INTERNATIONAL MANAGEMENT PACKAGES : TAILOR-MADE STRUCTURING, ACCOUNTING FOR TAX CONSTRAINTS AND RISKS

Isabelle Cheradame, corporate partner,
Jérôme Commerçon, tax partner,
Scotto Partners

The management equity plan (or "MEP") is an unavoidable subject in a private equity transaction. Indeed, it is commonly expected that management will invest alongside the investment fund in the LBO transaction, in order to have "skin in the game" and be motivated for, and associated with, the creation of value in the group.

While the financial principles of the MEP are well-established and universal, its structuring, especially when involving an international management team, requires tailor-made solutions, taking into consideration tax constraints and risks.

Universal financial principles

When putting in place a management package, the financial challenge is to have management invest in instruments that put it at higher risk than the financial investor, but that in return allow it to obtain a better return on its investment. Two mechanisms make it possible to obtain such a result:

- the so-called "sweet equity" mechanism is based on a different allocation of the investment made by management and the financial investor between ordinary shares and shareholder loans (or other debt instruments with a priority, but capped, return), allowing

management to benefit at the outset from a disproportionate stake in subordinated equity instruments of the holding company.

- the so-called "ratchet" mechanism is based on the issuance of dilutive securities allowing management to increase their stake in the proceeds upon exit, depending on the performance levels met (IRR/multiple). Generally, the balance of the management's investment is then applied to the subscription of instruments that are *pari passu*, giving it a seniority and a return identical to that of the fund's investment.

The advantage of sweet equity is the simplicity of this leverage mechanism, based simply on ordinary shares. In addition, it offers better protection than the ratchet mechanism in the event of average performance (hence the need for an additional *pari passu* investment in the case of a ratchet structure). However, since its return depends on the hurdle rate i.e. the rate of the fixed-return instruments and the duration of the transaction, the capitalization of interest may reduce or even cancel out the leverage effect in the event of a late exit. The investment in sweet equity incurs dilution risks in the event of an injection of additional funds, for example in the event of a build-up, as the management rarely has the financial means to participate in the new capital increase.

On the other hand, the ratchet is a more flexible instrument, allowing a "tailor-made" calibration of the value capture (for example it allows for different triggering thresholds and percentages of value capture). It also more easily incorporates an anti-dilution mechanism in the event of an additional injection of funds during the transaction. However, it is complex to structure (requiring complex articles of association or contractual documentation) and risky in the event of poor performance (management having invested in an instrument that does not ultimately capture any value upon exit).

Tailor-made structuring

If the negotiation of the MEP can be based on either of the mechanisms detailed above, a number of elements should be taken into account before deciding on the structure of the package. Structuring will depend not only on the jurisdiction in which the holding company is incorporated, but also on the tax residence of the managers.

The use of sweet equity is recommended in many countries, such as Germany, Luxembourg and the Netherlands. Italy, on the other hand, recommends the use of the ratchet, as this instrument benefits from a legal presumption of capital gains treatment. France and the United Kingdom have a less clear-cut position, as both mechanisms are accepted, subject to compliance with certain conditions.

Other elements also come into play. Thus, in some countries, the tax regime, or even the exemption scheme, will depend in particular on the manager's percentage ownership. This is the case in Luxembourg, and in the United Kingdom under Entrepreneurs' Relief. The rules regarding the ratio between ordinary shares and shareholder loans also impose different structuring constraints. Similarly, in case of a company dedicated to management investment, it is important to pay attention to the form of company used (e. g. fiscally transparent companies such as the KG in Germany or the SCSp in Luxembourg).

Of course, the more the management team brings together managers from different tax residencies, the more complex it becomes to identify a secure investment structure.

Risk of recharacterization as wage income

The risk of recharacterization exists in all countries. In any event, it is necessary to demonstrate that there has been a genuine financial risk and that the management's investment has been made at market value. Otherwise, and insofar as managers also have a status of employees or agents of the group, they risk having their gain recharacterized as wage income and taxed as such, with penalties.

In practice, the risk is higher in Belgium and Luxembourg, where the difference in the tax rate for wage income and for capital gains is the largest. The stakes relating to social charges are also different, with French tax residents being the most exposed in the event of a recharacterization, as the charges are not capped.

Finally, it should be noted that in some countries, the employer may be liable if the management package is recharacterized as wage income and there has been no withholding of charges and taxes.

To be truly effective and successful, the negotiation of a management equity plan must from the beginning involve experts who are able to understand the existing tax constraints and risks. This is all the more crucial for international management teams, where different tax residencies reinforce the need to consider a variety of structuring options.