

How Best to Incentivize Your Employees to Ensure a Successful Sale Transaction

by Joe Schmelter and John Wilhelm

It has become cliché (because it is true) that for many businesses, the key assets – their employees – literally walk out of the building at the end of each work day. Business owners intuitively recognize that the everyday success of their enterprises is closely tied to the good morale and well being of their employee base, and thus they devote significant attention to providing competitive salary and benefits packages to attract and retain good employees. Increasingly, buyers and sellers of businesses are also coming to realize that maintaining the goodwill of “key” employees of the target is an absolute necessity to a successful acquisition transaction. Buyers and sellers who understand the variety of incentive compensation programs available to motivate their most important employees in the context of a sale, and who properly structure such a program to fit their particular transactions, maximize the chances that their M&A deals will be successful ones.



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“earnouts” – based on the acquired company achieving certain milestones after the closing, then an incentive package might be structured to pay employees bonuses tied to the same (or very similar) milestones that trigger payment of the earnout. The bonuses might well be funded with a portion of the earnout payments themselves.

- **Equity Compensation in Buyer.** The buyer might grant equity compensation, such as stock options and stock appreciation rights (SARs), to key employees of target. If the seller had a stock option plan, the target stock options could be assumed and converted to buyer stock options, provided the target’s option plan allows such a conversion or the employee consents.

- **Seller Retention Bonuses.** Finally, the selling owners themselves may rightly recognize that incentivizing their key employees is vital to ensuring their best efforts in preparing the company for a sale, and in assisting in the sale process itself (by preparing due diligence materials and disclosure schedules, for example). Here, a bonus plan announced by the seller in advance and payable to all or certain of the target’s employees at or immediately prior to the closing -- assuming they remain employed at such time -- could go a long way to smoothing the sale process.

with a sale may need to be capitalized rather than deducted.

Because tax consequences are complex and subject to numerous exceptions, the parties’ tax advisors must be consulted.

- **Accounting Implications.** Incentive compensation generally involves compensation charges to the financial statements of the employer. Particularly in the case of a publicly-traded buyer, this accounting treatment may limit the buyer’s desire to pay incentive compensation after closing. The buyer’s and target’s accountants should be consulted as to the accounting consequences.

- **Securities Laws Compliance.** Equity compensation must be structured to meet exemptions from registration requirements of federal and state securities laws or must be registered.

CONCLUSION

As discussed above, buyers or sellers (or both) may fund transaction-related incentive bonuses. Buyer funding makes most sense when the deal depends on the continuing efforts of the target’s employees following the sale. Buyers may also require sellers to have some “skin in the game,” to help defray the cost of an incentive program by funding some portion of the incentive payments. Where sellers wish to align the interests of their employees with their own interests and maximize their chances for successful earnout achievement, or where they need to motivate their key employees to assist in the sale process itself, then it makes sense for them to fund some or all of the incentive program’s costs. Buyers and sellers who are aware of the kinds of packages available to incentivize employees during and after a sale, and who properly structure such packages to fit their particular transactions and to minimize potentially adverse tax, accounting and securities law implications, ultimately maximize their opportunity for successful M&A transactions.

TYPES OF INCENTIVE PROGRAMS AVAILABLE

The particular terms of the deal hammered out between buyer and seller will naturally suggest certain incentive bonus programs for target personnel.

- **Buyer Employment Agreements, Including Bonuses.** Buyers may require that some number of the key management employees of the acquired business enter employment agreements to stay with the target for some transition (or longer) period after the closing, perhaps with bonuses for achievement of performance targets specified in the agreement or by the buyer’s governing Board.

- **Buyer Stay Bonuses.** Alternatively, the buyer might provide a series of “stay bonuses” for a larger group of employees, perhaps with an initial payment made after some short period of time (say, six months after closing) and another payment made later, provided the employee is still employed with the target or the buyer (perhaps 12 or 18 months after closing).

- **Earnout Funded Bonuses.** If the business deal provides for deferred, contingent consideration – often called

TAX AND OTHER CONSIDERATIONS

A number of additional considerations must be taken into account in structuring the appropriate incentive package, including the following:

- **Tax Consequences.** Incentive payments described above would generally be taxable as wages to the employees and deductible by the employer, with special rules applying to equity compensation. However, care should be taken to avoid numerous tax traps such as the following:

- **Deferred Compensation.** Deferred compensation subject to Internal Revenue Code Section 409A can result in taxation when “vested” and a 20% penalty tax unless certain requirements are met or an exception applies.

- **Golden Parachutes.** Unless an exception applies (such as for subchapter “S” corporations), compensation contingent on the sale which equals or exceeds 3 times an employee’s average base earnings over a certain period can trigger excise taxes on the employee and a deduction loss to the payer under Code Section 280G.

- **Capitalization.** In certain circumstances, bonuses paid in connection

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