

How to Be More Successful in M&A Transactions by Influencing the People (and the laws regulating the people): Key Legal Issues in Compensation and Benefits in M&A Transactions

Stephen W. Fackler

Michael J. Collins

Sean C. Feller

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GIBSON DUNN

MCLE Certificate Information

Most participants should anticipate receiving their certificate of attendance in three to four weeks following the webcast.

Our National Training Administrator will follow up with you regarding your credit.

Virginia Bar Association members should anticipate receiving their certificate of attendance in six weeks following the webcast.

Questions regarding MCLE information should be directed to Jeanine McKeown (National Training Administrator) at 213-229-7140 or jmckeown@gibsondunn.com.

Topics to Be Discussed

- **Keeping and Motivating Key Employees**
 - Handling existing incentive awards
 - Granting new incentives
 - Integration of Existing Benefit Programs
 - Negotiation of New Agreements
- **Effectively Transitioning Excess Employees**
 - Handling existing severance programs
 - Handling transitional employees
 - Obtaining releases and restrictive covenants
- **Managing Existing Liabilities/Problem Areas**
 - Pension plans/retiree medical
 - Multiemployer and other union benefit plans
 - Successor Liabilities
- **Different Issues When Going Global**
- **Possible Changes with the Incoming Administration**



Keeping and Motivating Key Employees

Handling Existing Incentive Awards

Equity Awards

- **Threshold Decision: Continue or Cashout**
 - **Continue**
 - **Preserve Existing Retention Terms**
 - **Minimize Depletion of Acquiror's Existing Stock Plan Reserves**
 - **May Even Assume Performance Awards, even if performance goals are finalized at closing (especially hybrid performance/service awards)**
- **Cashout**
 - **Avoid conflict with design of acquiror's long term incentives**
 - **Introduce new performance goals**
 - **Need to be sensitive to possible regulatory constraints: e.g. 280G/409A**
- **Cash Awards**
 - **Generally easier to address because shorter duration (e.g., one year)**
 - **Standard approach is to cut short performance period and calculate payouts on results to date**
- **GO FORWARD: Target's employees move into acquiror's incentive comp plans.**

Granting New Incentives

- **Private Companies**
 - **Consider the form of long-term incentive awards**
 - **Stock options**
 - **Profits interests**
 - **Phantom equity/cash-based incentives**
 - **Consider size of equity/incentive pool**
 - **Consider likely exit strategy**
 - **Sale**
 - **Public offering**
- **Public Companies**
 - **Consider alignment with existing executives/employees and existing compensation structure**
 - **Consider impact on share pool under existing equity plans**
 - **Consider potential proxy disclosure implications**

Integrating Existing Benefit Programs

- **Stock Purchase**
 - **In general, all plans “come over” unless a subsidiary is being purchased and the plans are at an upper-level entity**
 - **Common to have acquired plans remain “live”, at least until next open enrollment period**
 - **IRS nondiscrimination issues**
 - **Key exception is 401(k) plan**
 - **Plan termination timing/issues**
 - **Is there a benefits protection covenant?**
 - **Fairly common to require protection of aggregate benefit levels for 12 months following closing**
 - **If there is a covenant, may be constrained in moving over to buyer benefit plans**
 - **If plans are at the parent level, it is not unusual to have a TSA with the seller continuing to provide benefits for a transition period**
 - **For union (multiemployer) plans, equity purchase typically has no effect – contributions just continue and “history” is assumed**

Integrating Existing Benefit Programs

- **Asset Purchase**
 - **Plans usually do not come over**
 - **Getting employees on buyer plans can be an administrative challenge, especially if closing shortly follows signing**
 - **Thus, a TSA is fairly common**
 - **Benefit protection covenant**
 - **What to do if buyer plans are less generous**
 - **Special rules for multiemployer pension plans**
 - **Transaction may trigger withdrawal liability for seller unless ERISA section 4204 is followed**

Negotiation of New Agreements

- **Handled Selectively and Diplomatically**
 - Typically limited to a small number of senior executives and - sometimes - other key employees
 - Raised to evaluate ability to retain/cost of retention.
 - Documentation used depends on degree to which acquiror has standard policies/approaches to which it expects conformity.
- **Issues Addressed are Common to all Employment Agreements/Offer Letters**
 - But there are some recurring differences:
 - Reconciling Differences between Acquiror and Target's comp practices
 - Taking into consideration handling of pre-existing incentive awards
 - Taking into consideration any covenants in acquisition agreement.
- **Generally Less Customization with Ancillary Documents (e.g., confi agreements, other restrictive covenants, forms of releases (if applicable)).**



Effectively Transitioning Excess Employees

Handling Existing Severance Programs

- **In a stock purchase, the plan usually comes over**
 - **Need to review carefully**
 - **For example, restrictions on amendments/termination**
 - **Benefit protection covenants – severance sometimes specifically addressed**
 - **At the appropriate time, need to take the proper corporate action to terminate existing plans and policies**
 - **Otherwise, risk the plan/policy could “live on”**
- **In an asset purchase, the severance plan usually is not assumed**
 - **However, if the plan isn’t well-drafted, the transaction could trigger severance**
 - **Plans sometimes do not have carveouts for employees who receive offers from a buyer**
 - **Even if they do, there are conditions (e.g., match base salary, same geographic location, etc.)**
 - **Buyers need to be careful they don’t agree to indemnify for severance obligations of seller**

Handling Transitional Employees

- **Need to understand existing retention and severance arrangements**
 - **Is there an existing requirement/incentive for continued service post-closing**
 - **Will employees have “good reason” simply as a result of the closing**
 - **Can unvested equity awards be assumed/continued to provide retention incentives**
- **Are new incentive arrangements needed to retain transitional employees**
 - **How long are transitional employees needed?**
 - **Is the Seller continuing as a going concern?**
 - **Consider leasing employees/transition services**
- **What structure should retention incentives take**
 - **Time-based incentives only**
 - **Performance-based incentives**
- **For public companies, need to consider disclosure implications**

Obtaining Releases and Restrictive Covenants

- **Transaction-Based Payments**
 - **Consider whether to ask for/require releases in exchange for merger consideration**
- **Need to understand provisions in existing severance arrangements**
 - **Do existing agreements require releases in exchange for severance**
 - **Be mindful of ADEA/OWBPA requirements**
 - **Be mindful of Section 409A requirements regarding releases**
 - **Do existing agreements provide for restrictive covenants**
- **Consider whether to ask for/require new or additional restrictive covenants**
 - **How long should covenants run**
 - **Should covenants relate solely to transaction or also take into account future employment**
 - **Need to consider state law concerns/limitations**
 - **Sale of business exception in California**
- **Consider use of restrictive covenants to mitigate impact of Section 280G**



Managing Existing Liabilities

Pension Plans and Retiree Medical Benefits

- **Stock Purchase**
 - **Pension Plan Obligations Continue**
 - **Need to understand funded status of defined benefit pension plans and future funding obligations**
 - **Controlled group liability**
 - **Consider whether to merge with existing pension plan (if applicable)**
 - **Retiree Medical Obligation Continue**
 - **Need to understand ability to reduce/terminate benefits post-closing**
 - **Need to understand future benefit obligations and any funding arrangements**
 - **Need to consider any union issues**
- **Asset Purchase**
 - **Consider whether to assume assets and liabilities or leave pension (and/or retiree medical) obligations with Seller**
 - **Consider potential liability under Section 4069 if there is an underfunded pension plan**
 - **Potential for PBGC involvement/interference**

Multiemployer Plans/Other Union Benefit Issues

- In a stock purchase, multiemployer pension plan obligations just continue
 - Multiemployer plan background
 - Red zone/yellow zone/green zone
 - “Critical and declining status” – ability to reduce benefits
 - Future contribution obligations
 - Withdrawal liability
 - Controlled group rules
 - Buyer effectively takes on the contribution history in a stock purchase
 - Critical diligence item – potential withdrawal liability
 - Can impact financing availability/terms
 - *Sun Capital*
 - Any seller actions that could tie buyer’s hands (e.g., reduction in workforce – “70% decline” partial withdrawal

Multiemployer Plans/Other Union Benefit Issues

- **In an asset purchase, multiemployer plans are more complicated**
 - **Does buyer assume CBA?**
 - **Hotel deals – sometimes a sticking point**
 - **Does the transaction trigger a withdrawal, or make a future withdrawal more likely?**
 - **Section 4204 of ERISA**
 - **Buyer agrees to continue contributing, seller agrees to be secondarily liable for 5 years and obtain a bond**
 - **If followed, buyer assumes contribution history for the acquired operations**
 - **Successor liability (to be discussed later)**

Successor Liabilities

- **Courts have increasingly held buyers responsible as a “successor”**
 - **Pension liabilities**
 - **Severance**
- **Key standard is whether, with reasonable diligence, buyer should have known about the liability**
- **Key steps:**
 - **Identifying the issues**
 - **Pricing the deal**
 - **Indemnification**
 - **Insurance**
 - **Bankruptcy Purchase (363 Sale)**

Successor Liabilities

- **Identifying the issues**
 - **Carefully diligence the issues**
 - **Asset purchases traditionally involve less diligence than stock purchases**
 - **However, use stock purchase-type diligence for key items**
 - **Consider possible extensions of the successor liability doctrine**
 - **For example, single employer pension plans**
 - **Have specific exclusions from liability assumption**
 - **Get strong reps and warranties**
 - **Stock purchase-like on these issues**
- **Pricing the deal**
 - **Diligence is key**
 - **Since risk of successor liability is often unknown, can be a real challenge to reach agreement on price adjustment**
 - **Consider purchase price “holdback” until statute of limitations runs**

Successor Liabilities

- **Indemnification**
 - **Purchase agreements usually provide indemnification for breaches of reps and warranties and/or for imposition of excluded liabilities**
 - **One key issue – is the seller likely to be able to make good on an indemnification promise?**
 - **Often sellers dissolve after they wind up operations**
 - **Consider escrow**
- **Insurance**
- **Seller's employment claims insurance may not cover successor liability imposed on buyer in asset deal**
- **Reps and warranties insurance**
 - **Carves out “known” exposures – intended to protect against undiscovered risks**
 - **Can be expensive – often 2-4% of policy limit, typically with significant deductible**
- **Legal contingency/successor liability insurance**
 - **Typically covers specific issues identified in diligence**

Successor Liabilities

- **Bankruptcy**
 - **Section 363 sale**
 - **Allows “free and clear” sale of assets to a buyer**
 - **Seller markets assets; selects best bidder to be “stalking horse”**
 - **Bid procedures established to maximize price in auction of assets**
 - **Auction typically 3-4 weeks after bankruptcy court approves bidding procedures**
 - **Highest bidder wins, subject to approval of bankruptcy court**
 - **Sale hearing at court; creditors can object, and judge is required to consider their interests**
 - **Court order usually has very broad release of claims against the buyer and the seller**
 - **Proper process should shield buyer from successor liability claims**



Different Issues When Going Global

Regional Differences

- **Most noteworthy areas of regional differences.**
 - **Use of equity compensation (both in terms of scope of coverage and amounts)**
 - **Degree of Worker Protection: Continuation of existing terms of employment by the Acquiror and Ability to make future adjustments or changes.**
 - **Degree of Worker Protection: Payment of Severance with Respect to Excess Workers**
 - **Successful Integration of Foreign Employees**
- **Don't rush to integrate. Envision at the start as more of a partnership**
- **Observe first, decide later**
- **Retain existing management to extent possible, replace or supplement with home-grown managers with similar cultural values**
- **Respect and understand existing methods of doing business**
- **Make changes deliberately**



Possible Changes with the Incoming Administration

Legislative/Regulatory Possibilities

- Possible changes that could impact employment/benefits in transactions
 - Unions/NLRB
 - PBGC?
 - Less aggressive oversight?
 - *Sun Capital*-type cases?
 - Tax reform
 - Section 409A?
 - Incredibly complicated transition issues
 - Successor liability?
 - Mostly judge-made, so judicial appointments the driver here

Contact Information

- **Steve Fackler:**
 - sfackler@gibsondunn.com
 - (650) 849-5385
- **Mike Collins:**
 - mcollins@gibsondunn.com
 - (202) 887-3551
- **Sean Feller:**
 - sfeller@gibsondunn.com
 - (310) 551-8746