

5th P+P White Paper

Dr. Benedikt Hohaus, FAStR / Dr. Christoph Weber, LL.M., EMBA

MANAGEMENT PARTICIPATIONS AND THE CRISIS OF THE PORTFOLIO COMPANY

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Objective of P+P White Paper

Investors require a great variety of information regarding current legal and tax developments in order to take optimal decisions for their investments. This information is quite often not purposefully prepared for the investors' demands. For this reason, P+P has started its new line of P+P White Paper.

The P+P White Paper is primarily intended for internal use and shall present important legal and tax issues in the areas of M&A and Private Equity – from funds structuring to the acquisition of an enterprise to restructuring issues – ordinarily structured and with a practical focus.

The authors of P+P White Paper are lawyers and/or tax advisors of P+P Pöllath + Partners who are experts in the respective areas.

For further P+P White Paper please refer to:

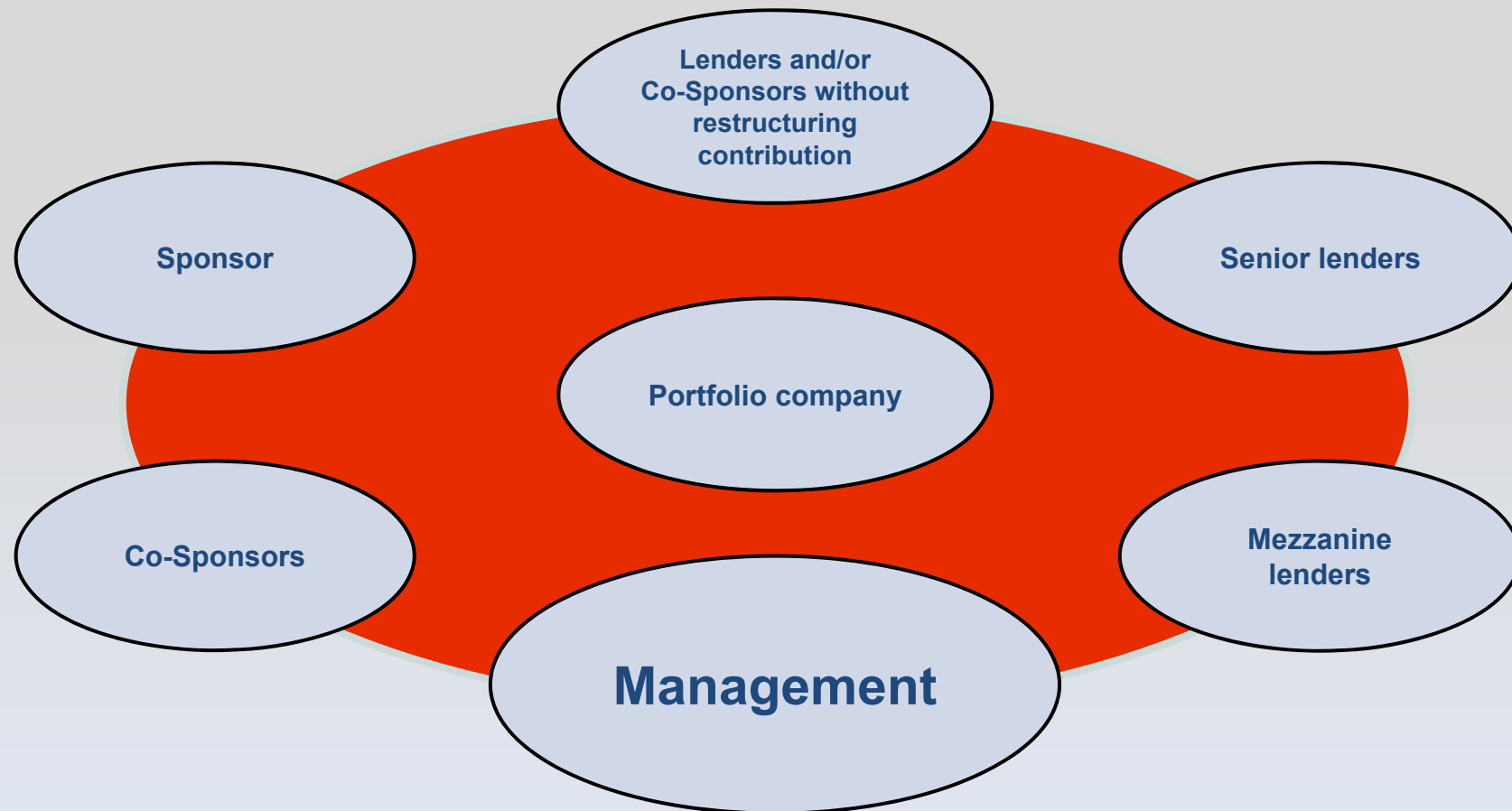
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Executive Summary

- ▶ Management participations enable to align common and divergent interests of Sponsors and managers of the portfolio company.
- ▶ In economic respect the (optimized) realization of the restructuring process asks for measures to maintain existent incentive principles.
- ▶ For the banks involved in the restructuring process, often the implementation of a new management participation program is the decisive prerequisite for their contribution to the restructuring.
- ▶ Capital measures often cause the risk that they dilute the shares held by management. Additionally, capital measures are accompanied by the risk that they reduce the originally agreed leverage. However, as the case may be, the Sponsor has committed himself to treat management that the economic disadvantages are settled as if there would not have been a negative impact on leverage.
- ▶ Capital measures as well as debt buy backs by the Sponsor might be associated with downsides for the management regarding income tax.
- ▶ In cases of leaving participants or of acceding participants of a management participation program, sometimes, inter alia, the originally agreed provisions governing the (re-) purchase price are amended on an individual basis.
- ▶ Statutory provisions which provide for a reduction of executive remuneration in slack times for the company do not apply to management participations. Nevertheless, the corresponding duties are noteworthy and have to be kept in mind for a comprehensive view.

Management and Restructuring

Amongst the parties involved in the consensual restructuring, the management takes a special position. The business plan is the basis of the valuation (purchase price) and the acquisition financing of the banks. The assumptions made in the business plan and the performance of the management are the crucial factors that determine the negotiation of restructuring measures and their success.



Management participations programs (MPP) aim at aligning concurrent interests of Sponsors and managers and to reconcile divergent interests. This applies to an even greater extent to conflicts of interest caused by a corporate crisis. Because of to a crisis general time pressure and pressure to act exists, incentives for the managerial conduct and to keep the management with the company are of particular importance.

Position of management

- ▶ **New incentives for achieving the original or newly determined goals**
- ▶ Compensation for **previous investments** within an MPP which performance goals are out of reach, as well as compensation of increased **reputational and liability risks** which were caused by the crisis
- ▶ **Implementation of incentives for management to stay** with the company in slack times of the company
- ▶ **No deterioration** of the own position by restructuring measures
- ▶ Upon leaving the company **highest possible repurchase price**

Position of banks

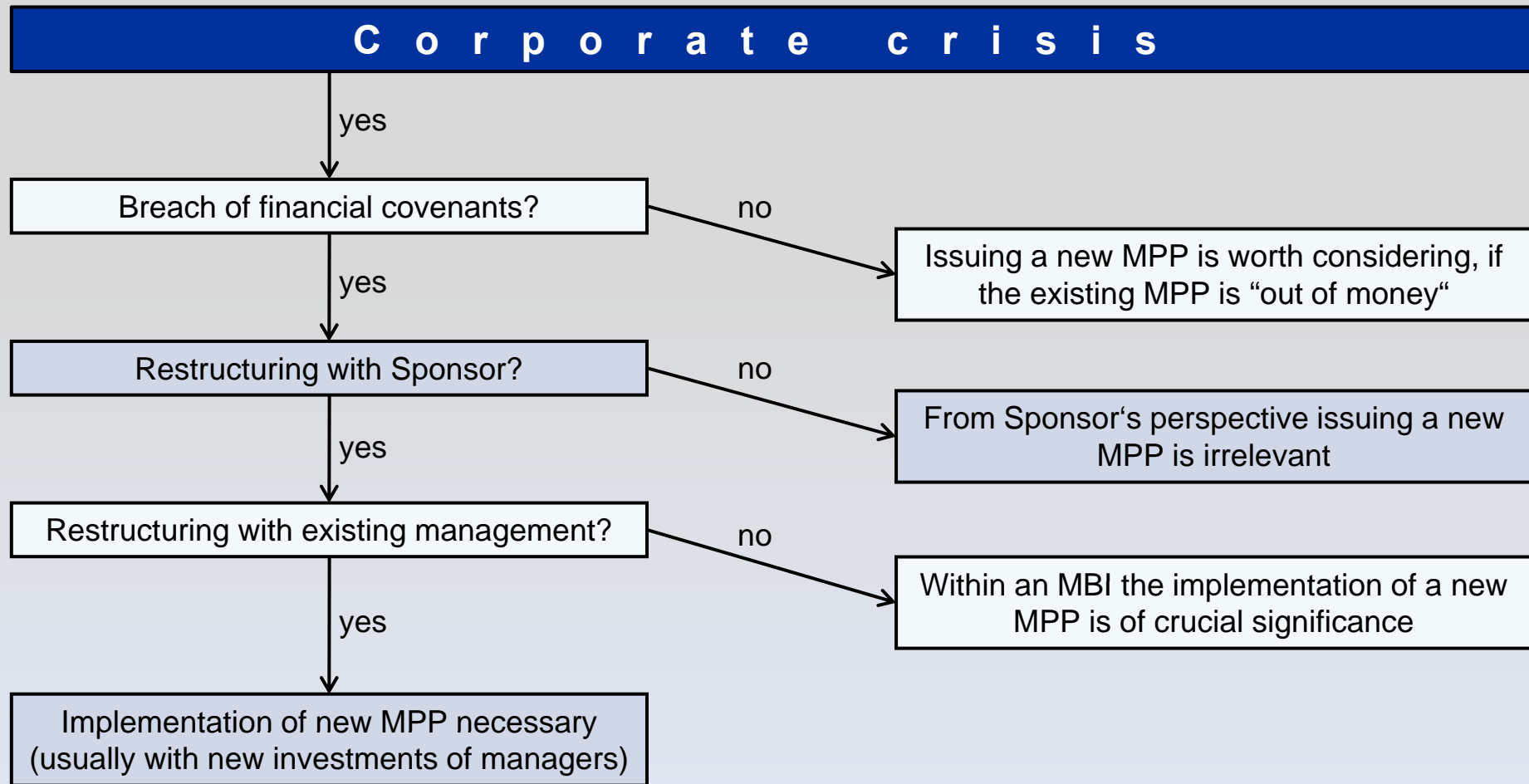
- ▶ **MPP as a prerequisite of the banks' contribution to restructuring**, which ask for sufficient management incentives for achieving the determined performance goals
- ▶ **(New) investment of managers themselves** in order to achieve managerial self-concernment

Position of Sponsor

- ▶ Incentives for **achieving performance goals** and **preservation of cooperation** and of the management's **know how**
- ▶ As the case may be, **need for adequate remuneration** for new management within an MBI
- ▶ As the case may be, **exit of Sponsor** who will have no more need for the implementation of a new MPP
- ▶ Upon withdrawal of managers from an existing MPP **low up to adequate repurchase price**

Functions of Management Participations within the Restructuring Process

The Sponsor has to pay attention to the interests of the funds, the needs of the portfolio company as well as the contributions and interests of the other involved parties. The condition of the crisis and the results of the restructuring negotiations determine which function the MPP may have.



Issuing a new MPP offers many upsides, but can also be economically irrational if the design of the MPP is inadequate. Key success criteria can be developed.

Balancing pros and cons	
Pro	<ul style="list-style-type: none"> ✓ Usually, MPP aim at creating managerial incentives that are in line with the market – by amending the terms of the MPP the new market conditions can be met ✓ Re-establishing the incentive function as originally intended/Motivation through new chances of yield return ✓ Compensation of the management for original investments that had no chance to yield return ✓ If crisis results solely from external effects, it seems to reasonable to compensate management for unsatisfied return expectations and to restore its satisfaction
Con	<ul style="list-style-type: none"> ✗ If previous management failures occurred and the business plan was based on wrong assumptions, appreciation of misconduct / underperformance ✗ Leveling original objectives ✗ Unfair risk allocation: release from windfall losses, while new chances are granted to realize windfall profits ✗ Dry Income problem (tax liability without cash inflow) ✗ Depreciation in trading books of Sponsors necessary

Success criteria
<ul style="list-style-type: none"> ➤ Exact determination of reasons for crisis, in particular, identifying management's responsibility for missing the originally defined goals ➤ Determination of remuneration parameters by making realizable assumptions in the business plan, attention to previous achievements and previous investments ➤ Eventually, new investment by management as guarantee for valid assumptions in the business plan ➤ Sustainable incentives and bonding of management to the greatest extent ➤ Eventually, obtaining a new valuation of business (e.g. expert opinion on restructuring) ➤ Upon determination of pros and cons, final weighting of all criteria to determine new performance parameters

**Management Participations and
Capital Measures**

Often capital measures are associated with the risk that they cause dilution of the shares held by management. Thus, the original agreed leverage might be affected to the disadvantage of the management.

Definitions

- **Equity Injection** Injection of capital equity by contribution in cash or in kind in order to lower the debt ratio and/or to stimulate further company growth.
- **Debt Buy Back** Sponsors acquire (indirectly or directly) loans of their portfolio company for prices below nominal value with the objective to contribute these loans to the company in order to reduce its leverage and to ease compliance with the Financial Covenants.

Problem of Equity Injection und Debt Buy Back in the crisis: Protection clauses are not applicable

- **Dilution** **Intended protection: Fair Market Value clause**
Capital increases by contributions in cash or in kind (particularly debt-equity swap) only if the respective increase is based on the fair market value of the shares or the assets of the shareholders and the contributed assets, respectively.
- **Loss of leverage** **Intended protection: Clause for maintenance of capital structure**
If and to the extent to which capital measures result in a change of the existing ratio of shareholder loans and equity, which has from the management's perspective a negative economic impact on the distribution of profits on the basis of the MPP, the Sponsor or the company are obliged to treat the management economically, upon or as of the point in time when management receives profits on the basis of the agreement, as if the ratio of shareholder loans and equity was not changed.

Problem: generally, protection clauses do not apply if a breach of covenants and insolvency, respectively, should be avoided.

Solution

- Avoiding the inapplicability of protection clauses**
- ← **Solution:**
 - **One sided shareholder loan by Sponsor**
 - **One sided subscription of preferred capital through Sponsor**

Criteria: each liquidation preference, no participation in hidden reserves, "interest" as usual in the market
 - ← **Alternative:** ▪ **One sided payment into the capital reserves**
Associated with tax risks for managers and disadvantages for Sponsors

Leaver / New Entry Scenarios

Upon leaver cases and new entry cases it might be useful to deviate from the originally agreed rules and to find solutions on an individual basis.

CHANGES OF MPP-PARTICIPANTS

Common Purchase Price Rules for Leavers

Good Leaver

- **Fair Market Value**
- 1. Multiple x EBITDA LTM - Net Debt
- 2. PE-Reporting (BVCA, EVCA)
- 3. Business valuation by expert
- 4. Retrograde linear method

Bad Leaver

- **„Lower of“ original purchase price and Fair Market Value**

- **Valuation by formula?**
 - Fixed multiple does not meet current market appraisal
- **Devaluation by fundsreporting?**
 - Fixed multiple does not meet current market appraisal
- **Buyout on individual basis?**
 - Purchase price: buyout for price above Fair Market Value as benefit that is taxable as income
 - Below formula: Sponsor is not willing to repurchase on the basis of the fixed multiple

Determination of the initial price for New Entries

Retaining the existing MPP?

- Not attractive for Sponsor on basis of previous valuation, as the Sponsor would have to correct the valuation in his trading books accordingly
- For the avoidance of dry income in case of low valuation expert opinion on valuation necessary

Implementation of new MPP?

- Eventually costly and time-consuming
- Eventually only a small group of New Entries
- Reasonableness of efforts with regard to New Entries

Implementation of a virtual program?

- Comparatively small efforts

Reduction of Remuneration

Management participations are not remuneration in a legal sense; therefore, statutory provisions demanding a reduction of executive remuneration within a corporate crisis do not apply directly.

Legal entity	Responsible organ	Material requirements	Legal consequences
Stock Corporation (AG)	Joint supervisory board (Secs. 87 para (2), 107 para (3) sentence 3 German Stock Corporation Act (AktG))	Deterioration of the company's situation: eventually given, if the company has to execute dismissals or to cut salaries and can no longer distribute profits. Always given in case of insolvency or a current crisis, but such crises are not necessary requirements.	<ul style="list-style-type: none"> ▪ Adjusting the remuneration to the appropriate amount: appropriate amount is determined by the condition of the company, tasks and performance of the management board member and by the usual remuneration (cf. Sec. 87 para (1) sentence 1 AktG). ▪ Extraordinary termination right of the management board member who can terminate her/his service agreement with effect to the end of the next calendar quarter with a notice period of six weeks (Sec. 87 para (2) sentence 4 AktG).
		Unreasonableness (for the company): continued remuneration is "unreasonable" if the management board has violated its duties, and also if it acted duly, while the company's situation deteriorates during the management board's responsibility and the management is accountable for such deterioration.	
		Supervisory board "shall" reduce remuneration: exception to the rule of reducing remuneration only upon extraordinary circumstances (e.g. remuneration was below average anyhow; hitherto uncompensated special duties within the crisis).	
		Period for pensions, payments to dependants and related payments: Such benefits may only be reduced within the first three years after retirement from the company.	
Limited liability company (GmbH)	Managing Director, shareholders, or, if applicable, supervisory board (Sec. 87 AktG applies not directly)	<p>As a rule, the company can demand from the externally hired managing director to give her/his consent to reduce its remuneration if</p> <p>(1) after conclusion of the contract the conditions worsened, and</p> <p>(2) for this reason the continued payment of the original salary would be particularly unreasonable (i.e. loss of corporate assets that are essential for the company's existence).</p>	<ul style="list-style-type: none"> ▪ Dependent on the character and size of the GmbH reduction of remuneration to the appropriate amount. ▪ Duration of reduction of particular significance.

P+P Pöllath + Partners

Attorneys-at-law • Tax advisors

Contact:



Dr. Benedikt Hohaus, FAStR

Attorney-at-law / Partner

P+P Pöllath + Partners

Telephone +49-89-24 24 0 372

benedikt.hohaus@pplaw.com



Dr. Christoph Weber, LL.M., EMBA

Attorney-at-law

P+P Pöllath + Partners

Telephone +49-89-24 24 0 372

christoph.weber@pplaw.com

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