The M&A LAWYER

February 2014 ■ Volume 18 ■ Issue 2

Roadmap to Providing Appropriate Incentives to Employees When Your Company is Going to be Sold

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When a company is being sold, it often results in lots of uncertainty and distractions for employees. In particular, employees will often worry about how their jobs will change and whether they will be fired while headhunters are flooding employees with new and exciting job opportunities. In this context it is imperative that the company's employees remain focused on running the company's business and delivering the business intact to the buyer. Having appropriate incentive opportunities and retention arrangements in place is critical to meeting this objective. This article walks through an analysis of determining whether an incentive or retention program is necessary and a framework for designing such a program. For purposes of this article, an "incentive opportunity" is one that is focused on rewarding employees for getting a sale completed or getting a higher deal price and is often granted well in advance of getting a sale agreement signed up, whereas a "retention arrangement" is one that is focused more on simply retaining employees through the closing of the sale or some longer period and is often granted after a sale agreement is signed up.

Is an Additional Incentive Opportunity Necessary?

To determine whether an additional incentive opportunity is needed, the company needs to (1) identify those employees who are critical and to getting the highest deal price and (2) determine whether these employees' interests are sufficiently aligned to motivate them during the deal process to help get the highest deal price. Providing ad-ditional incentive opportunities is considerably rarer than rolling out a new retention program, and in many cases a company may find that additional incentive opportunities are not necessary. Additional incentive opportunities are often awarded in private companies that are controlled by a single family where non-family member se-nior employees do not have any equity interests, so they do not stand to benefit financially from a sale of the company. Most public companies which provide equity compensation awards to their employees will find that additional incentive opportunities are not necessary.

What Is the Typical Structure for an Additional Incentive Opportunity?

Once a company has determined that additional incentive opportunities are necessary, it will need to focus on structuring the award.

Fixed Dollar Amount or Percentage of Deal Price. The simplest structure is to pay a fixed dollar amount at the time of closing of the sale or pay a fixed percentage of the deal price at the time of closing of the sale (the fixed percentage approach is similar to a grant of stock that vests on a deal closing). A drawback of the fixed dollar amount is that it only incentivizes getting a deal closed as opposed to rewarding the employee for a higher price.

The obvious benefit with the percentage of the deal price arrangement is that the employee would be rewarded for getting a higher deal price because his or her payment would correspondingly increase.

Fixed Dollar Amount or Percentage Only If a Particular Price Is Achieved. Another structure is to provide an incentive opportunity that only pays out if the deal price is more than a pre-set amount. The payment could be structured as ei-ther a fixed dollar amount or a percentage of the deal price. This approach obviously focuses the employee's efforts on driving the deal price to be more than the specified level.

Fixed Percentage of Deal Price Above a Designated Amount. Another structure would be to have the incentive opportunity pay out a fixed percentage of the deal price above a designated amount. This approach is similar to a stock op-tion because the amount paid is directly related to the value of a share of stock above a pre-set amount. This approach focuses the employee's ef-forts on driving the deal price to be as high as possible above the designated amount because the marginal benefit to the employee steeply increases as the deal price surpasses the designated amount.

Participants and Amount Payable

Additional incentive opportunities are not typically offered to a significant number of employees. It would be unusual to provide these opportunities to more than five or so employees and often they would be offered to only one or two employees. The amount available for additional incentive opportunities will vary a great deal depending on the facts and circumstances, including what other incentive opportunities are already in place, but will often be sized as a percentage of the anticipated deal price.

Payment Terms

Typically the entire incentive opportunity amount would be paid on closing, although it is not unusual to see a portion held back for a relatively short retention period.

Is an Additional Retention Arrangement Necessary?

To determine whether an additional retention program is necessary, the company needs to (1) identify those employees who are necessary to retain through the closing of the sale, (2) review and catalog the sale incentives (including cash and equity compensation arrangements) and severance protections already in place for these employees and to delineate which arrangements are so-called "single trigger" arrangements that pay or vest solely in connection with the closing of the sale and which arrangements are so-called "double trigger" arrangements that only pay or vest upon a termination without cause or resignation for good reason after the sale closes and (3) determine if the incentive and severance arrangements are sufficient to retain the employees. Notably, arrangements that only provide payment in connection with an employee's involuntary termination after the sale closes (such as severance arrangements and "double trigger" incentives) will only have retentive value for those employees who are expected to be terminated in connection with the sale. However, for sales and key operations personnel, who are the least likely to be terminated, these sorts of severance payments will provide little retentive value. Retention programs are not typically necessary for a company's most senior level employees because they often already have adequate levels of severance protection and/or have accumulated several years of equity compensation grants that will be accelerated in connection with the deal closing.

What Are the Typical Parameters for a Retention Arrangement?

Once a company has determined that additional retention arrangements are necessary for certain employees, it will need to focus on the specific parameters.

Type of Retention. The three typical types of retention arrangements are severance arrangements that pay out upon an involuntary termination of employment after the sale closes, deal bonuses that pay out upon the closing of the sale and retention bonuses that pay out a specified period of time after the sale closes. Frequently the buyer and seller will have diverging interests in what sort of retention arrangements are provided, with sellers typically preferring deal bonuses and severance arrangements and buyers preferring retention bonuses.

Aggregate Amount. The question of how much money should be available for the program is based on a variety of factors, including the deal size, the industry of the company being acquired, the number of employees who will participate in the program and the per employee amount. Although there are no "hard and fast" rules to follow, there are certain guideposts to keep in mind for these factors.

1. Deal Size. In most instances the size of the new retention arrangements will be measured against the aggregate size of the sale. In this regard, as the deal price increases the aggregate retention pool will often grow, but when measured as a percentage of the deal price the retention pool percentage will typically shrink as the deal price increases. Most additional retention programs will not be more than 1% of the deal price, with percentages nearing that amount most likely to appear in deals valued below $1 billion.

2. Industry. The industry that the company is in may also have an impact on the dollar value of the retention program. For example, companies with lots of key service employees (such as investment banking or consulting) would expect to need larger retention programs than traditional manufacturing companies. This is often going to be driven by how many employees have the ability to have a material impact on the company's bottom line.

3. How Many Employees Participate. The aggregate amount available under the retention program is also related to how many employees participate and which employees participate. As you would expect, as the number of employees who participate increases, the aggregate amount available under the retention program will likely increase. A typical retention program covers 10-50 employees. However, depending on the size of the company and the industry, a retention program can be offered to far more employees. In at least one instance, a retention program was offered to several thousand employees. As more senior level employees are eligible to participate in the retention program, you would expect the aggregate amount available under the program to increase because it will likely take more value to retain these employees.

4. Per Employee Amount. The next factor that will directly affect the aggregate amount available under the retention program is the amount that will be provided to each employee. These amounts will likely vary depending on the employee's level and function, and generally are measured off the employee's then-current salary (or salary and target bonus). One times salary is not an unusual reference point. The percentage of an employee's salary offered in a retention program typically is more in those deals that are expected to have a longer period of time between the signing and the closing because the value will need to retain the employee over a longer period of time. Likewise, where the payment or a portion of the payment may be made at some point after the closing, the percentage of salary offered may be higher for the same reason.

Severance Terms. Enhanced severance protection does not focus on retention through a specific date, but rather is designed to provide the employee with protection in the event his or her employment is terminated after the deal closes. As indicated above, this retention arrangement does not work well for those employees who are not expected to be terminated in connection with the sale because these employees will not expect any payment under this arrangement. In contrast, this design works best for those employees whose positions are likely to be eliminated in connection with the sale, but where it is not clear when the termination would occur. In this case, the enhanced severance protection will provide the employee potential retentive value in the face of the uncertainty of losing his or her job at some time in the future. The payments will be triggered if the company terminates the employee without "cause," where "cause" is typically defined to include circumstances where the employee has engaged in wrongdoing, for example gross negligence or a felony. Sometimes the payments are also triggered if the employee resigns for "good reason," where "good reason" is typically defined to include a reduction in salary or forced relocation of the employee. This severance protection often is limited to terminations within one or two years after closing.

Deal and Retention Bonuses. A retention program that provides for payment upon closing of the sale is the simplest structure. Typically, this type of retention program provides for payment to an employee so long as he or she is still employed on the closing date, with payment being made promptly thereafter. This sort of arrangement may also provide for payment to the employee on the deal closing date if the employee is terminated without "cause" before the closing.

A retention program that provides for payment sometime after the closing of the sale is a variation of this sort of arrangement. The main difference, of course, is that payments will be made sometime after the closing. Most often, these payments will be made after the six-month or one-year anniversary of the closing. In some cases, there are also performance metrics associated with the payment terms. For example, a payment could be structured to only pay out if on the one-year anniversary of the closing the employee is still employed by the company and certain integration metrics have been achieved. This type of retention program will also typically provide for payment to the employee if the employee is terminated by the company without "cause", and it may also provide for payment if the employee resigns for "good reason." These payment triggers are very important from the perspective of the company that is being sold because after the closing of the sale, the buyer could terminate any of the acquired company's employees at any time and/or significantly change, among other things, employee compensation.

A final variation of the deal and retention bonuses is a hybrid approach. It is quite common to have a program that provides for a portion of the payment (in many cases, 50% of the aggregate amount) to be paid on closing and the remaining amount paid at some time within the year after the closing.

Process for Implementation of the Retention Program. Once the retention program has been designed, it is necessary to implement the program. Rarely will retention programs be communicated to employees prior to the announcement of the sale because this approach will signal to employees, and to the extent the program becomes public, to the shareholders, that a sale is likely to happen. The most common approach is to implement the program in conjunction with the announcement of the sale. In this approach, the material terms of the program will have been disclosed to, and may have been specifically negotiated with, the buyer. The benefit of this approach is that employee anxiety can be assuaged quickly after the announcement of the sale once employees are informed about the additional retentive value they are eligible to receive. An alternative approach is to communicate the terms of the retention program sometime after the announcement of the sale. This approach may occur where the terms of the program have not been fully developed in connection with the negotiation of the sale.

Other Issues to Consider

During the process of determining who will be eligible for the additional incentive and retention program and in drafting the program, the company should keep several other issues in mind. For public companies, the company should consider whether the program will need to be publicly disclosed. In some circumstances, you may find that it does not need to be disclosed, such as when no executive officers are participating or the aggregate amount that could be paid under the program is not material.

The company should also be mindful of the Section 280G golden parachute tax rules and Section 409A tax rules relating to deferred compensation. Payments under the incentive or retention program could make an employee have compensation in excess of the Section 280G golden parachute payment threshold under the tax code, which in general is 2.99 times the employee's average compensation over the previous five years. If compensation that is contingent on the change in control exceeds this threshold, anything above the employee's average compensation over the previous five years could be subject to an additional 20% tax and the employer could lose the deduction on the amount that is subject to the additional 20% tax (although there are rules that allow shareholders of private companies to approve payments and therefore exempt them from Section 280G). Similarly, running afoul of the Section 409A tax rules relating to deferred compensation could trigger additional taxes on the employees. Fortunately, most programs can be drafted to be exempt from, or to comply with, the rules relating to deferred compensation fairly easily.

Conclusion

Designing and implementing an additional incentive or retention program is not a one-size-fits-all approach. Companies need to take into account many factors to develop a program that achieves its interrelated goals of getting the highest price for the company, delivering an intact company to the buyer and retaining the most essential employees. By following this roadmap, the hope is that a company facing an imminent sale can take a thoughtful and measured approach to achieving its incentive and retention goals.