

Battle Ready:  
Arming Your Company to  
**Manage**  
**Talent During**  
**M&As**

Imagine your CEO has just informed you of an unsolicited takeover bid or the board's decision to explore "strategic alternatives" — in other words, the start of a mergers and acquisitions (M&A) battle. If you're in human resources, it will be your responsibility to advise the company on how to retain key talent during the process and after the transaction is completed.

This article outlines the immediate steps your department will need to take, as well as an effective framework for talent management. While focused on the target company in an M&A situation, this guidance is also useful for the acquirer, particularly one whose employees face employment uncertainty as a result of combining the two entities.

By Yvonne Chen, Pearl Meyer & Partners

**QUICK LOOK**

- ➔ In the first 60 days after the M&A process begins, the first steps include setting up a process for management updates, being prepared with retention program alternatives and planning the employee communications strategy.
- ➔ The building blocks for talent management during M&A are a) identify employees who are retention risks, b) evaluate for what period the employees' services will be critical and c) determine what it will take to minimize the retention risks.
- ➔ There are three basic types of retention plans: enhanced severance, retention bonuses and transaction bonuses.



## What to Do First

In the first 60 days after the M&A process begins, the HR function typically is inundated with requests for data and new M&A-related plan designs. As with emergency room triage procedures, it is essential to establish your top priorities up front.

1. **Establish the information flow.** In the initial phase, information will be limited to a small group to avoid leaks. You need to help determine who among your own staff, as well as colleagues in other parts of the company, should be “under the tent.” For example, candidates include the vice president of human resources, director of executive compensation, chief accounting officer, treasurer and general counsel.
2. **Set up a process for management updates.** Regular M&A updates to senior managers should pinpoint critical roadblocks as early as possible, without burying recipients with excessively detailed information and questions. Establish a schedule and format for periodic updates. Updates can be provided by e-mail, daily calls, weekly meetings, etc.

3. **Take a data inventory.** Identify the human resources/M&A information that is readily available, as opposed to information that will require research. One source for easily accessible information is the M&A team’s “data room.” It features materials that will be provided to prospective acquirers, as well as additional data needed internally for issues like identifying retention risks, determining the new organization structure post-transaction and determining potential severance costs, as well as quantifying exposure to any related golden parachute excise taxes. A typical data request list includes materials like employment agreements, incentive plan documents and award letters, pension and other benefits plan documents, severance plan documents and the terms of hiring awards.
4. **Be prepared with retention program alternatives.** Typical alternatives include enhanced severance, a retention bonus and a transaction bonus, all of which are discussed in more detail later in the article (see Table 2 on page 60). Even if you

are not in a formal M&A process, it may be appropriate to complete some groundwork as a defensive maneuver if your company is a likely target.

5. **Plan the employee communications strategy.** A talent retention program should be supported by clear and timely employee communications to help manage expectations and acknowledge/reduce uncertainty. Such communications include preparing responses to expected employee questions before and after a transaction is publicly announced, as well as planning to proactively reach out to employees or address any misinformation. Communications with executives are typically handled through in-person one-on-one or group meetings. Communications with the broader employee population may be handled through a Web cast or town hall meetings within each business unit or region. The most effective method will depend on the company’s culture and existing employee communications practices.

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## Framework for Talent Management

The building blocks for talent management during M&A are a) identify employees who are retention risks, b) evaluate for what period the employees’ services will be critical and c) determine what it will take to minimize the retention risks.

- a) **Identify employees who are retention risks.** To avoid the potential of management favoritism, begin with a sound methodology that leaves room for discretion in identifying retention risks, especially in the unusual event that your premerger decisions end up being scrutinized in a shareholder lawsuit. Many companies create an actual scorecard to determine eligibility

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TABLE 1: SAMPLE SCORECARD FOR RETENTION AWARD ELIGIBILITY

Factor	Finance manager	HR manager	Sales manager
<b>Criticality to the company — Does the individual have:</b>			
A strong impact on the business going forward?			√
The expertise needed to close the transaction?	√√ <i>(This individual gets an extra checkmark because credit-markets expertise is absolutely critical to closing the transaction.)</i>		
A key role in dealing with potential acquirers?	√	√	
Significant experience/tenure?	√		√
<b>Likelihood of turnover and replacement cost — Does the individual have:</b>			
A high degree of flight risk to a competitor or a likelihood of retirement?	√	√	√
Skills/expertise that would be difficult to replace?	√		
Significant employment uncertainty due to the M&A process?			√
A high probability of job loss post change in command?	√	√	
<b>Combined score:</b>	<b>7</b>	<b>3</b>	<b>4</b>

**Evaluation of existing retention value**

Individual's base salary (example)	\$100,000	\$100,000	\$100,000
Existing retention value?	\$500,000	\$0	\$50,000
Guidelines for desired retention value/multiple?	Tier I 3x salary = \$300,000	Tier II 1x salary = \$100,000	Tier II 1x salary = \$100,000
Potential additional cost of including this individual in the special retention award plan?	None	\$100,000	\$50,000
Retention award eligibility:	No special retention award is needed since there is already sufficient retention value in place (i.e., \$500,000 compared with desired retention value of \$300,000).	Yes. Guideline for Tier II and zero existing retention value suggests \$100,000 award. However, the talent manager may apply discretion and award less than the guideline (e.g., \$75,000).	Yes. Guideline for Tier II and existing retention value results in \$50,000 retention award.

TABLE 2: THREE TYPES OF RETENTION PLANS

Type of Plan	Characteristics
<b>Enhanced Severance</b>	Continuation of pay, either over time or as a lump sum
Provisions	<ul style="list-style-type: none"> <li>• Possible continuation of health and welfare benefits</li> <li>• Possible extension or enhancement of outplacement benefits</li> <li>• Payment contingent upon involuntary termination within a limited period following change in command (CIC) or upon termination in anticipation of CIC</li> <li>• Examples of enhanced severance benefits: <ul style="list-style-type: none"> <li>– Extension of pay continuation period</li> <li>– Redefinition of pay to include salary and target bonus</li> </ul> </li> </ul>
Market practice	<ul style="list-style-type: none"> <li>• Commonly provided to a broad population</li> <li>• Relatively low-cost way to provide additional retention value (no payment without termination post-CIC)</li> <li>• Pay period often extended in a down economy (reflects greater difficulty in finding other employment)</li> </ul>
Advantages	<ul style="list-style-type: none"> <li>• Limited cost for the acquirer (or the company if a CIC does not occur), since payments are contingent</li> <li>• Limited cost allows company to address employment uncertainty for a broader population</li> </ul>
Disadvantages	<ul style="list-style-type: none"> <li>• Plan uniformity is unlikely to retain high at-risk employees since competitors can easily offset contingent payments</li> <li>• Retention value may be insufficient if the M&amp;A process is lengthy</li> </ul>
<b>Retention bonus</b>	Typically a fixed cash award
Provisions	<ul style="list-style-type: none"> <li>• Payment is contingent upon continued service to a specified date(s). For example: <ul style="list-style-type: none"> <li>– Vesting: 50% vests at CIC closing and 50% at 6 months post-CIC</li> <li>– Vesting: 30% vests 6 months and 70% 12 months after the award is granted, with acceleration upon earlier CIC closing</li> </ul> </li> <li>• Vesting/payment may be accelerated upon termination without cause</li> <li>• Usually three or four eligibility tiers with different award values</li> <li>• Higher award values usually reserved for executives or when the desired retention period exceeds one year</li> </ul>
Market practice	<ul style="list-style-type: none"> <li>• Used often, but participation is more selective than in enhanced severance</li> <li>• Award values vary widely, from \$5,000 up to two times annual salary and target bonus</li> <li>• Total award pool often below 1% of equity deal value (the larger the deal value, the smaller the percentage)</li> </ul>
Advantages	<ul style="list-style-type: none"> <li>• Size and timing of retention bonuses can be individually customized</li> <li>• Selection criteria typically targets high at-risk employees</li> </ul>
Disadvantages	<ul style="list-style-type: none"> <li>• Potentially costly if most participants end up staying and receive awards</li> <li>• If paid before CIC, additional retention bonuses may be needed</li> </ul>
<b>Transaction bonus</b>	Typically cash, but pre-CIC stock awards also possible
Provisions	<ul style="list-style-type: none"> <li>• Awarded as fixed-dollar value, percentage-of-equity-deal value or fixed number of shares (value dependent on deal price)</li> <li>• Payment contingent on CIC closing and possibly threshold deal price</li> <li>• Payment occurs on CIC closing, with possible acceleration on termination (company cannot fire individual to avoid payment)</li> <li>• Participation limited to individuals responsible for creating transaction value</li> </ul>
Market practice	<ul style="list-style-type: none"> <li>• Used infrequently, but may be sizable</li> <li>• Effective when board wants to sell the company, but only after management improves the business</li> <li>• Participation usually limited to a small group of executives (e.g., under 10)</li> <li>• May not be appropriate if executive value from existing compensation programs is already significant</li> </ul>
Advantages	<ul style="list-style-type: none"> <li>• Awards are strongly linked to value contribution</li> <li>• Larger award size and limited participation focus executives on closing a favorable deal for shareholders</li> </ul>
Disadvantages	<ul style="list-style-type: none"> <li>• Only addresses retention for a select group</li> <li>• May need to modify the transaction bonus or provide additional retention value if the deal price and/or timing differ from original expectations</li> </ul>

for retention awards and, in some cases, to calculate retention award values.

The sample scorecard shown in Table 1 on page 59 is based on eight retention factors of equal weight, although you may want to consider other factors or different weighting. “Existing retention value” includes any compensation or benefits that would be forfeited or reduced if an individual chooses to terminate employment, including:

- unvested equity awards
- unvested pension and deferred compensation
- potential for early or full retirement (e.g., based on age and service levels)
- potential to earn in progress annual and long-term incentives
- severance payments.

Such a bottoms-up analysis should be paired with a top-down analysis to determine if the total cost is acceptable

or affordable to the company, given that the acquirer may impose financial restrictions in the merger agreement. The company’s board may also want to limit total change-in-command (CIC)-related payments (e.g., payments are not to exceed 3 percent of equity deal value). If total cost is an issue, eligibility criteria can be adjusted to either limit participation in the retention program overall or reduce the number of individuals who will qualify for the higher retention award tiers.

b) Evaluate the time period for which the employees’ services will be critical.

Employees can be grouped by their expected retention length as follows:

- **keepers:** employees expected to stay long-term post-CIC
- **transitioners:** employees expected to stay for a short integration period post-CIC and then be terminated

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# The economic downturn and tightening credit markets are likely to make the M&A process **more challenging.**

- **leavers:** employees needed up to the CIC who will be terminated upon deal closing.

In many cases, it cannot be determined who will have a job post-CIC until late in the M&A process, so programs tend to focus on transitioners. In such arrangements, payments are often made at deal closing and six months later, with a provision for earlier payouts if the employee is involuntarily terminated without cause before the scheduled payment date. In essence, it is then left to the acquirer to develop plans to address talent retention post-CIC.

c) **Determine what it will take to minimize the retention risks.** There are three basic types of retention plans (see Table 2 on page 60), including:

- enhanced severance
- retention bonuses
- transaction bonuses.

There may be one plan with different tiers of award value or multiple plans offered to different participants.

It should be noted that some employees may already be sufficiently covered under existing severance arrangements. Employment agreements for senior executives often provide enhanced severance — such as three times salary and target bonus — upon CIC and involuntary termination. Broad-based plans for rank-and-file employees also may offer sufficient severance, such as two weeks of salary for every year of service,

with a minimum of four weeks and a maximum of 52 weeks.

If the M&A process renders existing annual and/or long-term incentive plans obsolete, the goals under those programs may need revision. In addition, prorated payment of cash incentives is often provided upon a CIC based on target or actual performance. For example, if a long-term award is earned based on achievement of a targeted level of three-year cumulative earnings per share, but the company is acquired in the first year, it will not be possible to measure three-year cumulative earnings per share. As such, the prorated payment may be determined using the target award value, or the company may deem a specific level of performance to have been met based on the progress to date toward the three-year goal.

Keep in mind that the technical ramifications of any retention program design should also be carefully reviewed by tax, accounting and legal experts. Several important technical areas to consider include:

- tax efficiency under Internal Revenue Code Sections 280G (golden parachute), 409A (deferred compensation) and 162(m) (\$1-million limit on tax deductibility of compensation)
- accounting expense before/after CIC
- possible public disclosure requirements for new retention plans
- merger agreement terms and conditions.

Going forward, the economic downturn and tightening credit markets are likely to make the M&A process more challenging. A well-designed framework for talent management will help human resources successfully manage one of the company's most life-changing events. Despite the challenges, M&A activity is often the key driver of a company's business growth strategy. WS

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