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

Episode 45: Navigating Employment Considerations in M&A Transactions

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FEBRUARY 2025

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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 Employment and Benefits Practice Group. I'm joined today by two colleagues in my practice group.

Megan Monson: Hi, I'm Megan Monson, a partner in the practice group. Happy to be here.

Taryn Cannataro: Hi, and I'm Taryn Cannataro, counsel in the practice group as well.

Jessica Kriegsfeld: Today's discussion will center on navigating employment and executive compensation considerations during an M&A transaction. This episode will delve into the typical treatment of certain types of payments and equity in connection with a transaction, certain employment related considerations, and other best practices to keep in mind when undergoing an M&A transaction as a seller.

As always, this is not intended to be an exhaustive discussion, so we encourage you to consult with your legal counsel if your company expects to undergo a transaction. To level set, there are certain payments that employers should be aware of and how they could have an impact on a transaction.

Taryn Cannataro: Once you know that an M&A transaction is underway, there are certain types of payments to employees that a company should be aware of that could be impacted by the transaction. A few examples of these are, first off, change in control bonuses or also known as sale bonuses. These may trigger payments at closing and could require a cost outlay. Another example, depending on the type of transaction, is severance payments.

Severance payments arise frequently in the context of an asset deal where employment is not being transferred to the buyer as a matter of law. And depending on the underlying contract or severance plan, it could trigger payment and require cost outlay at closing as well. Another thing that you want to look at is the treatment of equity.

And we'll discuss this in further detail later on, but it's important to note that the treatment of equity, for example, whether options are assumed or are going to be cashed out and canceled in connection with the deal, could have an impact on the deal structure and the deal value. Another example of payments that could be implicated by a transaction are withdrawal liability.

And this usually arises when a company has a multi-employer plan. And the employer could be responsible for a share of the unfunded liability for a complete withdrawal or even a partial withdrawal, which occurs if there's a decline of 70% or more of the pension front contribution.

Megan Monson: Yeah, so I think on that point, Taryn, it's important to think about whether if a company's utilizing a union workforce, whether they, one, will be utilized going forward, and whether the terms of the collective bargaining agreement will be renegotiated because those are situations that could trigger withdrawal liability.

And if there is an asset sale and the collective bargaining agreement is being assumed, the company can do what's called a 4204 transfer to avoid the withdrawal liability being triggered. So again, it all comes back to knowing what your documents say, how the deal is structured, but just being aware that these things are out there.

Taryn Cannataro: That's exactly right. And if withdrawal liability is something that the buyer has to take on, it could lead to a reduction in purchase price in the deal too.

Megan Monson: So another consideration is to think about how Section 409A, which governs non-qualified deferred compensation, applies to the transaction. There could be payments that are being triggered in connection with the change of control and the buyer or the seller may want to contemplate changing the time of those payments, which may or may not be permitted under 409A.

It also is relevant since arrangements that are subject to 409A may be more heavily scrutinized in diligence. So again, just being aware of what type of payments that you have that are out there that could be triggered by the deal and being cautious before making any changes to the terms of those payments.

Taryn Cannataro: And one other item that you want to be aware of is Section 280G. And depending on the type of company, 280G could be relevant to the transaction, specifically if your company is structured as a C corporation, and 280G could result in an excise tax on certain types of payments in connection with the transaction. So if you're a C corporation that's undergoing a change of control, you want to make sure that you talk to your legal counsel and accountants just to see if 280G could be relevant.

Jessica Kriegsfeld: How should a company undergoing an M&A transaction think about outstanding equity awards?

Megan Monson: So ultimately, it's going to depend on the terms of the equity plan and the terms and type of M&A transaction. But at a fundamental level, it's really important to have equity plans that allow for maximum flexibility in connection with a change of control so that you aren't being stuck structuring the deal in a way that works with your plan, right? That you have a plan that's so broad, the deal can be structured and the equity could be treated however you want that works under law, and you can have it handled as you need under the plan.

So the common potential treatments of equity is cashing out, meaning a cash payment in exchange for cancellation or other non-cash consideration, such as an equity award of a buyer. Cancellation of underwater or unvested options without consideration. That one I'll pause and say that's really important and having your plan allow for that. And it's something that became more commonplace over the past five or 10 years.

And so we sometimes see older equity plans that do not have that flexibility, and it can be more challenging to figure out how to treat outstanding awards in connection with the deal if the board doesn't have unilaterally ability to do that. And you want to avoid having to go out and get consent from a lot of option holders to take certain action because that could have potential holdup value in the deal.

You also want a plan to allow for cancellation of unexercised options without consideration while having a plan that allows for you to accelerate vesting either time or performance-based if desired. And that also allows for assumption or substitution of equity into a new plan of the buyer or acquirer. Again, I think the goal here is maximum flexibility under the plan and making sure that the plan allows for whatever you're trying to do.

Jessica Kriegsfeld: What if the buyer wants the management team to rollover their equity rather than cash it out in connection with the deal?

Taryn Cannataro: Management rollovers are not uncommon, but it's ultimately a business decision. Key management may be given the opportunity to transfer or rollover their equity to the post-closing entity. Some advantages of agreeing to a management rollover are it incentivizes key employees from the seller to stay involved with the go-forward business. And this can be important, for example, if there's an earn-out that has to be achieved.

There's also less initial outlay of cash for buyers and sellers can delay tax implications on sale proceeds. Some disadvantages of management rollovers are sellers receive less compensation up front, sellers also risk their equity being diluted and decreasing in value, and rollover equity may cut into the post-closing entity's profits if the post-closing entity is later sold.

Jessica Kriegsfeld: What about earn-outs? Can you explain to us what they are and whether it's common for a portion of the deal proceeds to be paid out after closing?

Megan Monson: Earn-outs are a form of deferred payment to the seller that is contingent on achievement of post-closing milestones. For example, an earn-out can be tied to a certain level of post-closing revenue or a performance goal. They are pretty common in mid-market deals. Earn-outs can benefit a buyer by making sure that the company performs as represented because now they have a vetted interest in hitting those metrics because it's tied to part of their proceeds in the deal.

And by delaying part of the purchase price, it also incentivizes sellers to remain involved in the business since their financial interests are tied to the business' performance. So it kind of has the benefit for the buyer in ensuring those folks are going to stick around. Earn-outs can also be beneficial to the seller potentially by staggering a seller's tax burden over several years and ensuring that the seller remains involved in the business.

Again, but making sure from the seller's standpoint that there are sufficient protections so that the buyer cannot remove these people from the business, then they're terminated without cause, and now that they can't hit those earn-out metrics.

Taryn Cannataro: One thing to think about is whether an earn-out is structured to be compensatory or deal consideration, or most often it's going to be structured to be deal consideration. But if it is compensatory, you need to worry about compliance with Section 409A because it could be viewed as deferred compensation depending on the terms.

And just one other point to be aware of with respect to earn-outs is they can have an impact on the stock option exercise price if options are assumed by a buyer. And so that can make other aspects of the deal challenging to figure out how much option holders are actually being paid in connection with the transaction.

Jessica Kriegsfeld: Now that we've discussed the compensation and equity treatment, what happens to a selling company's employees in the context of a transaction?

Taryn Cannataro: Well, first, it depends on the structure of the deal. In asset sales, there's a termination of employment as a matter of law as of closing. So the buyer typically has the option to selectively hire the employees that they want from the seller or hire all employees and will typically be able to do so on their own forms. A buyer could use this opportunity to set new terms of employment.

In stock deals, there's typically no change in the employment relationship of the seller's employees. So unless terminated, all employees will continue with the buyer, and buyer assumes all employment related and benefits related liabilities, including benefit plans that are not terminated prior to closing.

But it will also depend on the deal terms. It's become increasingly popular to require a certain percentage of the seller's employees to accept employment with buyer as a closing condition. It's also common to require key employees to enter into new offer letters or employment agreements or covenant agreements as a closing deliverable.

Jessica Kriegsfeld: For employees who remain employed post-closing, what do their employment and compensation terms typically look like?

Megan Monson: So one of the first things to think about is whether as a seller to ask for any employment related post-closing covenants in your definitive transaction agreement. Otherwise, the buyer has flexibility to make a lot of changes subject to compliance with the terms of any underlying documents. So one thing we typically see is an employment related covenant that requires compensation and benefits to continue to receive those levels of compensation and benefits for a period of time, often 12 months post-closing.

Another thing that we often see is crediting of service with respect to participation and buyer benefit plans. And for the year of the transaction, if benefit plans are changing, it's also important to ask for crediting of co-payments and deductibles because employees would've already paid into one plan and now they are potentially being shifted onto a buyer's plan.

And employees care if things are changing and how their compensation and benefits compared to what they had before. So it's important to be mindful of how this is going to impact the employees and that'll also be relevant to how they're going to perceive the transaction. You also want to consider avoiding having any lapses in coverage under any health and welfare plans. So this is where the crediting of service can really come into play and be important.

Another thing to think about is considering the terms of employment. If the idea is for existing arrangements to stay in place, buyers are often going to want to review seller's underlying documents to ensure compliance with applicable law, that they are not inconsistent with the buyer's policies, that they generally follow the buyer's compensation philosophy, and that there's also adequate protection as it relates to restrictive covenants.

If not, those might be reasons that a buyer may ask for new arrangements for employees. And if new offer letters, employment agreements, or covenants agreements are being entered into in connection with the transaction, whether it's a stock or asset deal, consider how and when to communicate the terms of that employment to seller employees because it's often the first time that employees are interacting with the buyer. So messaging is key.

You really want to make them excited about the opportunity. And so if there are changes being made to their compensation or benefits, it is critical to make sure it's done in a way that it's viewed as a positive, especially if the employees are an integral part of the business that's being purchased.

Offer letters are typically used for rank and file employees versus employment agreements may be more appropriate for higher level employees with more complex compensation structures. And just generally with all of these points, making sure that there's consideration for any state specific laws that need to be considered, such as offering additional consideration for entering into new agreements.

Jessica Kriegsfeld: What if there are employees who are being let go in connection with the deal? Is there anything to consider with respect to them?

Taryn Cannataro: If you have employees who are being let go in connection with the deal, you want to be mindful of whether there could be any state and/or federal WARN Act considerations to keep in mind that would be triggered and who will bear the cost of that. The WARN Act requires that certain employers, generally those with 100 or more employees, provide advanced notice of any planned closing or mass layoffs.

And if WARN is triggered, you will have to consider the mandatory notice requirements, any severance obligations, which are mandatory in New Jersey, and also civil penalties for failing to comply with WARN.

Megan Monson: Just to interject on one point, Taryn, is that I think it's important to mention that some states have many WARN Acts, and so their thresholds could be lower than the federal threshold Taryn mentioned. And that also depending upon the structure, even if there is not we'll call it an actual layoff, such as it's an asset sale and people are still continuing or being offered employment, WARN could also be triggered. So it's important to look at the specific facts and circumstances.

Taryn Cannataro: Exactly. And determining who will bear the cost of these items could be negotiated within the purchase agreement itself. You also want to be mindful of any COBRA considerations and who's responsible for those. And this includes not only employees being terminated in connection with the transaction, but could also include those who are on COBRA prior to the transaction as well.

And similar to the WARN Act considerations, you can negotiate who's responsible for this obligation in the purchase agreement. If you don't negotiate it, the default will be that the responsibility lies with the seller unless they no longer maintain a group health plan post-closing. This often comes up in an asset sale where employees are not automatically continuing with the buyer.

And as we mentioned earlier, you also want to be mindful of any severance liabilities. And you would want to consider whether any severance obligations exist and who will be liable for paying those. And again, those could be negotiated within the purchase agreement itself.

Jessica Kriegsfeld: As you heard today, it's important to consider how the workforce and their compensation and benefits will be treated in connection with the transaction. When navigating an M&A transaction, companies should keep in mind the types of payments that might be triggered in a transaction, as well as what the terms of employment should look like post-closing.

If you're interested in learning more about how to prepare for an M&A transaction before it begins, please see our previous episodes on that topic. This episode is intended to be a high-level overview, but is by no means an exhaustive discussion. Thanks for joining us today. We look forward to having you back for our next episode of Just Compensation.

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