

Professional Perspective

Employee Compensation Considerations for M&A Transactions During and After a Pandemic

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Employee Compensation Considerations for M&A Transactions During and After a Pandemic

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The Covid-19 crisis continues to have a significant effect on the ways that companies approach employees and employee compensation in attempts to weather turbulent global economic conditions. Many companies have taken a range of employee-related actions to comply with governmental ordinances and maintain safety and sustain financial viability, while also availing themselves of relief under Covid-19 legislation such as the Coronavirus Aid, Relief and Economic Security Act (CARES Act) and other similar legislation.

As a result, the Covid-19 crisis has added a layer of complexity to corporate transactions for both buyers and sellers with respect to employee and compensation matters. The actions taken by companies in the midst of the Covid-19 crisis, along with the various and often complicated restrictions imposed by the Covid-19 relief legislation, prompt a number of new considerations that should be taken into account during the course of a corporate transaction when assessing the potential liabilities, integration difficulties, and other concerns that may arise with respect to employees and their compensation. This article discusses best practices for buyers and sellers when negotiating employee compensation matters in this new transactional landscape.

General Covid-Related Actions

Companies have taken a range of significant employment-related actions in order to reduce costs in connection with the economic downturn caused by the Covid-19 crisis, including hiring freezes, working hour reductions, furloughs, layoffs, and terminations. In addition to or in lieu of these employment-related actions, companies have also taken a range of employee compensation-related actions, including reductions in salary and other compensation, modification of incentive award metrics, and payouts and payment deferrals.

Diligence Items. In the context of an acquisition, the buyer should request a detailed description of all employment-related and compensation-related actions that the target company has taken, or plans to take in the future, in connection with the Covid-19 crisis, including hiring freezes, furloughs, layoffs, terminations, compensation reductions (including any impact on severance and change in control arrangements), incentive modifications, payment deferrals, or similar actions. Once the target company provides this detailed description, it should be confirmed that all actions have been taken in compliance with applicable federal, state, and local laws. For example, the target company should confirm that Worker Adjustment and Retraining Notification Act requirements were met with respect to any employee furloughs and layoffs, that any payment deferrals were made in compliance with Internal Revenue Code Section 409A, and that all paid sick leave has been provided in compliance with the Families First Coronavirus Response Act.

In addition, the target company should confirm whether it has received any complaints regarding any of the described actions, whether in a proceeding, government action, or investigation, through an individual's counsel or otherwise. The target company should also confirm that any benefit plan modifications that have been made, including any qualified retirement plan modifications required under the CARES Act, have been implemented in compliance with the terms of the plan and applicable federal, state, and local laws.

Prohibition of Certain Actions Between Signing and Closing. From an employee relations perspective, it is also important for the buyer to ensure that the target company is required to obtain the buyer's consent to take any employment-related or compensation-related actions between the signing and the closing of the transaction. Standard interim operating covenant provisions, which set out actions that may not be taken by the target company between the signing and the closing of the transaction without the buyer's consent, typically prohibit increases in compensation and benefits, the establishment, amendment or termination of compensatory plans and arrangements, and employee hiring, promotions, and terminations. However, in light of actions being taken by companies to reduce costs during the Covid-19 crisis, prohibitions on the following actions with respect to employees of the target company should also be considered:

- Implementation of any layoffs, furloughs, or reductions in hours.
- The rehire of any laid-off target employees, or the return of any furloughed employees to the workplace.

- Any reductions in compensation or benefits.
- The return of compensation and benefits back to pre-reduction levels.

Post-Closing Considerations. The post-closing employee covenants included in the transaction document typically require the buyer to provide target company employees with compensation and benefits at a certain level for a specified period following the closing of the transaction. The levels at which such compensation and benefits must be provided are typically set by comparison to the levels at which such compensation and benefits were provided to target company employees as of immediately prior to the closing of the transaction. For example, post-closing employee covenants may commit the buyer to providing, for one year following the closing of the transaction, salary, and target cash bonus opportunities at least equal to those provided as of immediately prior to the closing of the transaction, and other compensation and benefits substantially comparable, in the aggregate, to those provided as of immediately prior to the closing of the transaction.

Given that many companies have instituted reductions in compensation and benefits due to the Covid-19 crisis, target companies may wish to include language in the post-closing employee covenants providing that any voluntary and/or temporary reductions in compensation and benefits will be disregarded for purposes of determining the levels at which the buyer must provide compensation and benefits for the specified period following the closing of the transaction and that target employees will return to pre-Covid-19 levels of compensation and benefits no later than the closing of the transaction or a specified period of time thereafter. If the buyer has affected compensation and benefit reductions for its own employees, it may prefer to instead provide that the return to pre-Covid-19 levels of compensation and benefits will occur at the same time as it happens for buyer employees generally.

Also, to reduce the likelihood that employee-relations issues will arise from the post-closing employee covenants, buyers should consider placing certain provisions of the post-closing employee covenants in the disclosure schedules (which are generally not as widely distributed as the transaction document and are generally not publicly filed in the context of a public company transaction) rather than in the transaction document. This approach allows the parties to address potentially sensitive items such as timing of reversion to pre-Covid-19 compensation levels, treatment of severance, and other transaction-specific circumstances while reducing the potential of having broad disagreement or objection from buyer and target company employee populations.

Payroll Tax Deferral Program. Many companies are participating in the CARES Act Payroll Tax Deferral Program, which allows employers to defer the deposit and payment of the employer's portion of social security taxes that would otherwise be required to be made during the period beginning on March 27, 2020, and ending on Dec. 31, 2020. The deferred deposits of the employer's portion of social security taxes will be treated as timely paid if 50% of the deferred deposits are paid by Dec. 31, 2021, and the remaining deferred deposits are paid by Dec. 31, 2022.

Diligence Items. The buyer should request that the target company confirm whether it is participating in the deferral program. If the target company confirms that it is doing so, it should be asked to confirm a number of related diligence items to assess whether the target company has utilized the program in a compliant manner. This should include a description and calculation of the amount of the employer's portion of social security taxes being deferred and any Forms 941 reflecting such amounts. In addition, the target company should confirm that other employment taxes (i.e., federal income tax withholding, the employee's portion of social security taxes, and both the employer's and employee's portions of Medicare taxes) have not been deferred pursuant to the program.

Prohibition of Certain Actions Between Signing and Closing. Where a target company has demonstrated during the diligence process that it has been properly administering the deferral program, the buyer may feel comfortable allowing it to continue doing so. However, if diligence reveals any compliance failures in the target company's tax deferrals, or that the target company is not participating in the program, the buyer may want to consider either prohibiting the target company's deferral of taxes between signing and closing of the transaction without the buyer's consent or including a cooperation provision for the buyer and target to work together to implement the deferrals prior to closing.

Employee Retention Credit. Many companies have also been taking advantage of the CARES Act employee retention credit. The credit is a fully refundable tax credit for employers equal to 50% of qualified wages that eligible employers pay their employees between March 12, 2020, and Dec. 31, 2020, up to a maximum \$5,000 credit with respect to each employee. Employers may receive advance payment of the credit by filing a Form 7200 with the IRS. Employers are eligible for the credit if they carry on a trade or business during calendar year 2020 and either fully or partially suspend operation

during any calendar quarter in 2020 due to orders from an appropriate governmental authority limiting commerce, travel, or group meetings (for commercial, social, religious, or other purposes) due to Covid-19 or experience a significant decline in gross receipts during the calendar quarter. An eligible employer may not receive the credit if it, or any entity treated as a single employer under the aggregation rules, receives a loan under the CARES Act's Paycheck Protection Program (PPP) that it did not return before May 15, 2020.

Diligence items. The buyer should request that the target company confirm whether it is taking advantage of the credit. If the target company confirms that it is doing so, the target company should be asked to confirm a number of related diligence items to assess whether the target company has complied with the credit requirements, including:

- A description of (i) the target company's rationale for qualifying for the credit, (ii) the calculation of the qualified wage amounts being claimed, and (iii) the employment taxes that were reduced and not remitted in respect of the credit.
- Confirmation as to whether the target company has filed a Form 7200 to receive advance payment of any such credit.
- Confirmation that the target company (including any entity treated as a single employer under the aggregation rules) has not received a loan under the PPP, or alternatively that the target company (or applicable affiliated entity) fully repaid any such loan before May 15, 2020.

Additional Considerations. The buyer should consider including a cooperation provision where the target company has not taken advantage of the credit at the time of signing, but the buyer would like the target company to do so prior to the closing of the transaction with oversight from the buyer.

PPP Loans. Many companies have applied for and received loans under the PPP. The PPP provides small businesses with forgivable low-interest loans to assist in retaining employees, maintaining payroll, and covering certain other business costs. A company (together with its affiliates) must generally have 500 or fewer employees at the time of application to be eligible to receive a PPP loan. A PPP loan will be fully forgiven if the loan proceeds are spent within the applicable covered period following receipt of the loan, the loan is only used for certain permitted uses (payroll costs, interest on mortgage obligations, rent, and utilities), at least 60% of the loan is used for payroll costs, and certain other staffing and pay level requirements are met. The covered period during which loan proceeds must be spent is generally 24 weeks following receipt of the loan, or Dec. 31, 2020, if earlier (although recipients may use an 8-week covered period if the loan was received before June 5, 2020).

Diligence Items. The buyer should request that the target company confirm whether it has applied for or received a PPP loan. If the target company confirms that it has done either, the target company should be asked to confirm a number of related diligence items to assess whether the target company has complied with PPP requirements, including:

- Confirmation that the loan received under the PPP was either (i) less than the \$2 million safe harbor amount, or (ii) "necessary to support the ongoing operation of the Company" in accordance with the PPP rules.
- A description of how the target company calculated the amount of the loan received under the PPP.
- Confirmation that the target company (together with its affiliates) had 500 or fewer employees at the time of application or, if the target company (together with its affiliates) had more than 500 employees, a description of the rationale for qualifying for a loan under the PPP.
- Confirmation that the target company expects to receive (or has already received) forgiveness of 100% of the loan amount.

Prohibition of Certain Actions Between Signing and Closing. Where a target company has demonstrated during the diligence process that it has been complying with PPP requirements and maximizing the portion of the PPP loan that is forgivable, the buyer may feel comfortable allowing it to continue doing so. However, if diligence reveals any compliance failures with respect to a PPP loan, or that the target company is using the PPP loan for purposes that will reduce the forgivable portion of the PPP loan, the buyer may want to consider prohibiting any uses of a PPP loan or any other actions between signing and closing that would cause any amount of the PPP loan to not be forgiven or reduce the amount that

would otherwise be forgiven (including due to decreases in compensation, modification of awards, terminations, furloughs, hour reductions, and other similar actions).

Additional Considerations. Because the CARES Act does not allow companies (including any entity treated as a single employer under the aggregation rules) to avail themselves of the relief provided under both the employee retention credit and the PPP, the buyer should assess whether it, or any members of its affiliated group, is utilizing or has any intentions of utilizing the credit. If the buyer or an affiliated group member is using the credit or intends to do so, but the target company has received a loan under the PPP, the buyer and other members of the buyer's affiliated group may not be permitted to utilize the credit. In these circumstances, the buyer should consider requiring the target company to return the PPP loan, although guidance from the IRS remains unclear as to whether any such return of the loan that occurs on or after May 15, 2020, is an adequate cure that will allow the buyer and other members of the buyer's affiliated group to utilize the credit.

Other CARES Act Loan Programs. Companies may also participate in certain other loan and loan guarantee programs in accordance with the CARES Act Coronavirus Economic Stabilization Act provisions, including the Federal Reserve's Main Street Lending Program. Unlike under the PPP, companies that participate in these loan and loan guarantee programs are subject to certain limits on employee compensation beginning on the date the loan or loan guarantee is entered into and ending one year after the date the loan or loan guarantee is no longer outstanding. Under these limits, total compensation for each officer or employee during any consecutive 12 months during the limitation period may not exceed (i) if the officer or employee had more than \$425,000 (but less than \$3 million) in 2019 total compensation, the 2019 total compensation of such officer or employee, or (ii) if the officer or employee had more than \$3 million in 2019 total compensation, the sum of \$3 million plus half of the 2019 total compensation in excess of \$3 million. In addition, severance or other benefits upon termination of employment during the limitation period may not exceed two times the maximum total compensation received by the officer or employee in 2019.

If a target company confirms that it is participating in one of these programs, the buyer should consider any administrative concerns regarding employee compensation that may arise after the closing of the transaction due to the CESA employee compensation limitations. For example, the employee compensation limitations under CESA may affect the buyer's ability to put in place earnouts and other incentives for highly compensated employees following the closing of the transaction. Because the employee compensation limitation period extends until one year after the date the loan is no longer outstanding, returning a loan provided under CESA would not relieve the target company of the employee compensation limitations imposed under CESA. In addition, it remains uncertain how the compensation limitations imposed under CESA may apply following the closing to legacy buyer employees who become employed by or receive compensation from the target company, or to legacy target company employees who become employed by or receive compensation from the buyer or one of the buyer's other affiliates.

Conclusion. The actions taken by companies in response to the Covid-19 crisis and the various forms of relief provided under the CARES Act give rise to a number of new considerations that should be taken into account during a corporate transaction. It is also crucial to stay abreast of the constantly changing rules and guidance under the CARES Act, which may further inform or change the myriad of considerations that buyers and sellers should consider when negotiating employee and employee compensation matters in the context of an M&A transaction.