.schulz@allenoververy.com

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