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Employment Agreements in the Middle Market Merger

Factors in Getting Owners/ Employees On Board

By Matthew Henshon

Several years ago, I was involved in a middle-market transaction representing the seller. The deal seemed to be on track -- the stock purchase agreement had been negotiated quickly, and without acrimony, including a paragraph that outlined the terms of the employment agreements. Due diligence had gone smoothly, as the company was quite profitable and had been for much of its history. Minority shareholders had quickly tendered their shares, perceiving the price as generous. The buyer's financing, which was thought to be a bit uncertain, fell into place. Two days before the closing date, the draft employment contracts were delivered for review by the principal owner. The buyer considered these agreements to be fairly standard, and not really subject to negotiation.

The 55-year-old principal owner spent a sleepless night before the closing poring over the provisions of the four-page agreement. He called me early the next morning. "I can't bring myself to do it," he said. "I know they are offering us a lot of money, but all these provisions. All these rules. I've never worked for anyone in my life. I can't sign an employment agreement." Despite efforts to get him comfortable with the terms, the deal ultimately collapsed, and at no small cost.

As recent events indicate, the middle-market is open again, so deal-makers should be aware of the difficulties that can sometimes arise around employment agreements. While large-cap mergers have antitrust and other regulatory concerns (such as Hart-Scott-Rodino filings), middle-market mergers have their own specific issues. One such issue – and one often put off until the last few days before closing – is the employment contracts for people who consider themselves to be entrepreneurs. (It should be noted that these general comments about employment contracts are applicable in almost any form of middle-market deal.)

In middle-market deals, senior management is often the key for the target company's past success. Whether because of their Rolodex, their energy, or their leadership, the managers are often vital to its future as well. Lower-level employees, important for continued smooth operations, may be more likely to stay with the company if the "old management team" remains. Customers, too, may feel better about doing business with the new ownership team if they recognize many of the faces. Employment contracts are the way that the old management team is induced to stay in place.

First, we must define "employment contracts" in the post-merger context. Obviously, like employment contracts of any type, these agreements define the duties and compensation of (primarily) managers. Duties can be simply a general title such as "vice president" or "general manager" or provide a delineation of specific tasks that the employee will perform.

Compensation is always a key provision in any employment contract. Typical provisions will usually formalize a salary (and certain fringe benefits ranging from use of a company car to memberships in professional organizations). Additionally, in middle-market deals, senior managers of the target are often significant (if not majority) shareholders, so they will be receiving compensation at the closing for their stock. However, a buyer can easily "shift" dollars into the employment contracts, rather than deliver them as part of the purchase price at closing. Shifting dollars to the employment contract may have the effect of tax deferral, although the employment contract income will obviously be taxed at the individual's marginal rate (rather than a capital gains rate that is often applicable to

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payments made in consideration of the business being acquired). It is worth noting that significantly shifting the consideration structure toward employees to the detriment of consideration delivered to non-employee shareholders may open up the transaction to a fairness challenge.

The other major component of a typical employment contract is deferred and/or incentive compensation. Because comfort with a seller's financials can be one of the biggest hurdles in middle-market deals, a savvy buyer can devise stretch targets for senior managers in the target company post-closing. These targets will usually incorporate targeted goals to allow managers to focus on their own jobs (i.e., direct sales, profitability of the division), but in the case of a large acquirer, there will almost always be an additional element reflecting the broad performance for the entire acquiring company (i.e., restricted stock in the acquirer).

The term of employment contracts can be as short as a few months to several years or longer; the incentive structure is also often tied to the term of the contract. Short-term contracts are generally utilized when the incoming management team needs just a few months to learn the details of the business. But no matter how long or short an employment contract is, the buyer will want assurances that the employee (and former entrepreneur) will not compete directly with the acquired company for a post-employment period. These "non-competes" will vary by industry and region, but it is not unusual for a buyer to ask for a two- to seven-year term. Although care must be taken in the drafting of the documents to reflect the importance the buyer places on the non-competition provisions (i.e., that they are a vital part of the consideration for the overall acquisition), courts (both in Massachusetts and elsewhere) are usually willing to enforce such non-competes in the post-acquisition period, although they may draw the circle around the prohibited activity very tightly.

Another element of a well-drafted employment contract is a clear termination provision. In general, the employer (i.e., the acquirer) will not have the right to terminate the employment except (i) "for cause" (with such activities giving rise to a for-cause termination clearly defined, such as material breach of the agreement, or willful misconduct in performance of duties) or (ii) with a severance payment. It is also worth considering provisions that would apply in case the employee no longer wishes to remain in the employment of the acquirer, and considering whether all deferred compensation is forfeited.

Finally, buyers should allow review of, and input into, the actual terms of the employment contract – not just the general business terms as outlined in the term sheet for the deal, but the 2-3 pages of legal terms and boilerplate – as soon as possible in the process. Giving the future employee time to think about what the provisions mean, and how they will change his/her life, are important non-financial components to getting the deal done. In addition, a buyer may be surprised to learn that small (and relatively cosmetic) changes in the provisions of a standard employment contract may be all that is necessary to motivate the future employee to sign on – happily.

Employment contracts are left to the "night before closing" at the peril of losing the deal. For senior management of many middle-market companies, selling the company is an emotional experience. Having essentially worked for themselves for many years, and having built a company, often from the ground up, the thought of promising to be at the office for certain hours every day, or merely having a boss for the first time, can delay – or in rare cases, as shown above – prevent a closing. The sooner the buyer can identify, and discuss with the managers of the target, the buyer's expectations post-closing, the better the chances of completing the deal.

About Allerton Law Group:
Allerton is a Boston-based boutique law firm specializing in business and commercial real estate transactions.

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Matt Henshon founded the Allerton Law Group in 2000, after practicing at Hill & Barlow from 1995-1999. Directly prior to forming Allerton, Matt served as Senator Bill Bradley's "traveling" chief-of-staff during the 2000 Presidential campaign. He is a graduate of Princeton University and Harvard Law School. His email is mth@allertongroup.com.