MAXIMIZING VALUE IN MIDDLE MARKET M&A: CREATIVE STRATEGIES FOR EMPLOYEE RETENTION

By Michael M. Mannix and Adam J. August***

In most middle-market M&A transactions, the buyer-side due diligence team pores over volumes of information in a data room in order to assess the potential risks involved in acquiring the target, and the likelihood that potential damages will result. This analysis can lead to difficult negotiations for reductions in transaction consideration or other changes in contract terms. The diligence team's ultimate goal is to balance known risks and to help establish realistic projections on earnings and internal rate of return (IRR) related to the purchase. As all buyers know, risk is directly correlated to return.

But this complex system can yield up transaction value that is ultimately not sustained if key personnel of the target depart shortly after the closing. The risks of losing key employees, and corresponding plans for employee retention, are central themes in the negotiations between acquiror and target. The loss of key personnel can lead to loss of institutional knowledge within the target, low morale among remaining employees and, often more importantly, damage to customer relations. Cash retention payments or other benefits to key employees and important consultants appear in many, if not most, middle market M&A transactions, especially where the target is a services-oriented business.

Private equity buyers, regardless of industry, understand this important concept well and often require management to acquire "rollover equity" in the sale. Such buyers want sellers who remain with the target post-closing to have "skin in the game."

Considerations in Employee Retention

The business owner and the buyer are rarely more closely aligned on any aspect of the deal than on the importance of employee retention, especially where a portion of the acquisition consideration is contingent

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* *Michael M. Mannix practices corporate law and corporate finance and is the Team Leader for Holland & Knight's Business Law Section's Mid-Atlantic Region. He represents public and private companies in IT, software, engineering, telecommunications, and other industries, of which many are government contractors. His practice emphasizes securities offerings and mergers, acquisitions and divestitures and corporate governance. Mr. Mannix has been the lead or co-lead counsel in recent matters having an aggregate transaction value in excess of $1B.*

* *Adam J. August counsels public and private company clients in a variety of industries including information technology, government contracting, software and telecommunications. He has been actively involved in merger, acquisition and disposition transactions with a combined value of over $1 billion, and financing/investment transactions and securities offerings worth over $600 million. Other commercial and corporate transactions he regularly works on relate to corporate governance; corporate reorganizations; development, production, and distribution of technology goods and services; employment and stock-related issues; and transactions with distressed entities and business bankruptcy.*

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upon the successful post-closing operation of the target's business, such as with an earn-out or seller-financing. Both buyer and seller understand the critical role played by the management team in establishing and maintaining the value of the target. This is particularly true in services industries where there is a high barrier to entry for employees. For example, in the government contracts industry, employees with security clearances add substantial value to the deal as it can take six months or longer to obtain even uncomplicated, low level clearances. The cost for such a clearance can run $30,000 per employee. Another example is the energy industry, where companies usually include employees who are either licensed to perform their services or are uniquely skilled to deliver services in challenging environments. The dividing line between acquiror and seller is, of course, the question of who pays the cost of retention, and this can be heavily negotiated.

Sometimes special considerations will dictate who bears the cost. Experienced buyers have an idea of what has worked for them in the past and need to fit the retention terms into broader acquisition policies and integration plans. In some cases, sellers desire to share some of the benefits of the transaction as a reward to employees who have made enduring commitments over long periods of service to the company. These rewards are paid for by the sellers but are tied into a retention scheme. In any event, the sellers know their business and its employees, and most come to the negotiations with proposed terms for a retention plan.

One significant consideration in planning retention payments is the tax treatment. Sellers who agree to make retention payments should be careful to structure them so that sellers are not treated as having used purchase consideration in making the payments. By using purchase consideration, the sellers could pay taxes on the amount of the payments as purchase price received, and could conceivably not receive an offsetting tax deduction or reduction in purchase price when it makes the payments. Another consideration is the deductibility of the retention payments. Public companies avoid such deductions as they also constitute a reduction in earnings per share, and would prefer to characterize the payments as purchase price with the added benefit of increasing the buyer's tax basis in the acquired business. On the other hand, private company purchasers prefer to structure payments to obtain deductions against taxable income. All retention plans need to conform to the requirements of IRC 280G, which imposes a twenty percent excise tax on the recipients of excess parachute payment amounts, and of IRC 409A, under which deferred payments under nonqualified deferred compensation arrangements are subject to current income taxation unless the nonqualified arrangement complies with the election, distribution and acceleration requirements of 409A.

Methods of Retention

Post-closing employment for key employees will often include grants of stock or options in the acquiror and employment agreements with attractive compensation plans. These are frequently not enough to ensure that the key management remains with the company. Additional retention benefits are needed, including additional payments to employees paid either partially or completely post-closing. Retention payments are contingent upon the closing of the acquisition, and, typically, the employee must complete some minimum period of service after the closing in order to receive the payment. There can be additional features to retention, such as where the payments are tied to the accomplishment of a specified goal. For example, retention payments can be contingent upon the completion of non-financial milestones, like successful integration of the target's business into the buyer's infrastructure, new product delivery or the award of a new customer contract. Sometimes, such payments are linked to the same criteria as the contingent consideration paid to the sellers in an earn-out. This provides both compensation income to the employees and maximizes the chance that the sellers will achieve the earn-out. Rights of employees under retention compensation plans or post-closing payments are frequently subject to forfeiture if goals are not achieved or the employee's employment is terminated before either the goal is achieved or the minimum period expires.

Treatment of Target Stock Options

Stock option plans in a target company provide a planning opportunity for both acquiror and sellers. From the view point of sellers of the target, option plans or agreements usually provide for the board of directors to take certain actions in connection with a "Change of Control," which is triggered when a company merges or undergoes a stock or asset sale. The impact can be employee friendly, such as the complete acceleration of all unvested options upon the closing of a Change of Control, or employer friendly, having no specific impact on the option terms, with the stock of the acquiror simply substituted post-closing for the stock of the target as the underlying security subject to the option. From the standpoint of the acquiror, typically, most unvested options do not automatically vest upon a Change of Control, and the door is open for option termination payments, which can be structured to enhance retention. Since it is acquiring all the outstanding stock and other equity rights of the target, the acquiror will frequently be amenable to making a termination payment to the option holder equal to the price per share of the stock in the transaction, less the exercise price in the option. In doing so, the acquiror has leverage to negotiate payments or other benefits in the treatment of the option that are more favorable than the terms of the plan or agreement require.

Creative Uses of Vesting Schedules

Vesting schedules with respect to options or restricted stock offer an opportunity for a company to plan for its sale. Would-be targets can use vesting to help motivate employees to work aggressively toward a sale and to remain with the company for some period following the sale. One method for doing this is to provide in the option grant agreement that the outstanding vesting period on the date of the Change of Control will be reduced by half, and that the options subject to the eliminated vesting period will become fully vested. For example, assume an employee of a target has an option containing this treatment of his options upon a Change of Control. Assume further that: (i) he has 3,000 unvested options on the date of the occurrence of the Change of Control; (ii) the options have a vesting schedule of exactly 3 years; and (iii) over the 3 years, his options vest at 1,000 each year. Under this arrangement, half of these, or 1,500 of his options, would vest upon the closing. If the company is sold, under the terms of the target's plan, the acquiror's stock would be substituted for the target's stock as the security underlying the remaining 1,500 options, which would now vest over half of the original period, or over eighteen months. In planning for the Change of Control, the company can adjust the percentage of options to vest, and the length of the post-closing vesting periods, in order to balance the need to motivate against the need to retain the employee.

Such partial acceleration of vesting permits the employee to obtain a greater benefit in both the Change of Control (*i.e.*, more vested options to exercise into the sale) and a post-closing benefit (*i.e.*, the remaining options will be vested in a shorter time post-closing). As the prospect for a Change of Control actually emerges, the target's management can always negotiate for the customary termination of the remaining options for the termination payment as discussed above.

Group Retention Plans and Forfeitures

Sometimes the nature of the target's business suggests treatment of the management team as a group. In one real life example, the owners of a relatively small telecom hardware company sold all their stock and options to a large revenue public company for a combination of cash and stock in a stock purchase of $52M. Under the terms of the transaction, the target's stock was conveyed and all its outstanding options were terminated.

The target's business was highly technical fiber optic hardware, and many of the stockholders were engineers and other technical types. The hardware was seen within the industry as strategically important but had not been completed and no units had been sold. However, since the product was not completed as of the closing, the buyer sought aggressive terms to keep the technical team together, with corresponding incentives, until product completion and debugging. The acquirer and each seller, who was a current employee of the target, agreed to an escrow arrangement for the portion of the consideration that was the acquiror's stock. Each employee had his or her portion of the stock placed into a separate account inside the escrow, which was to be released to him or her based solely upon the employee remaining with the target for eighteen months post-closing. There was much at stake as the stock escrow represented forty percent of the acquisition consideration. A separate cash escrow addressed product development milestones.

Like many escrows, the stock escrow covered the risk to the acquiror of employee departures post-closing by requiring that the departed employee forfeit his or her consideration, here the stock. Most escrows provide that the forfeited consideration would go back to the buyer as a reduction in purchase price. When employees depart, the buyer gets a depleted management team and should arguably pay less. But the stock escrow for the hardware company employees had other seller-friendly, creative features. A departed employee forfeited his or her interest in the escrowed stock of the buyer in favor of those employees in the escrow arrangement who remained with the company. In this structure, with each such departure, the remaining employees are less likely to depart since each has an increased amount of stock available to him or her when the escrow breaks. On the other side of the coin, if certain specified, indispensable personnel left or if more than a threshold number of all employees in the escrow pool left, the entire escrow was terminated and the stock reverted to the acquiror with a corresponding reduction in the purchase price. This reflects the post-closing damages to the acquiror that has little prospect of completing the product without the core of the engineering team.

Additional Creative Terms

Not to be overlooked in this hardware company stock escrow arrangement was a key provision negotiated on behalf of the sellers. That is, the right of the sellers to trade their newly-acquired buyer stock before the escrow broke. Each seller had the right to cause the escrow agent to sell the stock in his or her account and substitute the cash as the escrowed item at any time after the first anniversary of the closing. The sellers' stock in the escrow had the normal restrictions on resale, unless the stock was registered with the SEC. Without registration, the stock would be a restricted security and the holder must wait for the expiration of a one year holding period as then required under SEC Rule 144. This turned out to be the key provision of the escrow as the hardware transaction had an eighteen month escrow of the unregistered public company stock. Accordingly, the sellers had to hold the stock for at least one year. Fortunately, the ownership subject to the escrow was treated as ownership by the sellers for purposes of Rule 144. Between the date of closing when the escrow was created and the expiration of the one year waiting period, the value of the stock had increased ninety-one percent. Shortly after the one year expired, all of the sellers sold their shares and substituted the cash for the stock in the escrow. At the conclusion of the escrow after eighteen months, the stock price had fallen by about a third from the average sale price for their stock and the sellers were happy to receive their cash.

Other Planning Opportunities

Sometimes the sellers will align their interests in an earn-out with the acquiror's interest in retention of employees. This goal can be achieved by establishing a new compensation plan in the target that is adopted shortly before the closing. The terms of the plan call for the employees to receive post-closing payments from the target, which are contingent upon the same criteria as apply to the earn-out payments to the sellers in the acquisition agreement. The employees should be motivated to reach the goals that trigger both their retention payments and the earn-out payments to the sellers. By establishing the plan prior to closing there is no argument that sellers used purchase price to make the retention payments.

Payment plans designed for employee retention can be heavily negotiated terms of the acquisition agreement, but a little creativity can bring significant added value to the overall transaction for both the buyer and sellers.