Professional Perspective

Executive Compensation & Carve-Out Transactions

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Editor's Note: This article is part of an ongoing series exploring executive compensation considerations in different types of M & A transactions.

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This article provides a high-level overview of the key executive compensation matters that may arise for the acquirer in a carve-out transaction. A carve-out transaction is one in which a company (Seller) sells or divests one or more of its subsidiaries, divisions, business lines, or other component parts (Business) to a third party (Acquirer) and retains the remainder of its businesses.

While similar to the acquisition of an entire company, there are a number of complex issues specific to carve-out transactions that need to be addressed in the very early stages of the transaction. Particularly, the parties must determine:

- Which Seller employees will transfer to Acquirer in connection with the transaction (In-Scope Employees)
- Whether any compensation and benefits arrangements for In-Scope Employees will transfer to Acquirer in connection with the transaction
- Whether In-Scope Employees will forfeit any compensation or benefits as a result of the transaction
- The appropriate treatment of any pre-closing liabilities for compensation or benefits with respect to the In-Scope Employees

Acquirer's approach may vary depending on whether Acquirer is a strategic buyer with an operating business, or a financial buyer, such as a private equity fund, without existing programs. Strategic buyers often have existing compensation and benefits infrastructure ready to absorb In-Scope Employees. By contrast, financial buyers may need to implement new arrangements for In-Scope Employees in a short timeframe or request that Seller provide transition services for a period following the closing.

In either case, executive compensation practitioners should be engaged at the beginning stages of a carve-out transaction and remain in close contact with the broader deal team throughout the entirety of the transaction. This is critical to support the success of the overall transaction and post-closing integration.

Determine In-Scope Employees

The first step for Acquirer will be to determine which In-Scope Employees should transfer employment in connection with the transaction.

Initially, Seller identifies the employees who provide services to the Business, and Acquirer determines, to the extent possible based on limited information, which of those employees are necessary or desirable for the ongoing operation of the Business after closing. A specific standard may be used to determine the In-Scope Employees, such as all Seller employees who are “solely” or “primarily” dedicated to the Business, or the parties may instead agree on a specific list of individuals. Acquirer will often conduct business level due diligence, including site visits and employee interviews, to ensure that the In-Scope Employees are adequate for it to run the Business after the closing.

A specific point of negotiation between the parties may involve so-called “shared services” employees. These are Seller employees who do not qualify as In-Scope Employees but who are otherwise necessary for Acquirer to operate the Business. An example would be a human resources or finance employee who only spends 25% of their working time on the Business but is needed for the Business to operate after the closing because they are the only Seller employee who handles the function. In this case, Seller may agree to allow the employee to transfer to Acquirer—especially in a case where Seller has other employees who can handle the employee's other duties or may instead provide transition services for a specified period to allow Acquirer time to hire its own employees to handle the function.

While outside the scope of this article, additional consideration will need to be given to the appropriate treatment of unionized employees and employees located outside of the United States, including the engagement of local counsel.

Due Diligence

The due diligence process in a carve-out transaction differs from a complete company acquisition because some or all of the compensation arrangements that apply to In-Scope Employees may be sponsored by Seller, rather than sponsored by entities transferring to Acquirer as part of the Business. Seller-sponsored arrangements often cover both In-Scope Employees and Seller employees that will not transfer to Acquirer. Therefore, the due diligence process will be focused on determining which arrangements will transfer and which will be retained and, to a lesser extent, compliance issues relating to such arrangements that may impact the Acquirer.

The overall scope of the diligence review is similar to that which applies in the acquisition of an entire company and generally includes, as applicable:

- Employment agreements and other individual compensation arrangements
- Short-term and long-term incentive awards (cash and equity)
- Severance arrangements
- Retention, transaction, and similar types of bonuses
- Nonqualified deferred compensation arrangements
- Perquisites or other enhanced benefit arrangements

Many of these materials will not be publicly available, even if Seller is a public company. Consequently, Acquirer will need to conduct the due diligence process similar to that for a private company acquisition. This includes creating a comprehensive due diligence request list, participating in due diligence meetings with Seller and representatives of the Business, and reviewing materials generally provided in an electronic data room. The results of the review often are communicated by Acquirer's counsel to the broader deal team through the form of a due diligence report that summarizes the terms of the compensation arrangements and related potential liabilities.

Before conducting a substantive review, Acquirer should first determine:

- Which arrangements will transfer to Acquirer by operation of law
- Which arrangements will not transfer by operation of law but may need to be assumed contractually by Acquirer, e.g., employment agreements for In-Scope Employees or other arrangements that cover solely In-Scope Employees
- Which arrangements will not transfer by operation of law, will be retained by Seller, and will need to be replicated or replaced, e.g., broad-based health and welfare plans

Seller arrangements that do not cover any In-Scope Employees typically will not be subject to review unless there are potential liabilities that could become Acquirer's responsibility, such as certain pension liabilities.

A key due diligence point will be to determine whether In-Scope Employees forfeit any compensation or benefits as a result of the transaction. Incentive award programs often provide that awards will forfeit upon the cessation of employment. The structure of the transaction could result in termination of employment for In-Scope Employees with the Seller group, either due to the employee leaving the Seller group by way of an offer and acceptance mechanic, or due to the employing subsidiary leaving the Seller group. As a result, it is critical for Acquirer to understand the potential economic impact of any forfeitures and either modify the terms of the arrangements or negotiate which party bears the burden of potentially making the employee whole through new awards.

Transaction Agreement & Disclosure Schedules

The terms and conditions of a carve-out transaction are set forth in a transaction agreement, often in the form of a stock or asset purchase agreement, along with accompanying disclosure schedules. The provisions that are most relevant to executive compensation matters generally include:

- Compensation and benefits representations and warranties
- Provisions covering employee-related liabilities, including any covenants governing liabilities related to any forfeited incentive awards, or which require Seller to modify the awards
- Interim operating covenants regarding compensation actions that are restricted between signing and closing, as well as exceptions to those restrictions
- Post-closing covenants regarding the treatment of compensation arrangements for In-Scope Employees
- Any covenants for key In-Scope Employees to enter into new employment agreements

Representations and Warranties

The transaction agreement will include a set of representations and warranties made by Seller on various matters relating to the Business, including the compensation arrangements covering In-Scope Employees.

The transaction agreement generally includes the same level of representations as would be given in connection with the sale of an entire company regarding arrangements that will be transferred to Acquirer. However, it will often contain a more limited set of representations regarding any arrangements covering In-Scope Employees that will be retained by Seller. For retained arrangements, Seller may be hesitant to provide legal compliance representations, at least without significant materiality qualifiers, if the compliance failure would not have a direct economic impact on Acquirer.

The representations and warranties may survive the closing of the transaction and may be subject to post-closing indemnities, which places an increased emphasis on the level of materiality of representations made by Seller. In addition, the parties may decide to acquire representation and warranty insurance for the transaction, in which case the representations made by Seller may be more extensive and not subject to any materiality, knowledge, or similar qualifiers. The parties will need to take these matters into account where applicable to determine the appropriate scope of the representations and warranties and the impact of any related breaches.

Employee Liabilities

The transaction agreement will generally include provisions regarding the treatment of pre-closing liabilities relating to the Business, including pre-closing liabilities for In-Scope Employees. These liabilities may not be known as of the closing. They can range from claims under Seller's health plan for injuries that occur prior to the closing but are not reported until after the closing to matters such as sexual harassment claims regarding In-Scope Employees, also that occur prior to the closing but are not reported until after closing. The treatment of these employee liabilities will often follow the treatment of pre-closing liabilities in the broader transaction. But it is important to accurately reflect the business deal in the transaction agreement to ensure that all applicable liabilities are appropriately handled by the parties.

In addition, when completion of the transaction itself causes In-Scope Employees to forfeit incentive awards, the transaction agreement may contain an offset to the purchase price for all or a portion of the value of forfeited awards on the basis that Acquirer would grant make-whole awards to employees. Alternatively, the transaction agreement may provide that Seller take actions to permit the incentive awards to remain outstanding with the Seller after closing. If incentive awards remain outstanding with Seller after closing, the parties will also have to determine the appropriate treatment of any tax deductions for the awards, which if tied to service with the Acquirer, could result in a tax deduction that can only be taken by Acquirer, even if the cost is borne by Seller.

Acquirers should bear in mind that when deferred compensation arrangements are sponsored by Seller, there may be restrictions on the ability to pay out the arrangements at closing if the employing subsidiary is purchased by Acquirer. This is because under Section 409A of the Internal Revenue Code (Code), the In-Scope Employee may not have a valid "separation from service" if there is continuity of employment with the employing subsidiary immediately post-closing.

Interim Operating Covenants

The transaction agreement and accompanying disclosure schedules will contain covenants governing actions that may be taken by the parties for any period between the signing of the transaction agreement and the closing of the transaction (interim period).

In a carve-out transaction, these covenants typically cover various items regarding In-Scope Employees, including the ability to:

- Make compensation and benefits increases to In-Scope Employees
- Adopt or amend severance arrangements covering In-Scope Employees
- Create employee retention pools or award change in control bonuses to In-Scope Employees
- Terminate any In-Scope Employees
- Hire any new employees who will qualify as In-Scope Employees
- Transfer or modify the employment of any In-Scope Employees so that they do not qualify as In-Scope Employees
- Transfer or modify the employment of any Seller employees who do not qualify as In-Scope Employees so that they do qualify as In-Scope Employees

One key difference between interim operating covenants in a carveout versus an entire company acquisition, is that in a carveout acquisition, the arrangements being retained by Seller will also generally cover employees of Seller who are not part of the transaction. Therefore, Seller will often want to be able to make changes to those arrangements without any consent of Acquirer, even if those changes also impact In-Scope Employees.

Acquirer often will not want this to occur—especially where Acquirer is required to replicate the level of pre-closing compensation or benefits provided by Seller, and the ultimate outcome will be subject to negotiation between the parties. A potential middle ground would require Acquirer to replicate only the level of compensation or benefits as in effect prior to the signing of the transaction agreement rather the closing of the transaction, so that any changes during the interim period are not required to be replicated.

Another difference involves Seller's ability to transfer employees during the interim period. This often arises when Acquirer is purchasing the stock of a subsidiary but the In-Scope Employees are not employed by that subsidiary. In this case, the In-Scope Employees would need to transfer employment to Acquirer by way of an offer and acceptance process unless the In-Scope Employees are transferred to the subsidiary before closing so that they transfer employment to Acquirer by operation of law.

A similar situation arises where Acquirer is purchasing the stock of a subsidiary whose non-In-Scope Employees may need to be transferred to another Seller entity before the closing so they do not transfer to Acquirer by operation of law. In either case, the parties will need to agree upon the standards that will apply in determining which employees will be transferred into or out of the subsidiary and how that transfer will occur, e.g., through a letter to the employee notifying them of the transfer.

Simultaneous Sign and Close

Additional issues may arise in a carve-out transaction that closes immediately upon the signing of the transaction agreement without an interim period. In this case, there is often no opportunity to inform all In-Scope Employees about the transaction before it occurs. This can complicate any transfer of employment that may need to occur at the closing if employment is not transferring automatically by operation of law.

In addition, it may not be possible for Acquirer to have benefit plans, payroll, and other applicable arrangements in place for the In-Scope Employees as of the closing and it may need to receive transition services from Seller for a specified period after closing. It is crucial to determine whether these issues may apply as soon as possible in the transaction. That way, appropriate measures can be taken to ensure a smooth transition for the In-Scope Employees.

Post-Closing Covenants

The transaction agreement may include covenants requiring Acquirer to maintain compensation and benefits levels for In-Scope Employees who become employed by Acquirer from the date of closing for a specified period of time after the transaction closes. For example, Acquirer might agree for one year after closing to provide In-Scope Employees with at least the same base salary, a substantially similar target cash bonus opportunity, and other employee benefits that are substantially similar in the aggregate to the employee benefits provided by Seller immediately prior to closing the transaction. The length of this protection period and the types of protected items usually are subject to negotiation between the parties.

Because carveout transactions often do not include transfers of the most senior executives of Seller, or a transfer of a majority of Seller's workforce, post-closing covenants are not always included in transaction agreements. When included, they may not rise to the level of the obligations imposed in full company acquisitions. Nonetheless, post-closing covenants can be seen as mutually beneficial because they set forth the intentions of Acquirer and can provide comfort to employees about their ongoing employment with Acquirer.

Transition Services

As noted previously, Acquirer may not have an existing compensation and benefits infrastructure to cover In-Scope Employees who transfer to Acquirer. In addition, establishing new plans and vendor contracts may not be feasible prior to closing. In this situation, Acquirer will need to receive transition services from Seller until Acquirer is able to get all applicable arrangements and infrastructure in place.

Transition services typically consist of payroll and administrative human resources support, health and welfare plan participation, and sometimes continued 401(k) plan participation. It is important for Acquirer to determine if these transition services will be needed as soon as possible in the transaction to ensure that any Seller obligations are appropriately documented.

Golden Parachute Payments

While treatment of so-called "golden parachute payments" under Code Section 280G may apply to In-Scope Employees in a carve-out transaction, the analysis of whether a carve-out transaction implicates a "change in control" triggering tax consequences under Code Section 280G is somewhat different than when an entire company is acquired.

In a carve-out transaction, unless the stock of a subsidiary is being sold, the relevant test under Code Section 280G may be whether the assets of the Business represent more than one-third of the gross assets of Seller. In that case the transaction would constitute a change in control of Seller. If that is the case, and there are entities within Seller's ownership chain that are taxed as C-corporations, then Seller will need to determine if any of the In-Scope Employees constitute "disqualified individuals" that are subject to Code Section 280G and whether any payments being made to them would trigger excise taxes and loss of deductibility under Code Sections 280G and 4999. If this is the case, Seller may be able to have its stockholders conduct a stockholder vote to cleanse the payments if Seller meets the applicable rules relating to private companies.

Post-Closing Compensation Arrangements

Acquirer may desire to enter into new employment agreements with key In-Scope Employees, especially if Seller arrangements covering those employees before the closing are retained by Seller in the transaction and do not transfer to Acquirer. These arrangements are often negotiated and executed before the signing of the transaction and generally become effective at the closing of the transaction.

Conclusion

The allocation of employees and associated liabilities is central to any successful carve-out transaction. Because carve-outs raise unique and complex compensation issues that do not apply in the acquisition of an entire company, parties should seek to identify these issues early in the process so they may be appropriately negotiated and included in the transaction agreement.