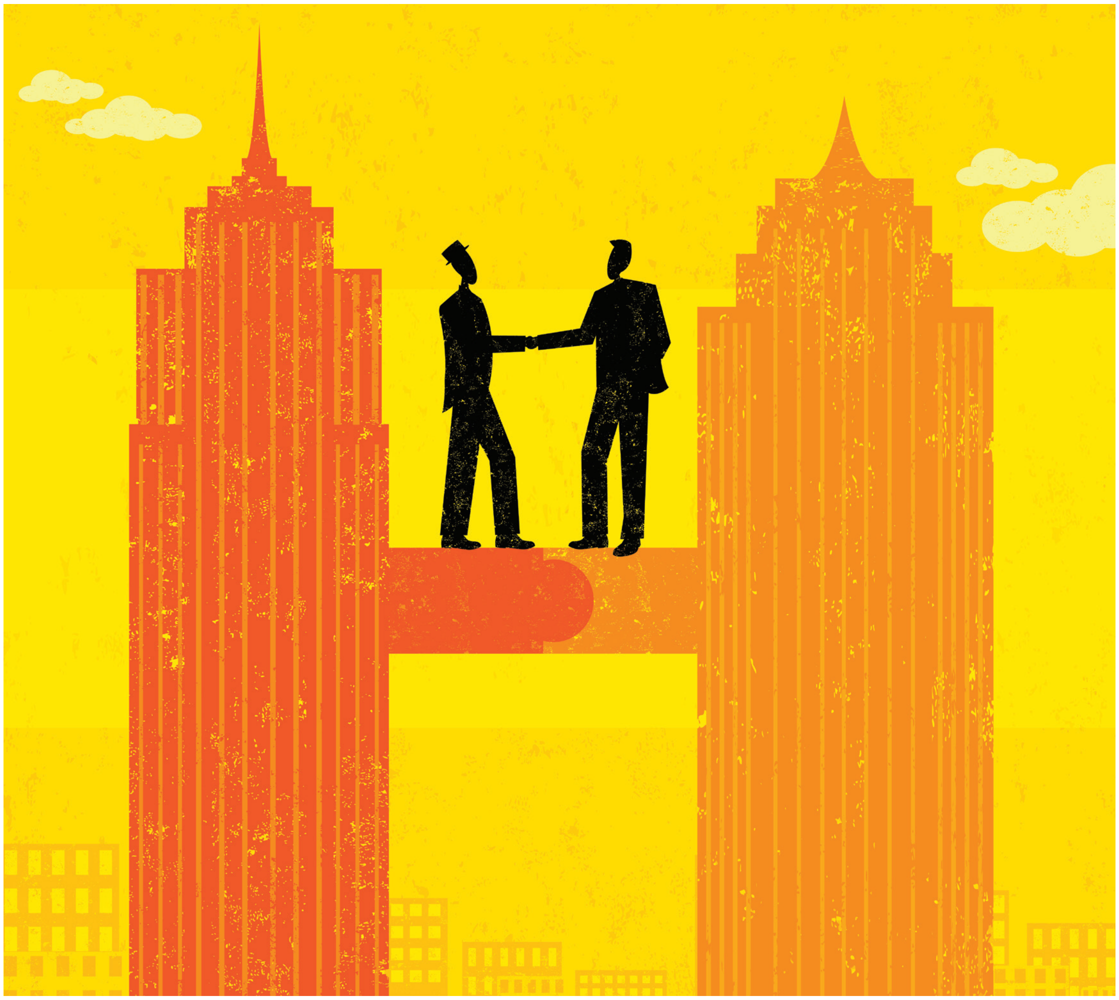

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Human Capital Due Diligence in a Merger or Acquisition

Key talent plays a critical role after the transaction. Here's a look at what to ask for and what to look for.

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In theory, the expectations from a human capital due diligence effort are significant. The due diligence should provide an understanding of the target's workforce and workplace. It must identify, and quantify where possible, payments and investments that impact closing, transition, and ongoing costs. The due diligence is also expected to assess human capital strengths and risks that potentially affect the generation of future value.

With this broad reach, the topics for review in a merger or acquisition include key talent and workforce profiles, capabilities and associated agreements; compensation, benefit plans and liabilities, and HR polices and compliance; organizational design, and even the organizational culture.

In reality, the scope of the review tends to be more constrained. The questions vary – often greatly – based on the transaction specifics[1] and circumstances. If the transaction is competitive and highly confidential, then time and available data may be limited during due diligence. In these instances, the buyer writes conditions into the transaction agreements to protect itself from unanticipated human capital risks and costs, and conducts substantial investigation only after signing. If the transaction is noncompetitive, and the seller is amenable to providing the information requested, the buyer has the privilege of time and access to perform a more thorough due diligence.

This article will focus on three critical key talent topics in due diligence:

- assessing contractual obligations;
- identifying key high-performing talent; and
- designing retention and termination packages.

ASSESS CONTRACTUAL OBLIGATIONS

One of the first things the buyer does during due diligence is to request all individual employee contracts, especially the non-standard or tailored contracts (typically in place for key talent), and evaluate the associated terms and financial obligations. Clauses specifying payments that need to be made with a termination or a change of control are hot buttons because of their potential material impacts. With this, it is important to determine whether the proposed transaction consistitutes a change-of-control event under the employment and transaction agreements.[2]

For key executives, payments to be made with a termination or change of control can be significant, and are accordingly termed "golden parachute" provisions. They can include severance, accrued or deferred incentive payouts that have been earned but not paid, and equity cashouts. They may include accelerated payouts of long-term compensation, defined benefit payments, accelerated retirement payouts, continued access to post-employment medical plans, and, in some instances, lifetime health care commitments. Some individual contracts may commit to a duration of employment, with compensation to be provided through the end of the term, even if the employee is terminated prior to term completion. There may be obligatory outplacement costs, and expatriates may have housing, school fees, relocation and other extraordinary costs to be settled.

The buyer needs to assess the cost impacts of such employee contractual obligations irrespective of whether these obligations are to be assumed by the buyer in the go-forward entity or paid out with the change of control or termination. The buyer also needs to determine the extent to which funds to cover these obligations have been accrued on the seller's balance sheet and calculate payments to be made (at closing or at specified events) to close funding gaps. These amounts – whether they are to be paid into the organizational balance sheet, or to the individual – can be a material input in price negotiations.

Going forward, the ideal is to replace employee contracts with at-will employment. The reality, however, is that to retain key talent it may be necessary to continue with select employee contracts and related provisions. Where possible, though, the buyer should identify how to limit the scale and scope of such contracts.

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IDENTIFY KEY HIGH-PERFORMING TALENT

Key talent tend to make disproportionate contributions to the organization's value. Hence, a primary due diligence objective is to understand the key talent profile – who they are, what they are responsible for, their capabilities and their contributions. The buyer then applies this understanding to the transaction strategy to determine who is essential to continue with the go-forward entity, and who might not be as critical.

How does one identify key high-performing talent? Start with individuals who have tailored, non-standard employment contracts, assuming that the existence of a contract implies that the individual makes a notable contribution. Augment this list with leaders who may not have employment contracts (the top two levels below the CEO in the organizational chart is a useful rule of thumb), and senior individuals in core value-creating functions, which will vary by industry. Collect additional data to refine the list: research publicly availabile information on key talent, and request job descriptions and records of key contributions – for example, reports on sales and key account relationships by individual. Inspect individual total compensation and incentive compensation, which are useful proxies for value created. Consider market competition for critical capabilities, as well as retirement age, to assess potential flight and retirement risks.[3]

With the information that you now have at hand, conduct exploratory discussions with the seller to answer open questions about individual capabilities, contributions and retention risks.

At this point, you are ready to prepare a tiered list of individuals with commentary on the risk to organizational value upon their departure, and any insights on retention risk.[4] Analyze this list in light of the resources and capabilities that you think are necessary to realize the deal strategy and determine who should be earmarked for potential retention or termination packages.[5]

DESIGN RETENTION AND TERMINATION PACKAGES

The financial retention package[6] typically offers a series of structured payouts made at intervals post-close, portions of which are tied to performance. The retention incentive can be offered in conjunction with total rewards. The buyer may revise the legacy reward components and associated weights to align with the deal strategy and reward philosophy, keeping the overall package the same or better.

The retention award also has a nonfinancial aspect, focused on role scope and growth. This can be a gray area to navigate. In the case of a merger or partial integration, the future organizational design is probably not in place, so one cannot reasonably commit to a certain position. Perhaps more importantly, the buyer may not have sufficient knowledge of the key talent bench during due diligence, making it difficult to assign them to roles in the go-forward entity. It is in the period between signing and close – and more so, in the months after close – that the buyer learns about key talent capabilities. At that point, the buyer has had better access to information about historical individual performance, and likely interacted with many through the transaction and transition processes. Only at this point is it realistic or feasible to map individuals to roles in the go-forward entity. With this in mind, it is advisable to build in elbow room when communicating role scope in key talent retention packages, if such commitments are needed prior to signing.

When it comes to employee terminations, they generally occur post-close,[7] but it is necessary to record anticipated key talent termination costs as part of the deal closing and transition costs. For individuals with contracts, follow contractually based severance commitments, when such contracts are assumed by the buyer. For individuals without contracts, turn to severance practice (used by the buyer or seller), or develop severance formulae for the transaction.

CONCLUSION

Due diligence is often conducted in competitive and confidential contexts, when the information provided is limited and the timeframe compressed. In these instances, clearly specify key talent unknowns and risks in the due diligence report, and state qualitative conditions (when the quantitative analysis cannot be completed because the information received is insufficient) in the relevant transaction agreements.[8] Ideally, these conditions are met before signing, but if that does not happen, write in the necessary language for price adjustments for the close. Key talent contractual obligations as well as retention and termination agreements can be sensitive and contentious topics, with real material impacts to transaction negotiations and price. PC

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FOOTNOTES

1. The human capital questions are informed by: a) the transaction financial structure (for example: full or partial investment; asset or stock purchase); b) the transaction type (for example, merger, partial integration, joint venture, or a spin-off); c) the transaction strategy components (for example: goals related to growth, integration, transformation, cost takeout), and d) the target's scale and complexity. It is necessary to tailor the due diligence information request to issues critical to the particular transaction and circumstance.
2. Note that a transaction may not trigger a change of control. In some instances, the obligations of the employment agreements are simply assigned to and assumed by the buyer. If the transaction is in fact a change of control event the conditions that trigger payments will need to be assessed. For example, some payments may be triggered immediately upon a change of control, and others are payable only upon the occurrence of additional events.
3. Review year-to-date (YTD) data and the last two years of the employee census file or payroll run to obtain insights into compensation and demographic parameters.
4. For example, if the transaction triggers a golden parachute, the individual may choose to leave.
5. There are a number of reasons why an individual ends up on the termination list. It might be a matter of role duplication in the case of a merger or need to realize cost synergy targets. Or an individual may simply not be a good fit with the capabilities and culture required to realize deal value. Sometimes an individual makes a termination list because that person's reward costs are significantly more than the buyer thinks worthwhile.
6. There will be differences in retention incentives offered. For example, individuals critical to driving the deal strategy will likely have stronger retention packages than those who are needed primarily to facilitate the transition for a period of time post-close.
7. In instances when the buyer wants to terminate one or more individuals pre-close, raise and negotiate such terminations with the seller, and offer associated adjustments to the purchase price, and indemnifications.
8. These agreements can include access to requested key talent information, commitments to pay or share payment of accrued and unfunded liabilities, retention, and termination payments.