Merger & Acquisition Focus

October/November 2007

Staying power

HOW TO RETAIN KEY EMPLOYEES DURING THE M&A PROCESS

Nothing can turn a sweet M&A deal sour faster than a key employee leaving the company before the transaction is final. This kind of loss can reduce a company's selling price, hinder integration plans, turn a star executive into a formidable competitor and even shut down a deal altogether. But bonus plans and other incentives can motivate key employees to stay and help reduce the odds that this common M&A mishap will happen to you.

Before you offer an employee a retention bonus, be sure to thoroughly assess the individual's performance and productivity.

An offer they can't refuse

Companies increasingly are using bonus plans to retain vital staff through transitions and help motivate continued productivity after a merger. Common bonuses include:

Retention. These "stay" bonuses typically are offered by the selling company to retain experienced and knowledgeable staff during the integration process. They usually are provided to executives but can also be used to retain other key employees, such as top salespeople or key product developers, who add value to an M&A deal.

Most retention bonuses are awarded as a percentage of salary or a lump sum amount. But they may also take the form of:

- Stock or stock options,
- Flexible working hours or extra vacation time,
- A change in responsibility, work flow or assignments, or
- A better severance package if the employee will be employed for only a limited time.

Retention bonuses typically are offered to between 5% and 10% of the employees of the overall company or division being acquired.

Project completion. This type of bonus is offered to employees assigned to specific projects that are usually short-term (between three to six months). The bonuses may constitute 5% to 20% of an employee's total compensation for work on the project. Companies might base the payout for this type of bonus on the importance of an individual's

role in the project, its successful completion and possibly the customer's satisfaction.

Management by objectives (MBO). MBO bonuses are offered by employers to enable the successful completion of internal projects that might otherwise be neglected or overlooked as staff focuses on merger integration. Employees might receive a list of specific tasks, deliverables, due dates and dollar value for completing each assignment based on the company's priorities. These bonuses are built into employees' overall compensation plans, with dollar value buckets from which quarterly project assignments are made.

Assigned tasks should be able to be completed by the employee with minimal help from co-workers. Otherwise, it may be difficult to determine how much of the task was completed by the employee assigned — which could lead to disagreements, even a lawsuit.

Gain-sharing. Companies wanting to jumpstart synergies following a merger might consider this bonus program in which individual employees or teams are rewarded for determining and implementing cost-savings plans. Gain-sharing bonuses can include profit-sharing and restricted stock plans — all of which tie compensation to the company's growth and profits.

Committing to the future

Before you offer an employee a retention bonus, be sure to thoroughly assess the individual's performance and productivity to ensure he or she is worth the financial commitment and really is essential to the successful execution of your M&A deal. Also make sure that the employee is invested in the future of the company and willing to stay on board.

Paying bonuses in installments gives employees an incentive to remain as long as you need them. But you also may want to consider asking employees to sign agreements that bind them to your company for a specified time period. Clarifying their roles and performance expectations and ensuring that changes in compensation policies and processes, bonus arrangements, benefits and share schemes don't affect them adversely will also help you retain key staff.

Not all employees receive retention bonuses, but it's still important to reassure rank-and-file workers that they're part of the team and crucial to the future success of the new organization. Early communication about the deal is essential, including the rationale behind your decision to award certain employees bonuses. A management representative — possibly from your human resources department — should be available to answer questions and address concerns about the merger and its implications.

Get an early start

There's no simple formula for establishing an effective retention bonus plan. So start thinking early in the sale process about how you'll keep your experienced and knowledgeable team members in place. The ill-timed loss of even one key employee could mean the difference between a successful deal and one that falls apart before you reach the finish line. ■

One size doesn't fit all

You'll likely find that a bonus plan is just part of a larger strategy to entice key employees to stay — one that also includes a good working environment, feedback and praise, and new challenges.

It's also important to ask employees what they want and prepare to be flexible in what you offer them. One employee may want an employment contract with a one-time bonus structured to prevent an undue tax burden. Another may prefer a bonus in the form of a defined benefit plan that is funded with after-tax dollars and later can be rolled over into the employee's 401(k) or IRA. Other employees may be satisfied with nonfinancial incentives such as vacation time, a reduced schedule or the option to telecommute.

Steer clear of purchase price adjustment disagreements

It can be difficult for business buyers and sellers to arrive at a final purchase price that satisfies both because they often have competing objectives. In the early stages of a deal, buyers may offer a higher price to engage interest from the seller, intending to make adjustments at closing. Sellers, on the other hand, will try to minimize any giveback on the final price.

The parties often agree to a postclosing audit that seeks to confirm that each party's book value and net worth at closing are comparable. If they aren't, a purchase price adjustment usually is necessary. But purchase price adjustments can alter the value of the deal for both parties.

Varying accounting methods

Buyer and seller differences often are rooted in the fact that the parties may use different accounting methods to prepare financial statements. Carefully worded purchase agreements and procedural planning can save significant time and resources for both parties to the transaction.

Purchase agreements generally provide for the accounting policies by which the closing balance sheet will be prepared. They may state that the buyer is responsible for preparing the estimated closing balance sheet but that it's prepared using the seller's accounting practices. Generally Accepted Accounting Principles (GAAP) aren't always referenced in the balance sheets.

And even if GAAP is specified in the balance sheets, the agreement may not provide a remedy for situations where the seller's historical practices and GAAP conflict. It's critical — particularly from the buyer's perspective — that the purchase price agreement specify that, in instances of inconsistencies between GAAP and the seller's historical practice, GAAP will win out.

Potential disputes

Even if a company's financial statements are prepared in accordance with GAAP, they may contain specific line items that aren't recorded within GAAP's technical requirements. These items — including accounts receivable, outdated inventory and other unrecorded liabilities — often become the subject of postacquisition disputes if they're not addressed in the negotiation of the purchase agreement.

A seller, for example, may calculate the allowance for doubtful accounts and reserve for outdated inventory based on its historic practices. The buyer, however, might consider its actual experience with such accounts and inventory after the sale to evaluate the adequacy of the selling company's allowance. The parties can avoid a dispute by indicating in the agreement whether the seller's practices or the buyer's actual results through a specified date after closing are the standard by which accounting estimates are determined. The agreement might also specify a formula that calculates the allowance based on an agreed-upon measure, such as how long accounts receivable have been outstanding.

Other disputes may be triggered when a seller completes financial statements before receiving all outstanding invoices. The buyer pays the invoices received after closing and determines that, for the financial statements to have been prepared in accordance with GAAP, the invoices should have been recorded as liabilities and expenses as of the closing date.

You can head off these kinds of issues by making sure your purchase agreement discusses how specific statement items that require judgment and estimates should be handled. Specify effective dates and set a time period after the closing during which the seller remains responsible for invoices that relate to liabilities incurred before the closing.

Allow for adequate time

Purchase agreements allow for at least a 90-day period after the deal closes for the buyer to prepare the closing balance sheet. Typically, the seller has 45 days to look over and comment on the closing balance sheet and supporting documentation, and the parties have another 45 days to negotiate any differences. Disagreements may be submitted to arbitration.

Buyers gain control of the books after the deal closes, and, because they may be unwilling to disclose financial information at that point, sellers should enlist the help of their accounting and M&A advisors in preparing initial balance sheets while they still have unrestricted access. This will better enable the seller's advisors to evaluate the closing balance sheet.

Buyers, on the other hand, should be able to support conclusions — with detailed and specific information — reached in the closing balance sheet. And, to facilitate agreement, it's important for buyers to respond to the seller's inquiries as quickly as possible during this phase.

Bypass eleventh-hour surprises

Curtail surprises during the purchase price adjustment phase of a deal by agreeing beforehand on contract language and accounting procedures. Taking these steps can help you avoid conflict and enhance value at the back end of your transaction. ■

Turn on the tap

LEVERAGED RECAPS OFFER A LIQUIDITY ALTERNATIVE TO SELLING

Business owners approaching retirement or seeking liquidity for other investment opportunities may think that selling their company outright is the only option. Unfortunately, a sale typically terminates an owner's control over the business and may leave valued employees — including family members — high and dry. A leveraged recapitalization may be a better alternative. This financing structure can help you raise cash, while at the same time enabling you to stay on as owner or your company's current management to assume ownership.

Leveraged recaps take one of two forms: 1) The owner partners with a private equity group to share ownership; or 2) management borrows money to redeem the principal owner's shares or pay an extraordinary dividend. The viability of either method depends on many factors, including your liquidity objectives, your management team's commitment to the future of the company and your business's general financial health.

Partnering with private equity

Private equity partnerships typically are preferred by owners who aren't yet ready to give up control of their company. When you partner with a private equity group, the group buys a portion of your equity — usually

between 60% and 80%, but possibly as little as a one-third stake.

The private equity group usually includes debt as part of the finance structure to better secure a portion of its principal investment in the event your company fails. Private equity groups finance their acquisitions with a combination of funds from their general investment pool and senior and subordinated bank debt, and they usually intend to sell their investments within five to seven years.

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A private equity group will have input into your company's major strategic decisions and may attempt to realize synergies with your company and others in its investment portfolio through, for example, shared sales and marketing resources or joint distribution channels. But it's likely to be hands-off when it comes to the day-to-day operations of running your business. In fact, private equity groups depend on your experience and expertise and that of your company's existing management team. The team is expected to have some kind of equity investment in the business and may receive further performance incentives in the form of equity options.

Because private equity groups eventually sell their ownership interests — generally either to another private equity group or a strategic buyer, but possibly in the form of an initial public offering — this structure may not be the best option if you want to keep your business in the family. (You may, however, retain the right in your agreement to repurchase these shares.) Also, the most likely candidates for private equity investment are higher-growth companies capable of earning an internal rate of return of 25% of their investment over their buyer's investment timeline.

When management assumes ownership

If you're concerned about giving up control to outside investors or placing a sell-by date on your company, you might want to offer your management team a chance to buy you out. In this case, management finances their equity acquisition with a combination of personal funds and bank debt — borrowing against the business's assets and cash flow. Management will be personally responsible for repaying any senior debt. If more funds are needed, subordinated debt also may be available.

This type of leveraged recap, however, isn't appropriate for every business. In addition to a strong management team that's financially and emotionally committed to the future of the business, companies must have:

- A history of profitability,
- Low debt,
- Good growth potential,
- Predictable cash flows,
- Low future capital expenditure requirements, and
- Adequate collateral.

After the transaction, the company will be highly leveraged, making it vulnerable to general economic or industry downturns — and fiscal responsibility essential. Management may find seeking additional financing for future growth ventures difficult.

Consider the big issues

A leveraged recap may be able to answer your liquidity quandaries. But before you start seeking private equity investors or discussing a management buyout, take the time to consider your business succession objectives, retirement income needs and how involved you'd like to be in the future of your company. This will help you decide how large a stake you'd like to sell and how much control you're willing to give up. ■

Ask the Advisor

Q: Should I include a "go-shop" clause in my sale agreement?

A: An increasing focus on good corporate governance means many boards of directors of selling companies are under scrutiny. To help reassure shareholders that they're securing the highest purchase price and enhancing shareholder value — particularly in cases where the initial bid is made by a management team partnered with a private equity group — some boards are including "go-shop" clauses in their sale agreements.

A green light?

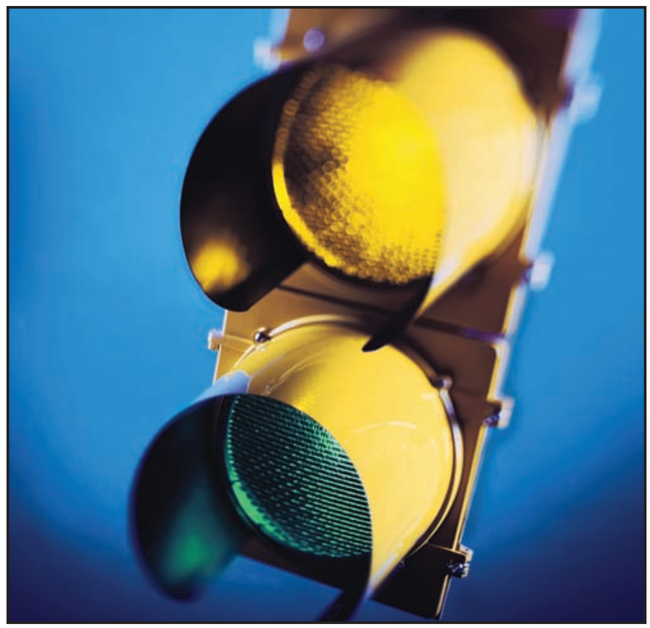
During a sale, buyers and sellers generally sign a sale agreement containing a "no-shop" provision that bars the seller from soliciting or considering additional bids. The only exception to a no-shop clause occurs when the seller receives an unsolicited bid. Its board is then allowed to take a "fiduciary out" and consider the offer to ensure it has properly discharged its fiduciary duties. But even in the event an unsolicited bid is made, the previous bidder may hold "matching" rights that allow it to match or top the later offer.

Go-shop clauses — a relatively recent M&A phenomenon — allow companies to actively solicit competing offers even when one's already on the table. The provision gives sellers a set period — generally between 40 and 60 days after signing the sale agreement — to seek and accept bids.

If a better proposal is received, the provision lets sellers negotiate and sign a sale agreement and terminate the initial agreement with the original buyer. The provision also provides the seller with some leverage by setting the original offer as a price floor and initiating an auction environment in which bidders compete to exceed the original offer.

Possible drawbacks

While go-shop clauses can give sellers desired flexibility, they aren't without potential drawbacks for both parties to an acquisition. A new buyer entering a deal with a higher bid may find that the go-shop period doesn't allow it enough time to perform adequate due diligence. Additionally, new bidders must not only offer a higher price than the current bid, but pay breakup or termination fees as well — which in some cases can be exorbitant.



What's more, the existence of a go-shop clause that enables a seller to seek better offers elsewhere can make some initial bidders uneasy about the viability of the deal and reluctant to enter into a sale agreement in the first place. Go-shop provisions, therefore, don't necessarily result in a higher purchase price or more competitive bidding process.

Not for everyone

Go-shop clauses can make it possible for selling companies to attract multiple bids, raise their selling price and reassure shareholders that the board is protecting their interests. But it may not be the best option for every seller. M&A advisors can help you decide if a go-shop clause will help enhance shareholder value, or, as some critics contend, offer later bidders little incentive to make competing offers. ■