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PERSPECTIVE

Retention bonus program considerations in M&A transactions

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If your company or business is the target of a merger or acquisition, ensuring that key employees are retained is a critical component to a successful transaction. Often times companies will put in place a retention bonus program that is designed to incentivize a select group of employees to continue providing services up to, and if desired, for a transition period following the closing of a transaction. A retention bonus program may also serve to mitigate the uncertainty around the transaction so that employees may focus their efforts on continued service, a successful transaction and a smooth transition that provides the acquirer with business continuity. This article highlights key considerations for establishing a successful retention bonus program.

Review Existing Compensation Plans. In order to assess whether a retention bonus program is desirable, it is important to understand the terms of existing compensation plans and agreements with employees and the impact of the transaction under those plans, including any expected payout of incentive awards, whether in the form of cash or equity, resulting from the transaction. Companies should also consider the extent to which employees may be entitled to severance pay as a result of an involuntary termination of employment, including in connection with a change in control, whether pursuant to an employment agreement, equity award or broad-based severance program or practice.

One of the key decisions for any company undergoing a sale process will be whether to establish a retention bonus program as a tool to incentivize key employees to continue to provide services in order to achieve a successful transaction.

Eligibility. When evaluating the scope of employees who will participate in a retention bonus program, companies should consider those employees who are critical to the short-term and/or long-term success of the business, including those needed for integration purposes. At the same time, companies should identify those key employees who may be at most risk for leaving employment in connection with the transaction, whether initiated by the employee or the acquirer which may have a view towards eliminating certain positions. Eligibility may be limited to individual employees or a broad group of employees. The timing of the transaction is also an important factor as it may be appropriate to include a termination date for the program if the transaction has not closed prior to a specified date.

Value of Retention Bonus. The value of a retention bonus generally varies depending on the level of seniority of the participants. Senior executives may receive retention bonuses having a value in the higher range of twelve to eighteen months of annual salary, while retention bonuses for non-senior employees are generally lower to reflect their positions, but are typically based on a fraction of annual salary or annual target compensation. The retention bonus may be expressed as a fixed dollar amount, a percentage of current compensation or, less typically, based on a formula which may be tied to a transaction price or one or more performance metrics or milestones that are keyed to the business. The value of existing compensation entitlements, including equity acceleration and entitlement to severance, and any long-term incentive awards that may be issued by the acquirer should also be factored in determining whether a retention bonus may achieve its intended result for each participant.

Form and Timing of Payment. Payment of a retention bonus is typically made in the form of cash, although equity incentive awards may also be used, but companies should consider how those awards are treated in the transaction, such as whether the awards will be cashed out and/ or assumed or substituted for by the acquirer. While most retention bonuses are fully paid at closing, some retention bonuses are designed with a portion paid at closing and the remainder payable at a fixed date or on a schedule of dates following closing, which often range from six to twelve months post-closing, and may vary among participants depending on the expected duration of their transition services. The expected timing between signing and closing should also be considered as it is not uncommon for a portion of a retention bonus to become payable prior to closing for transactions with long pre-closing periods.

Continued Employment Requirement. In order to receive payment of a retention bonus, participants are generally required to be actively employed either on the payment date or through a specified date with payment to follow shortly thereafter, such as the next regularly scheduled payroll date or within thirty days thereafter, as the programs are typically designed to be short-term payments and not providing for the deferral of compensation which may require compliance with complex rules under Section 409A of the Internal Revenue Code.

A key issue to consider is whether payment of the retention bonus should be accelerated for participants whose employment is involuntarily terminated by the company or its successor without cause, or, for certain participants, by the participant for good reason (i.e. a material diminution in the participant's base salary or target bonus opportunity or a relocation of the participant's primary work location). Protection for payment of retention bonuses upon a resignation for good reason is often limited to a very small group of executives or management, and the good reason triggers are subject to close review by acquirers and negotiation as both the acquirer and management are sensitive to changes in terms and conditions of employment, such as a change in title, authority, duties or reporting relationship, that may occur post-closing as a result of the transaction. For accelerated payment of retention bonuses on an involuntary termination of employment, companies will often require that the participant execute an effective release of claims as a condition to payment and, in some cases, may condition payment on the participant's continued compliance with certain restrictive covenants, such as non-competition, non-solicitation, confidentiality and non-disparagement covenants, subject to enforceability under applicable state law.

Cost of Retention Bonus. The cost of the retention bonus is likely to be borne by the company as a reduction in the transaction proceeds payable to the sellers, though acquirers may put in place their own retention bonus program post-closing or become responsible for payments that become due following an involuntary of employment as a result of action taken by the acquirer post-closing. Also, when calculating the cost of a retention bonus program, companies should analyze the impact that retention bonus payments, together with other transaction-based payments, may have under the golden parachute rules of Internal Revenue Code Section 280G which can potentially result in adverse tax consequences to the participant and the company, unless an exception or mitigation strategy is available.

Communication to Acquirer. Companies should consider the timing of communication and presentation of the retention bonus program to an acquirer in the context of general discussions surrounding the transaction. Communication is key as the acquirer is likely to have its own views on the overall cost of the program together with those employees viewed as critical to the transaction.

Public Company Concerns. Public companies should be particularly aware of issues that may arise in connection with adopting a retention bonus program, such as concerns from institutional stockholders and proxy advisory firms over the level of payout if excessive, public disclosure in a merger proxy or other registration statement required to be filed for the transaction, including pursuant to a say on golden parachute pay vote, if applicable, and consideration by the board of directors and its compensation committee of the interests of participants, including officers, as those interests may be different from the interests of the company's stockholders generally. A properly designed retention bonus program should serve to increase stockholder value with retention of key talent being a critical component of the transaction.

One of the key decisions for any company undergoing a sale process will be whether to establish a retention bonus program as a tool to incentivize key employees to continue to provide services in order to achieve a successful transaction. For companies that decide on paying retention bonuses to employees, a variety of terms and conditions are available to effectively design a program that is uniquely tailored to the goal of talent retention in the uncertain environment of a transaction that reflects the company's individual needs. ■

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