Talent Retention: A Toolkit for M&A

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Some mergers and acquisitions (M&A) only provide limited inorganic growth to a purchaser—they are actually about facilitating future organic growth—about finding a missing piece to enable or supercharge an existing business. Plenty of publically available treatises and articles are devoted to technology transactions (one common such missing piece), whereas relatively little attention is devoted to talent or culture driven acquisitions, which are surprisingly common in the strategic M&A context given the need for client relationships, international talent, technological skill and other human factors that drive business growth.

This article is designed to serve as a roadmap for the legal options available to help keep talent following an M&A transaction. It outlines both traditional employment legal options and certain unique options only available in the M&A context.

Employment Agreements and Consulting Agreements—The terms of engagement of key talent set the tone of the relationship and create potential for both positive and negative results. A standard (and far too lightly considered) solution of parties is a consulting arrangement, under which the former employee may continue to provide similar services for an indefinite period, or could be strictly limited to a transition of customers and other relationships for three to six months following closing.

Oftentimes, the consulting agreement approach is driven by tax, employment cost and flexibility considerations. A properly crafted employment agreement, however, is usually the most compliant approach and still allows for substantial flexibility.

- **Consulting/Independent Contractor Agreements—**Consulting agreements are particularly appropriate where client transition is the primary goal and the individual will otherwise have substantially reduced workload and time engaged on work tasks. Consulting agreements have a few major downsides: First and foremost are restrictions established by the IRS. Many of the desirable features of post-acquisition talent retention agreements fall squarely against IRS mandates for independent contractor relationships, particularly: (1) restrictive covenants requiring current and future exclusivity (non-competition, non-solicitation of employees and customers); (2) the individual performing strategically integral tasks; (3) variable or success-based compensation tied to business performance; and (4) substantial control by the contracting entity.

  All four factors suggest employment rather than independent contractor status. Improperly classified independent contractors are an enforcement priority for the IRS and several other federal and state agencies. Second, consulting agreements convey a different level of dedication from both sides in the ongoing relationship. Where the individual is to play a key role in the ongoing enterprise, full engagement should be the focus. A "consultant" label conveys temporary service rather than embodying the team structure necessary for morale and commitment.

- **Employment Agreements**—Employment agreements are often underappreciated in regard to their potential flexibility. A common rationale used for consulting agreements is the ability to easily terminate the relationship. While many employment agreements follow a predictable form that allows for substantial employee protection and severance upon termination, those items are not a requirement. An employment agreement can contain virtually any terms the parties agree upon, including immediate "at-will" termination by either party without notice, cause, good reason or severance.

  The most important areas of specificity in a post-acquisition employment agreement are: (1) metrics for variable compensation; (2) the circumstances and consequences of termination (or non-renewal in the event the agreement contains a specific term of months or years); and (3) restrictive covenants.

- **Timing.** If new employment agreements or consulting agreements are to be entered into at the closing of the transaction, consider entering into such agreements at signing of the purchase agreement and conditioning employment or consulting agreements' effectiveness on the occurance of the closing.

The benefit of this approach is that no single individual can refuse to sign their employment agreement and hold up the overall transaction. The date releases are signed can be more complicated based on the time period in which claims are likely to arise and may be better executed on the closing of the transaction.

Cash Incentives for Continued Service—Executives and key employees are often given stay bonuses by the seller, to retain value of the entity, or by the buyer, to ensure a smooth transition. The downside of a stay bonus is it only buys time. Without a tie to individual or entity performance, the only incentive is to show up and bide time until the bonus is paid. These bonuses are most effective when used with individuals who are not integral to the long term strategy of the business, but perhaps have significant client contacts or who the buyer may want to keep out of the market for some time post-closing.

Earnouts—There is no reason that an earnout must be based on the business acquired and not on the performance of the business of the buyer after integration of key employees and assets. In addition, earn-outs can be tied to many forms of performance metrics—such as milestone events, acquisition of new customers and internal operation performance targets. In addition, the earnout results can be determined by a variety of methods, ranging from buyer discretion to third party audit. Accordingly, it is possible to craft earn-outs which heavily incentivize specific performance by key executives even if such performance is not quantifiable in financial metrics.

A specific group of considerations become relevant when earn-outs are used for talent retention purposes. First, how many shares do the key employees being incentivized own? Earnouts typically pay equally to all shareholders or sellers and sellers may be reluctant to hinge their consideration on the performance of specific employees. In some cases it may be possible with certain procedural safeguards (such as unanimous shareholder and board votes prior to sale evaluated under applicable state corporate law) to craft an earnout that only applies to certain shareholders (*i.e.*, a greater payment or lesser payment than ordinary shareholder consideration depending on performance).

Second, an earn-out is a significant structural commitment by both buyers and sellers and it won't be appropriate if there is no business appetite on either side for delayed payments or valuation spreads. Third, earnouts, particularly those without auditable financial targets, must always be entered into carefully after full discussion and evaluation and with appropriate dispute resolution metrics.

Parent or Subsidiary Stock Award—If the buyer is a publicly traded company with existing stock award based benefits plans, a stock award or derivative stock unit award will be considered as a matter of course for rewarding key executives. Perhaps less well known is that equity in an otherwise wholly owned subsidiary can also be awarded to individuals. In such cases, the equity award becomes a long running earnout with majority control / decision making typically located with the buyer or parent company of the buyer. If you look carefully, several public companies have transactions of this nature embedded in their organization structure (surviving post-IPO), often from growth stage acquisitions.

There are a host of issues with this type of subsidiary award, ranging from new accounting concerns to tax roll-over issues, but where desirable such equity arrangements can be worth investigating.

Transition Services Agreements—Most transition services agreements (TSAs) are heavily focused on status quo service level back-office, mechanical or group services functions in carve out transactions, however, TSAs can also be structured such that specified individuals are the presumptive service providers and such that the service standard is a fully negotiated high level standard with key performance indicators.

Leaseback of Employees—In certain situations, it may be appealing (or necessary) for the seller to retain employees and lease their services to the buyer. In particular, the structure is appropriate in highly regulated environments. For example, the seller may have government security clearance, approval to conduct certain medical testing or some other specifically required license to operate the business. Often, the employees performing the sensitive or regulated tasks must be employed by the licensed entity. Until the buyer secures licensure, it may have no alternative but to leave the employees with the seller.

In these situations, a specific employee leasing agreement apart from the TSA is preferable to set forth the cost and liability obligations of the parties. As a general legal matter, however, both parties will likely be subject to employer liability under employment laws. Another situation where employee leaseback arises is where the buyer does not have administrative functions in the United States and cannot adequately support the back office requirements of maintaining a workforce. The emergence of Professional Employer Organizations ("PEOs") has largely solved this need. PEOs offer a suite of employment services, ranging from single employee payroll withholding to full Human Resources support capabilities and benefit plan establishment.

Non-Competes—Virtually every transaction imposes restrictive covenants on seller entities and individuals. Usually the most important among those is the non-compete. Non-Competes are an obvious tool in M&A to ensure that sellers cannot compete with the business. Frequently however, such provisions are the narrowest and least protective when entered into with people who have the greatest potential resources and desire to compete because the provisions become deeply negotiated in such instances.

As a practical matter, there are enough currently very successful second time CEOs with 3 or 5 year blank periods in their resumes to show that non-competes are valuable, but not a panacea for a buyer.

- **Enforceability—**Non-competes are a separate body of law which must be analyzed in each state from both a corporate and employment perspective. The level of enforceability will vary drastically based on the individual circumstances and state involved. Courts want to see general fairness when enforcing a non-compete. Was the individual fairly compensated for the bench time? Do the restrictions go too far in prohibiting the individual from making a living? Do they cover an area beyond the reasonable scope of the business? In some states, additional consideration is required (beyond employment itself) to support a valid non-compete. In California, non-competes are generally prohibited.

- **Maximizing Effectiveness—**To enhance the likelihood of enforcement, non-competes should be used in both the purchase agreement and individual employment agreements. Even states that are reticent to enforce non-competes (such as California) have exceptions for those arising from a sale of the business. Sale-of-business non-competes have the highest chance of enforceability, but may only apply for a certain time period following closing (usually 3-5 years). To bind the employee beyond that time period, another non-compete should be included in the employment agreement, tied to termination of employment.

- **Rules of Thumb -**The following are typically enforceable features of M&A related non-competes:

  – Length—3-5 calendar years post-closing in purchase agreement; 1-2 years post-termination in employment agreement.

  – Geographic scope—Coextensive with either the current or reasonably foreseeable footprint of the business acquired.

  – Business scope—Focus on industries and business lines, to the extent possible, that, if competition from the seller occurred, would deplete the value of the purchased business. (Tip: SEC filings can be a key resource to craft a verifiable business scope).

As an additional comment, non-competes are often the source of very careful consideration and negotiation, but non-solicitation provisions do not always receive the same care. Consider carefully exactly what conduct should be prohibited by a non-solicitation provision—should posting a job to social media (with many former colleagues connected) be permitted?

% Employee Closing Condition—Where the key employees desired to be retained are highly diffuse or where, as sometimes occurs in an asset sale structure or cross-border transaction, new employment contracts and/or offer letters must be used to create an employment relationship between the buyer and the employee population, it is sometimes appropriate to consider an explicit condition precedent requiring that a certain percentage of employees accept their offer letter prior to closing.

Employee Benefits Covenants—It is possible to include a covenant in the purchase agreement specifically agreeing with the sellers that certain employment, benefits, severance or other treatment will occur. For example, a specific covenant to maintain salary and benefits (or more narrow forms of treatment such as maintenance of seniority levels) at substantially similar levels can be drafted. Of special importance with provisions of this type is to explicitly ensure that no third parties other than parties to the agreement can enforce the obligations of buyer and that the provision will not be construed as a grant of employment rights, benefits rights or interfere with post-closing individual employment management.

Employment Representations—Employment representations in acquisitions agreements are best used, like other representations, as a risk allocation and risk discovery tool. There can be a temptation to use employment representations as sources of discovery for detailed employee information, but, often such treatment results in late disclosure (too late for some integration planning) and disclosure schedules which are confidential (from a salary and benefits perspective) and subject to privacy restrictions.

Thinking Ahead—The purpose of this article is to provide, in a central place, many of the options available to create the right incentives to ensure a successful integration of target company talent with existing buyer business. But, even the best laid plans must have a back up plan. As a final thought, consider the following—employment law releases, amended mechanical severance benefit provisions, non-disparagement provisions, post-closing confidentiality provisions and IP assignment clean-up provisions.