Insights Conversations: Employment Factors to Consider in Carve-Out Transactions

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Carve-out transactions can quickly become complicated by employment considerations — who stays, who goes and what practices govern the transitions. At the April 18, 2016, "Skadden Cross-Border M&A Conference 2016: Successfully Navigating Complex Acquisitions," partners Erica Schohn and David Schwartz discussed key employment issues to consider in carve-outs to ensure the continued success of both the parent company and the carved-out business.

How do you approach employment considerations in a carve-out?

David: From an employment standpoint, there are two main phases: due diligence and planning for the transition. The due diligence phase involves gathering the critical pieces of information that will help us move the transaction from signing to closing. We start by assessing how many employees are involved and what roles they play. Key questions we need to answer include: Are they primarily working for the parent company, or are they primarily working for the carved-out business? Are there certain people who need to be treated differently because they are critical to operations? Are there people who support both the parent company and the carved-out business? How will they be handled and will any necessary functions be left uncovered?

Preparations for the actual transition involve figuring out the best way to transfer employees as well as how to communicate the changes to them. Do you have to transfer existing employment plans or start anew? Should you implement a retention plan to keep employees from leaving in large numbers?

What is your starting point in evaluating existing employment arrangements?

David: After we've considered what the population looks like, we start thinking about documents. Do they have employment agreements? Employment contracts often have successor-and-assigns provisions, which allows the company to transfer the contract. If the contract is silent on those provisions, we look to applicable state law, which varies on an employer's ability to assign employment contracts. We also look at employment agreements to see if they have severance provisions and, if so, what would trigger them. Complications can arise when moving employees from one entity to another, or if employees are moved from one affiliate to another. You may have to pay the severance or try to amend the employment agreements.

Erica: In any transaction, you want to review the change-in-control provisions. For instance, it's common to see some type of accelerated vesting protection of long-term incentive (LTI) awards in connection with a change in control. Often, however, these provisions will not be triggered in a carve-out transaction because the change-in-control provisions are triggered by the sale of the entire entity, not just the sale of the carved-out business. As a result, the employees stand to lose significant value in their seller LTI awards when the employees terminate employment from the seller group at the time of closing. As an acquirer, you may find yourself faced with unhappy employees, and so it can become a key deal issue. To address this, acquirers may ask sellers to either provide full or pro-rata vesting of LTI awards. If the acquirer does not have enough leverage to get the seller to agree to accelerate vesting, the buyer should consider whether a post-closing cash or equity retention program is appropriate to replace the lost equity value.

David: Another factor can be collective bargaining agreements. The union membership rate in the U.S. private sector is relatively small — 6.7 percent in 2015. But if you have them, you need to address them. Often in an asset transaction, the employer can leave the union contract behind, meaning they don't necessarily have to assume the collective bargaining agreement unless it contains a specific successors-and-assigns clause. But, if you hire a majority of the unionized workforce, you at least have to recognize the union and then bargain with them for a new contract.

In the case of multiemployer pension plans — plans that are generally sponsored by the union and, as the name implies, includes a number of different employers that the union has organized — they are generally defined benefit plans and often underfunded. As a buyer, you should know that part of what you're buying may be contingent withdrawal liabilities related to underfunded multiemployer pension plans. Those liabilities may be triggered in an asset sale if the sale results in the seller's withdrawal from the plan. Under successor liability principles, the acquirer can be on the hook for the seller's withdrawal liability obligations if the seller refuses or is unable to pay. As with single-employer defined benefit plans, the acquirer may be able to negotiate a purchase price adjustment on the basis that the potential withdrawal liability is a preclosing liability. One option to avoid multiemployer plan withdrawal liability being triggered by an asset deal is for the acquirer to assume the seller's contribution obligations for the plan. Unlike with single employer pension plans, it may not be an option to just leave the liability behind with the seller.

How are employees typically transferred, and how might the methods differ between the U.S. and Europe?

Erica: In the U.S., a stock transaction is by far the easiest way to transfer employees. Since the employees' employer is not changing, their employment automatically continues post-closing, and there is no need for the acquirer to make offers of employment to individual employees. U.S. law doesn't require the maintenance of specific terms and conditions of employment, so there's flexibility for an acquirer to change terms post-closing even in a stock transaction. Outside the U.S., the potential downside of a stock transaction is that the acquirer usually is unable to change any of the terms and conditions of employment applicable to acquired employees, so the acquirer must set up a program that maintains them, which is more difficult if they are not taking on any of the existing employment plans.

Where the carve-out is an asset transaction, which for employees means that the stock of the employee's current legal employer is not being acquired in the transaction, the acquirer will either need to offer employment to individual employees or, in certain jurisdictions, an automatic transfer process may apply. The automatic transfer process applies in Europe (where the transfer is sometimes referred to as a "TUPE-transfer" after the U.K. law governing these transfers) and in a smaller number of jurisdictions in South America and Asia. A benefit of the offer-and-acceptance process is that you have the flexibility to change the terms and conditions of employment if the employees accept the change. In some countries, there also is a limited ability to change some terms and conditions of employment in the context of a TUPE-transfer. The downside of this structure is the added administrative difficulties with negotiating with individual employees and union and works council representatives, who can make significant demands before they agree to the transfer.

What else do you look for?

David: We have to consider whether there are any significant litigations, especially on the buy side. Are there big class actions? Is there a lot of money involved? If so, should there be a purchase price adjustment? Issues often come up about who's going to control the litigation — who can settle the litigation and whether the seller is going to indemnify the buyer. It is also worth considering whether the buyer will have access to documents and witnesses to determine the actions and whether any changes in personnel practices are required.

Worker classification is a very hot topic in U.S. employment law these days. Depending on the duties they fulfill, certain employees may be exempt from overtime requirements, meaning they are paid a fixed weekly salary. During a carve-out, employees' duties may change, so as the buyer, you need to figure out whether you're acquiring any existing problems. You need to be aware of your potential employees' classification status. A transaction may also present an opportunity to change employees' duties and bolster arguments for exemption.

Why is it important to tackle employment issues early in the carve-out process?

Erica: From an employment perspective, carve-outs are some of the most complex transactions that we handle. It's important not to underestimate the amount of time it will take to navigate the complexities. Most companies grow organically, hiring as they get more sophisticated. Now imagine being a buyer who starts a company with 1,000-2,000 employees right off the bat; that's what happens in carve-outs. People will expect to be paid on time, whether you have an existing human resources framework in place or are starting from scratch. Companies need to understand that you can't put this off until the last minute.

The human resources and finance teams tend to work diligently — but in their silos. Finance teams negotiate the asset and liability statements for the carved-out business, and these statements feed into the purchase price mechanics. If the HR team is independently negotiating HR provisions, they may agree to assume preclosing liabilities that never end up reflected in the liability statements. That's a problem because as the buyer, you can end up assuming preclosing liabilities that you don't receive a price adjustment for, which increases the cost of the deal.

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Once a deal is announced, employees must get nervous. How do you help maintain stability amid the uncertainty?

David: Employees want to know what's going to happen to them. Are they going over to the new company? Staying with the old company? Are salaries and benefits going to change? Each deal is going to be different. It's important to have a game plan from the beginning and to think about how the company should communicate with the employees. A lot of the nervousness and consternation can be alleviated with proactive messaging. The company should consider whether the communication will be in writing or whether meetings will be scheduled. Is a point person going to be appointed to respond to questions?

You also need to plan if you're going to shed some employees. Under U.S. federal law, if you're laying off a large enough group of employees, they are entitled to at least 60 days' pay and benefits under the Worker Adjustment and Retraining Notification (WARN) Act. Some states have their own WARN acts, with provisions that vary for what triggers protections under the act.

Erica: If the deal announcement results in instability, companies need to look at retention plans, especially if you have employees who were part of a huge company with name recognition and now will be working for a company nobody has heard of. It may be worth negotiating whether the seller or buyer will be responsible for the cost of trying to keep employees in place.

In the U.S., if the buyer in an asset or carve-out transaction offers employment to the target company's employees, there is no statutory severance entitlement — severance rights are governed by contract. In the U.S., most severance plans provide that an employee who receives a comparable offer of employment in connection with a transaction will not be entitled to severance, even if that individual turns down the offer. That's very different from what you see in many countries around the world. Overseas, companies often have to maintain every term and condition in order to avoid any individual claiming a right to severance, which is a much higher bar to meet.

Employment matters in carve-outs are multifaceted. Careful preparation will help companies navigate the complexities and seamlessly transition employees for long-term operational and financial success.

This discussion is taken from the April 18, 2016, "Skadden Cross-Border M&A Conference 2016: Successfully Navigating Complex Acquisitions."