



Lowenstein Sandler's Executive Compensation and Employee Benefits Podcast: Just Compensation

**Episode 52:
Sell Your Company, Not Your Employees:
Employee Retention Tactics During Sales**

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- Megan Monson:** Welcome to the Lowenstein Sandler podcast series. Before we begin, please take a moment to subscribe to our podcast series at Lowenstein.com/Podcasts, or find us on Amazon Music, Apple Podcasts, Audible, iHeartRadio, Spotify, SoundCloud or YouTube. Now let's take a listen.
- Zachary Bocian:** Welcome to the latest episode of *Just Compensation*. I'm Zach Bocian, an associate in Lowenstein Sandler's Executive Compensation Employment & Employee Benefits group, and I'm joined today by Taryn Cannataro, counsel.
- Taryn Cannataro:** Hi, Zach. Thanks for having me today.
- Zachary Bocian:** And Megan Monson, a partner in the Executive Compensation, Employment & Benefits group.
- Megan Monson:** Pleasure to be here today.
- Zachary Bocian:** Today, we're diving into a topic that comes up frequently in a private company sale. How do you keep your key executives and employees on board during the uncertainty of a transaction and post-closing when employees are a key part of the business being acquired? When a company is preparing for a sale, talent retention can often be as important as the financials. Buyers want to know that the leadership team will stay focused, sellers want to protect deal value, and employees want to know that their job is safe after closing. And in certain industries, buyers want to ensure key employees will stick around post-closing. That's where retention strategies come in.
- In this episode, we'll talk about some of the most common retention tools, how these tools work, some of the legal pitfalls to avoid, and strategies that actually move the needle in keeping your employees engaged. As always, this is not intended to be an exhaustive discussion, and we

encourage you to consult with your legal counsel if you're considering implementing any of these retention tools. Now, to kick us off, I want to ask Taryn and Megan, why do retention tools matter during a sale negotiation?

Taryn Cannataro: Retention tools matter for a few reasons. A sale process can take months or even longer, so you're at risk of losing key talent when continuity matters the most. During this process, we can see employee attrition in a few ways. Employees could check out or leave the company altogether if they feel the future of the company's uncertain, or in light of the common trend we're seeing of courts disfavoring non-competes, competitors could try to poach talent if they hear rumblings of uncertainty in the company. It's important to keep your workforce around because buyers want the confidence that leadership and key employees are going to stick through integration. This sometimes can be critical to the business being purchased and the buyer needs the employees to stick around. Employee retention can also have an impact on deal value. Retention costs can be small compared to the cost of losing institutional knowledge, and that institutional knowledge might be needed to achieve post-closing earnouts or other contingent proceeds in addition to just keeping the continuity of the business.

Megan Monson: And I'll just add that it's even really important from a seller's standpoint. As you're undergoing a sale process, you don't want to be having high turnover in key management or key employees, who you really need to help drive through the sale process and continue the day-to-day operation. Because for all the reasons Taryn said, that could really then have an impact on the transaction generally or potentially derail a deal.

Zachary Bocian: What are some of the retention tools we see used most often?

Taryn Cannataro: We see a combination of both the carrot and the stick approach. One example is a transaction bonus, and that's usually structured as a financial incentive, typically cash, given to employees that are needed to stick around through consummation of the transaction. It's often used for executives or other key employees that are handling deal negotiations, and it's used as, sort of, a short-term clue to ensure that the company can get through the diligence process and get the deal closed with the people they need to do so. A few considerations to keep in mind with respect to transaction bonuses is that they may help you consummate the deal, but they're not a true retention tool because they're paid at closing regardless of post-closing services. So, if you want to keep someone around post-closing, you may want to structure their transaction bonus with a holdback component. You can pay out a certain portion period of time after closing to make sure that they stay on after closing.

Investors can view transaction bonuses as windfalls to employees; however, it's also a way to restore incentive value if outstanding equity awards are underwater. So, whether or not a transaction bonus is right for your company will depend on the facts and circumstances of your company and the transaction. Transaction bonuses have to be disclosed to buyers, which could also lead to adjustments in purchase price. So again, it's really facts and circumstances-specific whether this is a right retention tool for you.

Megan Monson: Another common retention tool we see is what's called retention bonuses. These are financial incentives, usually done in cash, but they can be in the form of equity awards as well, to retain employees for a period of time post-closing. And often, they will be contingent upon the employee continuing to provide services through a specified date or the achievement of a specific milestone. One of the most common ways we see this structured is lump sum payment on the retention date that's a certain period of time following closing. That'll be at six months or a year, we often see. That really is enough time to get through that transition period and give the employees some job protection. Another way that we typically see it structured is that there's a partial payment at closing, but the remaining payments are being made in one or more post-closing installments, again, so that there's that certain retention component tool. And these can be seen as longer-term job protections for key employees.

Now, there's a couple of key considerations when thinking about retention bonuses. One of the big questions is, who's funding them? Is this a cost from the seller or the buyer? We've seen it done both ways. It's really something that's negotiated in the transaction process, and to the extent that the seller is going to be bearing some sort of cost associated with that, that will be reflected in the definitive document for the transaction. And oftentimes where I see the sellers bearing a portion of that cost is when the employees are really a key portion of the business being acquired. And so, it's kind of part of the deal value that they're getting is that they need these people to stay on for the buyer to agree to the transaction.

Another key thing to think about is what the vesting conditions are, whether it's simply the passage of time, and again, they'll be paid on that date certain or if there's some sort of performance metrics as well, meaning the company to align with potentially certain earnout metrics and those being achieved. One other thing to be aware of is that promising these retention bonuses too broadly dilutes the impact. In certain industries, it is important to retain a lot of employees. So, in those corner cases, we will see them utilized on a more wide scale basis, but often, it really is focused on retaining key or senior employees post-transaction.

Taryn Cannataro: Another type of retention tool is a management carve-out plan, and the management carve-out plan carves out a portion of the sale proceeds to pay certain key individuals to motivate them to stay with the company through the transaction. These types of bonuses are typically paid on top of the waterfall. So to the extent your equity is underwater or won't pay out, the management bonus plan still would pay out. So, it could be either a kicker for individuals who already hold equity or a way to incentivize individuals whose equities may be underwater, and it's typically used to align management incentives directly with the deal success.

The one benefit of a management carve-out plan is that there's significant flexibility in structuring the plan. The bonus can be discretionary or tied to specific performance or tenure milestones. It can be a fixed amount or a percentage of sale proceeds. We typically see percentage of sale proceeds, but again, if you're closer to a deal and you have an idea of what the deal value is going to be, you can hardwire dollar amounts. You can also tie a portion of the bonus to contingent proceeds, so a portion is paid on closing and the rest of it is contingent on the payment of the contingent proceeds.

A few considerations in structuring the management carve-out plan is determining the right pool size and allocation methodology. You have to determine what percentage of the net proceeds you want to set aside for this pool and who should participate. Another consideration is whether to provide termination protection to anyone participating in the plan. To the extent we see termination protection, we typically see protection for people who are terminated within a short period of time before the deal's announced, usually three to six months. That way they stay incentivized to stay on through the deal, but to the extent their termination may be in connection with the deal, they still receive their bonus. It's important to keep clear communication regarding these plans to avoid perceptions of unfairness among employees, because this does pay out on top of the waterfall. To the extent that stock options or other equity is underwater, the employees might not be happy with the fact that they're not getting anything in connection with the deal, but the management team is.

On the other hand, you want to consider whether you want to double count the management carve-out with equity value or if payments under the management carve-out plan should be net of equity consideration. Either can be done and it just depends on what's right for your company in connection with the transaction. A management carve-out plan can also include a hold back to ensure retention post-closing. A portion is paid out on closing, a portion is paid out three to six months, even a year after closing and that the employee will have to stay employed till that retention date in order to earn that second portion of the bonus under the plan. A

management carve-out plan can incentivize executives that may not have equity to achieve performance goals that are needed to earn all contingent proceeds. So, it is a really useful tool in many transactions, and it is something that we see quite frequently.

Megan Monson:

Another tool available to employers is offering severance plans, and this could be either in the form of a broader contractual protection for executives. Severance arrangements can take a couple of different flavors. There could be broad contractual protection for executives that are terminated after a sale, whether in the form of a formal severance plan that the seller adopts prior to closing that the buyer would then inherit to give those executives certain protection. It could be in the form of one-off negotiated severance protections in individual employment agreements. And another place that we see this pop up is in terms of post-closing employee covenants in a purchase or merger agreement. And in the third situation, sometimes a seller will negotiate for protection of all of their employees to have some sort of severance benefits to the extent that they are terminated without cause within 12 months following a change of control.

So, a few things to keep in mind are, one, will buyers be required to adhere to the terms post-closing? Again, if it's an agreement that is in place prior to closing and it's a stock or merger transaction, the buyer would inherit those plans. If you include that type of protection in a sale agreement, again, the buyer would be bound by those plans. And so, you want to think about it and be strategic if you are trying to, again, give some employees certain protection. Depending upon what the terms of those arrangements are, a buyer may seek to have, again, seller share some of those costs if there is a termination, since they are arrangements that the sellers had put into place. So, there can be a negotiation on that point. And another thing to think about is, if the seller has a severance plan or severance policy in place, what are the differences between their arrangement and a buyer's severance policies, if any?

And again, that may be part of the negotiation and the deal process of a buyer not agreeing to take on those existing seller obligations, but they will treat employees to their similarly situated. With all of the various retention and incentive tools that we've talked about, we often couple those with restrictive covenants to the extent permitted by applicable law, to both incentivize employees and try to keep them from competing. Again, back to the carrot and stick approach that Taryn mentioned. And this can be really important, especially when the employees are a critical part of the business. You're incentivizing them by giving them the opportunity to get significant compensation, but you're also getting the protection of, well, if they choose not to stick around for that and they

leave, how can we also make sure that they're not competing and harming the business that was purchased?

Zachary Bocian: What might be some of the legal and compliance considerations and pitfalls of these retention arrangements?

Megan Monson: That's a great question, Zach, and I'll caveat it with, I'll mention these considerations at a very high level. All of these items that I'm going to flag are very technical aspects of the law and are one of the reasons that it's very important to involve legal counsel when you're adopting these type of arrangements. The first is, any of these arrangements must be structured properly to be exempt from or comply with Section 409A of the Internal Revenue Code, which governs deferred compensation. And if an arrangement is not structured properly and it violates 409A, bad outcome, there is a penalty tax on the employees. If it's not caught properly, the employer has potential failure to properly withhold and report. So, not a good outcome for anybody, and so it really is important to make sure that you're getting it right when these arrangements are being implemented.

Another thing to think about is, if your company is taxed as a C corporation, in connection with a change of control you have to be aware of a provision of the tax code called Section 280G. And as a planning opportunity in these type of retention or incentive arrangements, you could include what's called a 280G cutback to help mitigate if there is a 280G issue in a transaction, to both incentivize any impacted employees to sign a waiver as well as seek a shareholder vote, which is something that's commonplace in private company transactions involving entities that are taxed as a C corporation. We've talked about 280G in further detail on a prior podcast, and we'll include a link to that in this episode.

Another item to be aware of is, unlike we'll call it traditional equity, the tax treatment of any of these arrangements that we've talked about is going to be taxed at ordinary income, so there's no potential for capital gains treatment. And depending upon the terms of the arrangement that's adopted, if there is a possibility for payments following a termination of employment, another thing that you have to be aware of and think about is, does ERISA apply to this, and do we have to structure this as, what we'll call a top hat plan? Again, we have another episode fully talking about the implications and intricacies for top hat plans that we'll include a link to as well. The really big picture takeaway is that there's a variety of pitfalls and areas of the tax and benefits law to be aware of, and so making sure that, again, you're being thoughtful about it and structuring it properly at the onset is key.

Zachary Bocian: Thank you, Megan. What are some typical features you can incorporate into these types of plans?

Taryn Cannataro: Well, as we've been saying, these plans can be pretty flexible in terms of features and you can structure them in a way that works for your company. But a few typical provisions that we see incorporated, as Megan briefly mentioned before, it could be a good opportunity to include restrictive covenants if covenants are not already in place. One caveat there is that enforceability of restrictive covenants depends on state law where employees are located, so it can complicate drafting and will definitely be something that you want to connect with counsel on.

You should also condition payment under each of these retention tools that are going to be made in connection with the sale on execution of release. It might be a good opportunity to get releases from employees that would not otherwise be required to sign one, which will definitely make the buyer happy, and also gives the seller comfort that any claims that the employees could have against them will be waived. You also can condition payment on the deal occurring on or before a certain date, so they're not outstanding in perpetuity. This is good from both just a business perspective, but also for tax reasons for Section 409A planning, as Megan discussed earlier.

Zachary Bocian: Thank you, Taryn. What are some strategic business considerations to keep in mind here?

Megan Monson: I'll start with saying that there is not a one-size-fits-all approach, and so some of these considerations that we're raising in terms of things to think about is going to look different of what's going to apply to one company versus another. The first thing to think about is, who should be covered? Is this going to be offered only to the most senior executives or is this something that needs to be rolled out on a broader scale to most of the employee population? And again, whether which avenue you go down is going to depend on the business and what their needs are. Related to that, you also want to think about balancing the cost versus the incentive. So again, trying to be strategic in, who do we need to retain and how much do we need to pay them to properly incentivize them?

Another important thing to think about is the communication strategies and how much transparency employees will have about this before closing. Again, it could be important based on the business context to adopt one of these arrangements to, again, help incentivize employees to get through the sale process, in which case they would have visibility into the terms of the plan or bonus arrangement. But there could be other situations where you're looking to adopt this basically immediately prior to closing, and that way it kind of forces the buyer's hands to be subject to that.

So you just want to think about really what your business needs are and what do you really need to do to get your employees through the sale process and beyond? It's also important to think about the buyer and seller negotiations in the deal process. And so, for the reasons that we mentioned earlier, again, the seller may want to fund some sort of retention to help protect deal value. The buyers may also want to have the flexibility to renegotiate compensation post-closing, so there's going to be some competing dynamics there. And so, the more you can be thoughtful about it earlier on in the deal process, the better.

And that leads me to my last point, is timing. We see some companies adopt these type of arrangements when there's not a sale on the horizon, and just, again, they're using it as an incentive tool for employees. There may be other situations where we see companies only wanting to promise it to somebody when they're kind of on the eve of a transaction, so they're comfortable with the purchase price and giving out certain allocations. And so while the timing can be variable, you don't want to do something that's going to derail the transaction. And you also then have to think about, if there's already a deal underway, that's something that will need to be disclosed to the buyer. And again, it's better to avoid something coming up at the 12th hour.

Zachary Bocian: Thank you both. Today, we discussed a few common tools companies rely on during a sale to keep people in their seats. The big takeaway from today should be that retention planning is not just about money. It's about timing, communication, and aligning incentives between sellers, buyers and employees. Consult with your legal counsel early. Be clear about who you're targeting, and don't underestimate compliance traps like 409A and 280G. The key to a successful retention tool is designing incentives that align employees' interests with the success of the deal, while keeping legal and tax compliance in mind. Thanks for listening, and if you enjoyed today's discussion, please subscribe, leave us a review, and share this episode with your colleagues. You can also reach us via email if you have questions or ideas for future topics. We look forward to having you back for our next episode of Just Compensation.

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