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

Episode 38 – How the Structure of Your M&A May Impact Your Workforce

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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.

Jessica Kriegsfeld: Welcome to the latest episode of Just Compensation. My name is Jessica Kriegsfeld and I'm an associate in Lowenstein Sandler's Executive Compensation and Employee Benefits Group. I'll turn it over to Darren and Megan to introduce themselves.

Darren Goodman: I'm Darren Goodman. I'm the vice chair of the firm's Executive Compensation and Employee Benefits Group.

Megan Monson: And I'm Megan Monson. I'm a partner in the same practice group as Darren and Jessica.

Jessica Kriegsfeld: In the context of mergers and acquisitions, it's important to think about the impact of the transaction on the existing workforce, including the impact on employee benefits such as outstanding equity awards like stock options. Today's discussion will look at how the structure of a transaction influences these items, what we typically see in the market, and other considerations. As always, this is not intended to be an exhaustive discussion, so we encourage you to consult with your legal counsel if you have questions on how to treat these items in a transaction. As a threshold question, how does the deal structure impact employees and benefit plans? What are some key decision points?

Darren Goodman: So at a high-level, an initial question is whether you have an asset sale or a stock sale. So there's a lot of structures that can be out there, but big picture, a stock sale, the acquirer entity is literally acquiring the stock or the membership interests if it's an LLC. Whereas in an asset sale, the acquirer is not actually acquiring the equity, instead they're literally buying the assets. So if a seller holds a factory, they sell the factory itself, for example, and there's different legal consequences that flow from that, including with respect to employees and from benefits.

Megan Monson: So with respect to employees, as Darren mentioned, the structure of the deal is key in thinking about how they should be treated. And a stock sale employment is just going to continue by operation of law versus in an asset sale because again, only the assets are being purchased. Employees are going to have a technical termination of employment by the seller, even if they may have a seamless transition from the seller to a buyer. In both a stock and asset sale, it's important to think about what you want to do with key employees who are going to be integral to the business going forward, and whether to require them signing onto a new employment agreement or offer letters, which might be deal deliverables. Sometimes the decision turns on whether to continue existing agreements or whether the buyer wants to make changes such as to title, role compensation, et cetera. So those are all threshold questions to be thinking about in terms of deal structure and also what you're going to be putting in the purchase agreement.

In an asset sale, a seller could assign existing agreements such as offer letters and restrictive covenants agreements to a buyer. But on the flip side, a buyer may also want to enter into new agreements set on new terms of employment that they've set, and on documents that are kind of their standard suite of documents. You could want to enter into completely new agreements with the entire workforce, given it's a technical termination of employment. And again, to have uniform documents, especially if you're onboarding employees into an existing company.

Darren Goodman: Megan, I'd add that it's not a one size fits all, and if you're a buyer, you're going to do diligence. You're going to see what the existing agreements are like, and if you're comfortable with them, you're more likely to want them to be assigned than if you're not comfortable with them.

Megan Monson: That's a great point. And I guess related to that as well, to think about if you're integrating employees into an existing business or if you're forming a new entity to acquire those assets. So these are just kind of some considerations of what's going to make sense based on deal structure and what the buyer's go forward plan is. Another important thing to think about is just the messaging to employees, and this is going to be something to think about, whether it's an asset or stock sale. You want to typically incentivize employees going forward and also trying to avoid taking actions upfront that's going to demoralize employees such as reducing their compensation or benefits. These are people that are going to be integral to the go forward business, and so it's important to think about how to let them know one, about the transaction and two, what does that mean for their employment going forward.

Darren Goodman: So with respect to employee benefit plans, again, it varies depending on whether you have a stock or asset sale. With a stock sale, in some ways it's simpler because the buyer is simply stepping into the seller's shoes. So a plan, like a health insurance plan, for example, I would normally expect to simply continue as if nothing had changed. If it's an asset sale, those plans may not continue automatically. They might be able to be assigned to the buyer. The buyer might be able to create mirror plans that have the same terms as the seller's plan, but it's a new buyer plan that is in effect from the closing date going forward. So obviously there's planning that would need to be done either way. One nuance is that if you have a stock sale and your buyer has a 401k plan, if the seller also maintains a 401k and the buyer only wants to have a single 401k, the seller needs to terminate that before the closing. And the typical practice is to terminate one day prior to closing.

And for some technical 401k reasons, if it doesn't happen before the closing, the buyer would then have two plans and would be unable to simply terminate the seller plan post-closing. The buyer would have to merge it into its own plan, which can be more work, and buyers often find undesirable. So again, something to be aware of because you can't terminate a 401K plan on a dime. A seller's got to think about this and plan for it. Well, in advance of closing.

Megan Monson: One point on that, I think it's worth mentioning is to technically terminate a 401K plan from a legal standpoint, often all that's needed is board resolutions to actually terminate the plan. As always, we'd recommend consulting the underlying plan document as that will govern, but it's typically a fairly straightforward process, and there's a lot of the work related to the termination that occurs after that's done, and that aspect of it can be done post-closing.

Darren Goodman: Namely, the distribution of the balances to participants, so that all happens post-closing. It's a great point, Megan. There are some other aspects to think about. If employees are being moved to a new buyer plan, mid-plan year, presumably they're going to have expenses that they have incurred previously co-payments, credit towards deductibles, and buyers can work with their benefit plan providers to give employees credit for that, so they don't lose the benefit of those payments because of a mid-year switch to a new plan. Then there's some other considerations with respect to retirement plans that are just too technical to get into on this podcast, but that we have discussed in two other episodes, one called Multi-Employer Pension Plans, mitigating risk in the context of a business transaction and the other, the Fine-to-Benefit Plans, mitigating pension liabilities in a business transaction.

Jessica Kriegsfeld: As another key decision point, how should outstanding and equity awards be traded in a transaction?

Megan Monson: Similar to treatment of employees and treatment of benefit plans, there's not a one-size-fits-all approach, but as a threshold matter, it's important to look at the seller's equity plan and underlying award agreements to see one, if the transaction is considered a change of control that would trigger any sort of potential payout. And two, what type of treatment is permitted under those circumstances if it is a change of control. Ideally, an equity plan would have a lot of flexibility in terms of how outstanding equity is treated upon a change of control. But again, the underlying plan documents and award agreements govern, and so it's really important to look there to see what alternatives are available as you think about what may make sense in this transaction. Often, vested equity awards are either cashed out or sometimes rolled over into equity awards of the buyer or one of its affiliates. A question that comes up often is what to do with unvested awards.

Again, if you have a plan that has a lot of flexibility, often those will be canceled for no consideration, and sometimes depending on the facts and circumstances, a board may choose to accelerate vesting in connection with the transaction even if the underlying option agreements don't automatically provide for acceleration.

Darren Goodman: One point there Megan, so I agree about the cancellation of the unvested awards. Sometimes executives negotiate what's called double trigger protections, where if there is a sale and the executive is fired without cause after the sale, they get accelerated vesting if they're unvested. However, if the plan says that unvested can be canceled on the closing of a sale, it can render the double trigger moot, and the executive doesn't have the protection they think because their awards don't survive for closing. So if you are receiving an equity package and you're supposed to get this double trigger acceleration, it's an important point for negotiation.

Megan Monson: That's a great point, Darren. And one other thing I'll mention in terms of options that are being canceled either in exchange for a cash payment or unvested options that are being canceled with no consideration, sometimes buyers may want to get option cancellation agreements with a release of claims from option holders, and again, whether one that's permissible, you have to check the underlying plan documents and two, even if it is, whether practically you're going to be able to get those signatures, especially in advance of closing. So if a company decides instead to cash out employees, the employee equity holder would receive consideration equal to the value of the award, and then to the extent there is any sort of escrow or earn out in that deal, a corresponding portion is held back and is subject to the same contingencies as other stockholders.

From a deal perspective, a full cash out could cause the seller's employees to lose the incentive and retention value that the equity awards were intended to provide to the employees in the first place, especially if their payouts are substantial. So that's just one consideration in terms of thinking about what makes sense in terms of how you're treating equity in a deal. And again, big picture, what's the go-forward plan for these employees that are coming over as part of the transaction?

Jessica Kriegsfeld: If the parties in a transaction elect to roll over equity awards into the buyer entity, what happens to employees' outstanding equity awards?

Darren Goodman: If there's a rollover, what it means usually is that rather than having an equity award in the seller, that award becomes an award in the buyer. It's typically the same type of award. So if I had a stock option and seller, I now have a stock option to buy stock of buyer, and typically the terms stay the same, and there's some legal reasons for that that Megan will get into, but in general, everything stays the same. Vesting schedule stays the same, expiration date stays the same. If it's a stock option, just the share subject to the award changes.

Jessica Kriegsfeld: What are some considerations if a company elects to roll over equity?

Megan Monson: Regardless of whether equity is going to be canceled or rolled over in a transaction, it's important to articulate that in the purchase agreement and be very clear. So one, there's alignment amongst the parties, and two, it's drafted in a way that complies with all of the legal requirements. If there is election to roll over equity, the purchase agreement needs to be drafted in a way that preserves the value of the awards, and particularly to comply with 409A. And if there are adjustments being made to the shares because now, they're being exercisable for shares of a buyer, there's things that need to be done to preserve ISO treatments so that the spread of the underlying awards is not increasing. And so there needs to be a lot of care to both comply with the 409A and ISO rules. And having that clear in the purchase agreement is one of the keys to making sure that the treatment is preserved.

Darren Goodman: And Megan, to put a finer point on it, the simplest would be a one-to-one exchange. You've got a hundred stock options in seller, now you've got a hundred stock options in buyer, but the value of a buyer share might be different from a seller share. So you might need to make adjustments to the number of options or the exercise price to make sure that you preserve that same spread. And it's binary, the options cannot be more in the money pre-closing than they were. So your exercise price is rounded up, your number of shares are rounded down to make sure that the value does not go up even by a penny.

Megan Monson: That's a great example, Darren. And one thing to mention is that if equity is being rolled over into a buyer, you're typically then going to give some sort of communication to existing option holders, and so that they'll understand that all other terms of their option will remain the same except for whatever adjustments may be needed to preserve that economic value and that they will be exercisable now for shares of buyer entity instead of the previous seller entity. Another thing to think about is if there are outstanding options that had performance-based vesting conditions, how does that translate into what the buyer's business is going forward if that's different from the seller's? And whether there needs to be or should be adjustments to some of those vesting conditions if existing options are remaining outstanding.

Jessica Kriegsfeld: What happens if the price per share in a deal is lower than the exercise price for outstanding stock options?

Darren Goodman: That means the options would be underwater. So essentially the option is worthless and the transaction. So an equity plan will normally allow underwater options to be canceled without any payment, whether vested or unvested, and that would be the normal treatment for those awards.

Jessica Kriegsfeld: Are there any other considerations related to employees or benefits to be mindful of when engaging in a transaction?

Megan Monson: It's important to think about the timing element of when to advise employees that there is a transaction. In particular, this comes up in an asset deal if it is a simultaneous sign and close, which means the asset purchase agreement is signed and the deal closes at the same time, and you want to avoid there being a gap of people's employment, but you don't want to advise them of the transaction too early in advance in case it doesn't close. And so there's kind of this competing dynamic of, when is it the right time to advise employees of what's being done in the deal? And for both asset and stock sales, any sort of post-closing employee communications is also key if there's going to be any change in their benefits, just trying to understand what their role is going forward. Some companies tend to want to get ahead of it, and so they'll host a town hall or have a onboarding session with their new employees so that they can really understand what the impact of the transaction was to them.

Jessica Kriegsfeld: Employee and benefits related considerations are important to consider early in a transaction. We hope this discussion gave you some food for thought about the types of issues that can arise regarding employees and benefits in a transaction. Thank you for joining us today. We look forward to having you back for our next episode of Just Compensation.

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