

Employment Related Issues in the Purchase or Sale of a Small Business

Kimberly A. Lowe
Avisen Legal PA
Minneapolis

Minnesota CLE's Copyright Policy

Minnesota Continuing Legal Education wants practitioners to make the best use of these written materials but must also protect its copyright. If you wish to copy and use our CLE materials, you must first obtain permission from Minnesota CLE. Call us at 800-759-8840 or 651-227-8266 for more information. If you have any questions about our policy or want permission to make copies, do not hesitate to contact Minnesota CLE.

All authorized copies must reflect Minnesota CLE's notice of copyright.

MINNESOTA CLE is Self-Supporting

A not for profit 501(c)3 corporation, Minnesota CLE is entirely self-supporting. It receives no subsidy from State Bar dues or from any other source. The only source of support is revenue from enrollment fees that registrants pay to attend Minnesota CLE programs and from amounts paid for Minnesota CLE books, supplements and digital products.

© Copyright 2018

MINNESOTA CONTINUING LEGAL EDUCATION, INC.

ALL RIGHTS RESERVED

Minnesota Continuing Legal Education's publications and programs are intended to provide current and accurate information about the subject matter covered and are designed to help attorneys maintain their professional competence. Publications are distributed and oral programs presented with the understanding that Minnesota CLE does not render any legal, accounting or other professional advice. Attorneys using Minnesota CLE publications or orally conveyed information in dealing with a specific client's or other legal matter should also research original and fully quoted sources of authority.

Employment and Employee-Related Issues in the Sale of Small Businesses

TABLE OF CONTENTS

Overview	1
Letter of Intent.....	1
Due Diligence and Agreement Drafting	2
Closing.....	8
Post-Closing.....	8

Employment and Employee-Related Issues in the Sale of Small Businesses

Overview

Most businesses have a workforce – either employees or independent contractors – and most sales businesses require buyers and sellers to deal with workforces before, during and after the sale of a business. Regardless of the structure of the transaction, workforce-related matters must be considered. For sake of discussion, these issues will be referred to collectively as employee-related matters unless the nature of the workforce itself requires that the workforce be discussed separately as either a W-2 or 1099 workforce.

The following materials discuss employee-related matters that need to be considered throughout the deal process. For discussion purposes, the deal process has been broken up into the following phases: (1) Letter of Intent; (2) Due Diligence and Agreement Drafting; (3) Closing; and (4) Post-Closing.

Letter of Intent

Even before lawyers start to put pen to paper, the employees of a business are a critical element that needs to be considered. Without adding too fine a point, when buying and selling a business, employees can too be either an asset or a liability. For purposes of this phase, the individual human beings filling the various employee functions of the business are not what is under negotiation. While this can feel harsh, it is important for lawyers to practically guide clients through the purchase and sale process. To this end, understanding the goals of both the buyer and the seller of a business factors heavily into what happens with employees. From a legal perspective, the following questions need to be understood by the parties before considering how employees are handled:

1. Does the buyer intend to operate the business as it has been operated historically or does the buyer have another plan for the business – Going Concern Purchase versus Strategic Purchase?
2. Does the seller want to insure his or her employees continue to be employed post sale of the business or is this not an important factor?
3. Are there key employees (including an employee-seller) that need to be employed-post closing to operate the business successfully in the near and/or long-term?

The answers to the above questions guide the structure of the transaction. For example, if the answer to question 1 is that the buyer is purchasing the company for strategic reasons such as acquiring intellectual property or other competitive advantages, the fate of employees in the transaction may be that all of the employees of the target company are terminated at or before closing. Deal points like these will need to be included in the Letter of Intent and will work through the final agreements.

Due Diligence and Agreement Drafting

As the deal process progresses from the Letter of Intent phase to the Due Diligence and Agreement Drafting phase, issues and concerns regarding employees start to take on a certain tenor and tone. Generally, issues and concerns regarding employees during Due Diligence and Agreement Drafting fall into one of five areas of concern: (1) pre and post-closing liability, (2) value of the target company and/or its assets, (3) pre and post-closing logistics, (4) post-closing protection of the business or assets that were purchased, and/or (5) post-closing transitions and operation of the business.

1. Pre and Post-Closing Liabilities

As previously mentioned, in the sale of a business context, employees of the company being acquired and the historic relationship between the company being acquired and its employees are both assets and liabilities. To the extent a selling company has historic relationships and transactions with its employees that give rise to financial obligations that exists currently or will arise in the future (either because of discovery by the worker or the contemplated transaction itself), a liability exists. These liabilities will factor into both the pre and post-closing liabilities. Almost always, these sorts of liabilities are the responsibility of the seller. These liabilities may result in a reduction of the purchase price or a specific indemnification carveout.

2. Value of the Selling Company and/or its Assets

A business operation is the collective value of the work and enterprise of its founders and workforce. A business operation does not exist without some sort of intellectual service and/or contribution of its workforce – be it either a W-2 or 1099 workforce. During Due Diligence and Agreement Drafting, a great deal of effort surrounds determining if the selling company has properly “acquired” from its workforce and its founders the assets that comprise the business’ value. To the extent these assets have not been properly acquired or documented as being acquired from a selling company’s workforce, the value of the selling company may change.

3. Pre And Post-Closing Logistics

To the extent a workforce of a selling company is or will be terminated or retained in whole or in part in connection with a sale transaction requires a great deal of analysis and planning. In some instances, every single employee must to be reviewed, considered and determined to be terminated or brought along in a transaction. Regardless of outcome – termination or retention – there are a great deal of logistical issues that need to be considered. Its also critical to remember that in many circumstances, the impacted workforce does not know a sale transaction is underway which makes logistical planning more difficult.

4. Post-Closing Protection of the Business or Assets that were Acquired

A selling company’s workforce, whether retained, holds a great deal of valuable information about the company. The ability of a buyer of a company to protect or harness this information going forward to its benefit comes out during the Due Diligence and Agreement

Drafting phase. To the extent a buyer can and cannot acquire an unfettered right to an acquired company's information post-closing from a workforce is generally determinable and informs how the acquirer protects this information going forward.

5. Post-Closing transitions and Operation of the Business

When the workforce of a selling company is retained in whole or in part, or when one or more key persons of a selling company are retained in connection with the sale of a business, many issues need to be considered during this phase. Without a great deal of leverage, a buyer of a company cannot necessarily force a key person to continue to be retained with a company under either existing terms or new terms. Whenever a key person is required by a buyer, the negotiating power of the buyer and the seller is diverted to the key person. This shift in power requires careful consideration and the ability to navigate unknown situations.

Below is a standard due diligence request list related to employee-related matters for a standard business acquisition. This request list is not industry specific. The center column states the standard request. The column on the far left sets forth one or more of the areas of concerns described above. The column on the far right, to the extent necessary, provides additional explanation regarding the specific concern.

Area of Concern	Due Diligence Request	Explanation
1	All corporate policy and employee manuals covering hiring, employee benefits, regulatory compliance and internal controls.	Pre-transaction handling of a workforce may result in post-transaction liability regardless of the transaction.
1 and 5	Organizational charts of management by department and by legal entity.	
1, 3 and 5	Number of employees by department and by functional area.	FTEs impact acquisition and transitions. In many circumstances, a buyer may plan to reduce FTEs to achieve value in the transaction.
1 through 5	Copies of offer letters, employment contracts, bonus guarantees, severance agreements, change-of-control agreements, independent contractor agreements, nondisclosure and confidentiality agreements, non-competition agreements, management and consulting contracts.	
1, 2 and 3	Union contracts, collective bargaining agreements and a summary of any ongoing negotiations with unions.	Most buyers do not want a unionized workforce.

Area of Concern	Due Diligence Request	Explanation
1 through 5	Documents relating to all profit sharing and savings plans, pension or retirement plans, supplemental retirement plans, retiree medical arrangements, deferred compensation plans, severance, medical, flexible spending, dental or other health and welfare plans and any bonus, incentive, performance or other employee compensation/benefit plans or arrangements and related agreements (that provide benefits to current or former directors, officers or employees and their respective beneficiaries); materials describing any of the foregoing or contemplated amendments; and the applicable trust accounting, IRS determination letter(s), Form 5500 filing, plan audit reports, actuarial reports and other applicable financial statements for the three most recent years. Summary plan descriptions for each of the foregoing, to the extent available.	In addition to concerns regarding liability and logistics, benefit packages and the requirement for buyers to offer and provide equivalent packages to retained employees can impact value as well as the ability to transition a workforce.
1	Copies of all filings and correspondence with the IRS, the DOL and the PBGC (not covered in the preceding paragraph) made during the three most recently completed plan years.	Misclassification and wage and hour compliance can result in liabilities that need to be allocated.
1	Copies of complaints and other material pleadings and court filings in connection with any pending lawsuit involving any employee benefit plan or benefits thereunder, or any such lawsuit filed within the past three years.	Typically, any liabilities related to employee benefits or tax obligations survive closing indefinitely and are not capped or limited.
1	Any notices or other communications issued within the past three years relating to blackout periods under any defined contribution plan or regarding any future reductions in medical, pension or other employee benefit or regarding the termination of any employee benefit arrangements.	Benefits are risky.

Area of Concern	Due Diligence Request	Explanation
1 and 3	Cost/benefit information for each current plan for the most recent plan year, including (i) administrative costs, (ii) employer contributions, (iii) employee contributions, and (iv) benefit distributions.	Adds cost and impacts transition.
1 through 5	Copies of any Section 280G calculations performed with respect to potential parachute payments.	These sorts of payments can add costs that need to be allocated among the parties.
1 through 5	Description of any threatened or pending labor disputes, work stoppages, work slowdowns, walkouts, lockouts or union organizing activities. Copies of any National Labor Review Board or US Department of Labor filings.	Workforce instability impacts the entire transaction, especially if a buyer requires a workforce to achieve the value of the transaction.
1	Any indemnification agreements with any directors, officers, employees or agents.	
1, 2 and 3	Schedule of all compensation paid during the last fiscal year to officers, directors and key employees, showing separately salaries, bonuses and non-cash compensation, including bonuses paid or accrued, direct or indirect benefits or perquisites, and all benefits paid or accrued under all employee benefit plans.	Most buyers cannot reduce compensation going forward.
1, 4 and 5	Description of commissions paid to managers, agents or other employees of the Company.	
1 through 5	A listing of all outstanding loans to employees in excess of [\$10,000] (including loans granted under any 401(k) plan) including the amount of the loan, its rate of interest and whether or not it is secured.	Loans like these create questions of how to handle if the workforce is retained.
1 and 3	Absenteeism, disciplinary actions, accident records and turnover rates of the Company and its Subsidiaries.	Operational issues.
1, 3 and 5	Copies of any special compensation/retention arrangements in connection with the proposed transaction.	

Area of Concern	Due Diligence Request	Explanation
1	Stock option and purchase plans and equity incentive plans of any type, including forms of option and purchase agreements which have been or may be used for these plans, and any options or warrants not under an equity plan.	Impacts how purchase price is allocated.
1, 2 and 4	Any nondisclosure agreements, settlement agreements, releases, covenants not to sue and other agreements relating to intellectual property of the Company.	Key to protecting assets.
1 through 5	A schedule of all policies or binders of insurance or self-insurance arrangements, including medical, workers compensation, disability, automobile, general liability, fire and casualty, products liability, professional liability, business interruption, officers' and directors' liability and key- man life insurance, with deductibles, coverage limits, and other significant terms. Please indicate the name and address of all insurance agents, brokers and companies.	Insurance issues may be critical to many items.
1, 3 and 5	Federal, state, local and foreign tax returns for all open tax years, including sales, property, franchise, payroll, excise, withholding and capital tax returns and consolidated returns of the Company. Copies of tax elections, consents, agreements or waivers (other than as attached to tax returns).	Payroll tax obligations can cause issues throughout the process since the burden impacts a workforce.

Closing

When it comes to employee-related matters, closing matters tend to boil down to two key issues: (1) new “employee” agreements for key-persons; and (2) new “employee” agreements for rank and file workers.

Whenever key-persons are transferred from a prior employer to a new employer, issues related to compensation, severance, non-competes, non-solicitation and benefits and bonuses take center stage. If a key-person is critical to the success of the business going forward, obtaining new agreements with these key-persons is often a condition to closing. Each of these agreements need to be negotiated with each key person. The key items to consider while drafting and negotiating these agreements do not differ that much from onboarding a key-person to an existing business. These agreements are often litigated post-closing by the buyer and the key-person, so these agreements should be drafted and negotiated by an experienced practitioner.

Whenever a rank and file workforce are transferred (or retained) in connection with the sale and/or acquisition of a business, its important to put in place agreements that take into consideration the same issues that relate to a new workforce. To the extent a rank and file workforce is expected to execute employment related agreements such as non-compete agreements, it is critical to pay new or additional consideration to support these agreements.

Post-Closing

Employment related issues that arise after a transaction closes can be difficult to handle if the acquirer does not have experience with deal transitions. It goes without saying, that workforces that are transferred in connection with a business acquisition are less stable than workforces that are organically hired (assuming a well-managed enterprise). This instability is natural given the fact an acquired workforce generally did not select its employer. Generally, the more acquisitions a buyer has completed, the better prepared the buyer is to handle post-closing employment-related instability. Circling back to the three questions posed above in the Letter of Intent phase of the deal process, the parties need to consider and factor in its goals as it relates to the transaction.