

Mergers & Acquisitions 2009

Preparing for “Carve-Out” Transactions: Employee Benefits

July 13, 2009

We anticipate that the current economic climate will increasingly lead companies to engage in carve-out transactions (i.e., the sale of subsidiaries or divisions of a larger business enterprise). Not unlike the increase in distressed company acquisitions, we expect that carve-out transactions will be a dominant part of the M&A market over the next few years. Virtually every financial and strategic investor and intermediary will need to be well versed in these projects and the unique and challenging issues they present.

This LawFlash is one of a series of LawFlashes, each of which highlights certain complex technical, financial, and legal issues that need to be addressed in splitting off parts of a larger business. Morgan Lewis, with its broad array of relevant practice areas such as technology outsourcing (technical transitional services having become perhaps the most difficult aspect of carve-out transactions), intellectual property, labor and employment, and sophisticated tax analysis, is positioned to skillfully assist with these increasingly complex transactions.

While the emotional capital invested in any transaction is high—whether from the deal team or employees unsettled by the change in status quo, carve-out transactions in particular bring these issues into sharp relief, due to the fact that certain employees of the seller will stay with the seller and others will be transferred with the divested business. For the employees, there will be issues regarding bonus payments, benefit terms, outstanding options, and job security. For the employers, there are issues regarding plan terminations and satisfaction of deal conditions related to postclosing employee issues. Beyond the human component of a carve-out transaction lie the nuts and bolts of transitioning a group of employees from one employer to another (and from one set of benefit plans to another). Predicting how employees react to such a transaction and the impact on the business going forward are also critical aspects of the deal calculus.

To address the myriad of employee benefits issues raised by a carve-out transaction, both the seller and the buyer need to evaluate the impact of the deal early in the transaction process and organize its benefits and human resources teams to facilitate a smooth postclosing transition. Although the issues are always unique to each deal, a few of the important employee benefit issues that arise most often in carve-out transactions are as follows:

Identifying Employees

- **Seller Considerations:** One of the most fundamental decisions for a seller when contemplating a carve-out is which employees will remain with the seller and which will go with the divested business unit. Where a seller has multiple business units and utilizes certain centralized or shared services for each business unit, there can be a sizable pool of employees who provide services to the divested business while at the same time providing necessary services for retained business units. Whether such employees will be retained by the seller may be the subject of negotiation, as certain employees may provide functions that the buyer does not have in-house. Other employees may work primarily with the divested unit but are not among the employees whom the buyer desires to take with the business. In such a case, the seller will need to determine whether such employees can be reassigned within the company or whether it needs to make postclosing staff reductions—which may be a larger concern where the divested business represents a sizable portion of the seller’s business as a whole.
- **Buyer Considerations:** From a buyer’s perspective, the considerations are, of course, flipped—Are we getting the employees we need to run the business? Are certain employees unnecessary for the business? Do we have sufficient support and back-office personnel to support the acquired business? The buyer will also need to carefully review the duties of each proposed new employee to ensure that the seller is not using the transaction as a means to unload unnecessary personnel.
- **Retention of Key Employees:** Once the parties have agreed on which employees will be affected by the divestiture, the parties should next consider whether steps need to be taken to avoid the defection of key employees. Indeed, a buyer may condition a sale on the retention of certain employees. In such a case, those employees will likely need to be informed of the transaction in advance so that the buyer can negotiate employment or retention agreements as needed. For other employees, the seller may need to provide incentive for employees to remain with the business before closing. This can take the form of a retention or stay bonus, or including language in the transaction agreements requiring the buyer to retain certain employees for a specific period postclosing.
- **Benefit Plan Considerations:** Depending on how the seller’s benefit plans are structured (i.e., separated by business unit or universal across all company employees), the carve-out transaction may result in a plan termination or partial termination depending on the percentage of employees involved in the divestiture. Sellers will need to carefully navigate these waters so as to retain the viability of their plans for remaining employees. Buyers on the other hand will need to either fold acquired personnel into existing plans or create new plans—which would be more likely in the case of a financial buyer. The time and costs of establishing these plans will factor into the overall timeline of the transaction and can delay closing.
- **Identifying Underlying Costs:** Since many costs associated with employee benefits are not specifically identified in a company’s financial statements, buyers need to carefully review available data and related costs. A seller will need to be mindful of these costs as well, particularly in the event it is agreeing to provide some form of transition services. In the case of a financial buyer, new benefit plans and human resources functions will need to be in place at closing. Ascertaining the actual costs of providing benefits to the employees of the divested business going forward is the most critical aspect of the buyer’s employee benefits due diligence. This process traditionally involves a coordinated effort by deal professionals—including attorneys and benefits consultants as well as in-house benefits specialists.

