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Getting the Management Carve-Out Right

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Management carve-out plans can be an effective tool in an M&A transaction, particularly when outstanding incentives may be insufficient to motivate and retain employees through what is often a difficult and tiring process.

At its core, a carve-out plan sets aside a portion of transaction proceeds for management or other key employees, typically in cash and payable at or around closing. In a private company, a significant liquidation preference may mean that common equity has little or no value at achievable transaction prices, potentially eliminating the value of outstanding stock options. In a public company, executives may hold stock options that are so far underwater that even a normal transaction premium produces relatively little value. In either case, the existing equity program may look substantial on paper but provide limited motivation and retention power through the transaction being considered.

Determining whether a carve-out is appropriate and how to structure it requires looking beyond market practice to the transaction economics, existing compensation, and the incentives created at different potential deal values.

Start with the Broader Transaction Context

Before deciding whether to establish a carve-out, the board should first consider the broader transaction context. What kind of outcome is being contemplated for shareholders, what role is management being asked to play, and does the existing compensation structure already provide a sufficient incentive to pursue that outcome?

A carve-out is ultimately funded from transaction proceeds that would otherwise flow to shareholders. Although these plans are common, they are not necessarily appropriate for every transaction. The question is whether an incremental payment is appropriate given the deal economics and the compensation already in place. That means understanding what management may otherwise receive from existing equity, severance or change-in-control benefits, retention awards, transaction bonuses, or buyer-provided compensation. As discussed in a prior piece about transaction-related compensation, transaction-related awards are best evaluated in total rather than in isolation.

The answer can also change as deal value changes. At a lower transaction price, management's equity may be worth little or nothing, making an additional transaction incentive easier to justify. At a higher price, that same equity may generate meaningful value and reduce the need for a carve-out.

Carve-outs can also be considered where the board wants to reinforce a particular strategic path. For example, management may have greater long-term upside through an initial public offering (IPO) or continued operation of the business than through an immediate sale. If the board nevertheless determines that a sale is the better outcome for shareholders, a transaction-specific incentive can help address that disconnect.

Funding the Carve-Out

The most common structure is a cash pool equal to a percentage of transaction proceeds, although fixed-dollar pools and other approaches can also be used. Use market data as a useful reference point, not as the answer. A 10% carve-out can have very different implications depending on the company's capital structure, potential deal values, existing equity, and other transaction-related compensation.

In some situations, a flat percentage may work well while in others a variable structure may better suit the underlying economics. For example, the carve-out might provide a greater relative share of proceeds at lower transaction values, where management's existing equity has little or no value, and then decline as transaction value increases and the equity begins to participate. The plan can also include a minimum transaction value, a maximum payout, or both. The objective is to calibrate the plan around the range where the incentive issue actually exists rather than applying the same percentage across every possible outcome.

Model the Carve-Out with Existing Equity

The interaction with outstanding equity is an important part of the design. If management holds options that are significantly underwater at the transaction values initially being considered, a carve-out may be appropriate because those options provide little economic value. If transaction value increases, however, the options may move into the money and become meaningful.

If the carve-out continues increasing at the same rate, management may receive substantial value from both programs. That result may be appropriate, depending on the plan's objectives and the broader transaction economics. For that reason, model carve-out and equity values together across a reasonable range of transaction outcomes. The analysis should show what management receives from existing equity and the carve-out, and how total value changes as deal value increases.

In most cases, the desired result is intuitive: the carve-out should provide more of the incentive where equity provides less, and equity should do more of the work as transaction value improves.

The Waterfall Matters

A carve-out does not create additional transaction value; it simply reallocates proceeds that would otherwise go to shareholders. This makes the carve-out position in the transaction waterfall important.

If the carve-out is funded “off the top” before liquidation preferences are paid, preferred investors may bear some or all of the cost. If it sits below the preference stack, the burden may fall more heavily on common shareholders. In a private company with a significant preference overhang, that distinction can materially affect shareholder economics.

This is why waterfall modeling is often critical in the design process. The analysis should identify where the preference stack is satisfied, where common equity begins to participate, where options begin to have value, and who is effectively funding the carve-out at different transaction values. These inflection points are often much more instructive than broad market benchmarks.

Other Design Decisions

Once the core economics are established, the remaining plan terms are generally more straightforward. Eligibility is typically concentrated among senior executives and other employees who are important to executing the transaction, although a company may reserve some portion of the pool for broader participation. Individual allocations can be fixed at the outset or be partially discretionary if the transaction timeline is uncertain.

Most plans also require participants to remain employed through closing, particularly where retention is part of the objective. The company should determine how to handle an executive who is terminated without cause or resigns for good reason before the transaction closes.

The plan should also clearly define transaction proceeds, including how to treat debt, transaction expenses, escrows, earn-outs, and other contingent consideration. Any meaningful compensation provided by the buyer, including retention awards or rollover equity, should be considered as part of the total economics.

Finally, companies should consider when the plan should be formally established. Defining and communicating the arrangement earlier can strengthen its motivational and retention value, give participants greater certainty, and reduce the risk that the carve-out becomes a negotiating issue once a transaction is underway. On the other hand, waiting can give the board better visibility into the likely transaction value, waterfall, preferred shareholder rights, and the value of existing equity—all of which may materially affect the appropriate design. In practice, companies may seek a middle ground by establishing the basic framework and participation approach in advance, while reserving final funding levels, thresholds, and allocations until there is greater clarity around the transaction.

Design the Plan to Solve a Specific Problem

The most useful way to think about a carve-out is not as a standard percentage of transaction proceeds, but as a tool to address a specific incentive issue. That requires understanding what management would otherwise receive, how that value changes across transaction outcomes, how proceeds flow through the capital structure, and what outcome the board is trying to encourage.

A well-designed carve-out provides management with a meaningful incentive where existing compensation arrangements do not, while remaining reasonable in the context of performance, total compensation, and the impact on shareholders. The appropriate structure therefore depends less on a standard market percentage than on how well the plan addresses the circumstances that created the need for an additional incentive in the first place.

About the Author

Rob has 15 years experience in executive compensation and finance, specializing in life sciences and technology—especially emerging, high-growth companies navigating M&A and IPOs.

About Pearl Meyer

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