Employee Retention & Attrition in Mergers/Acquisitions: Minimizing Risks of Employee Defection

Insights
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A merger that looks good on paper can lose value when too many employees in the target company get nervous about what life will be like after the deal closes -- Will the culture be different?Is the acquiring firm too big?Too rigid?Will they understand how we do business?These risks have had enormously negative impacts on many mergers. Employee attrition following mergers and acquisitions is so common that it has been the subject of psychological studies, has been written about in Human Resources publications, and even has spawned its own name -- "Merger Syndrome."Back in 1986, *Psychology Today* published an article called, "*The Merger Syndrome: When Companies Combine A Clash Of Cultures Can Turn Potentially Good Business Alliances Into Financial Disaster.*" What can an acquirer's Legal Department do to manage this risk?

Check the Old Restrictive Covenants – Do They Exist?Are They Enforceable?. Start early in the process.During due diligence, check whether the target company has its key people under enforceable restrictive covenants.Don't just inventory HR files.Analyze what restrictions are in the contracts.Where are the employees located?Are those restrictions enforceable in those states?Were the contracts signed at the inception of employment or later?If they were signed later, then consideration may be an issue, depending on the state.

Will You Have Standing to Enforce the Old Covenants After the Deal Closes?. Even if there are non-compete agreements in the file for the right groups of employees, you must determine whether you – as the acquiring entity – will have the right to enforce the old non-competes after the deal closes.Do the covenants have clauses providing that the agreement is assignable, or better yet automatically assigned, to a successor upon merger or acquisition?If the clauses are there, you probably can enforce.If not, the question may be much trickier – it will depend on the state's law that governs, and on the form of the transaction.Mergers and stock purchases are more likely to transfer the right to enforce.Asset purchases are less clear.

Think About New Covenants. If you find that many of the old contracts are not enforceable, then you want to build into the negotiation a strategy for getting newer and better agreements from the key people, especially for executives you want to retain after the merger.Everyone knows that.But make sure you identify the types of attrition that can turn a great deal into a disaster.Often the sales force is a key.In September 2005, Wall Street giant Merrill Lynch agreed to purchase AXA's Advest brokerage unit for $400 million.By May 2006, it was being reported that 417 out of Advest's total of 505 brokers had jumped ship. *See K. Burke, "Failure to Launch," Registered Rep (May 1, 2006).* It

365 brokers had jumped ship.*See K. Burke, "Failure to Launch," Registered Rep (May 1, 2006)*. It literally became a case study of a failed merger.*See* S. Grantham, *Risk Assessment as a Function of a Successful Merger: Merrill-Advest Merger,* 11 Journal of Communications Management 247-57 (2007). Mergers and acquisitions can be especially stressful for employees lower down the chain of control, who have access to less information.As one study noted, mergers "can change an individual's working life significantly but fail to provide the individual with any control over the event."Julie K. Anderson, "*People Management: The Crucial Aspect of Mergers and Acquisitions*," Industrial Relations Centre, Current Issue Series (1999).Don't make the mistake of only worrying about the top few executive non-competes.Carefully assess points of exposure to potentially damaging employee defection, and then craft restrictive covenants that will protect the company.

Consideration for New Agreements. If new contracts are required, you must address issues of timing and consideration.The demands of adequate consideration vary depending upon the form of your transaction, and the states in which key employees are located.In a statutory merger or stock purchase situation, the employment of target-firm employees continues uninterrupted through and after closing.In many states, simply agreeing to continue employing people is legally sufficient consideration to support execution of a covenant not to compete executed during the midst of employment – what some cases refer to as "mid-stream" covenants.But in a substantial and important minority of states, merely keeping someone on the job is not sufficient consideration for a mid-stream covenant.In these states – North Carolina and Pennsylvania are two examples – you must give each employee new and sufficient consideration.Sufficiency will be measured in proportion to the employee's pay level and duties.A check that would be sufficient for one employee will not be seen as sufficient for a much higher compensated employee.

Determine Whether Key Employees are Located in "Problem States". It is inconvenient, to say the least, that nearly all of the legal issues relevant to the risk of employee defection are governed by varying state laws, rather than by one consistent federal standard.In fact, it is so inconvenient that many companies simply ignore this undeniable reality.They do so at great risk to their ability to protect themselves against defections.One size rarely fits all when drafting restrictive covenants.If you roll out one version of your agreement, it may well fail in any number of key locations, including tricky states such as California, Georgia and others.You probably can cover the national map with anywhere from three to six versions of an agreement, depending upon how many different types and levels of employees you are signing up.You may be tempted to side step this problem by inserting choice-of-law/forum clause, but this often fails and is inadvisable in any case.It is dangerous to put all your eggs in one basket.If things turn bad in your chosen state, you are out of luck everywhere.

Don't Forget to Use Carrots with Your Sticks. The company of course is even better off if employees decide to stay on board, and are happy about doing so.This is why the most effective method is to roll out an attractive employee retention plan designed to induce important players at all levels to stay around long enough get to know what is good about your company.Consider stay-bonuses, with repayment obligations that kick in if an employee leaves within a year (or two or threeyears, as the case may be) after receipt.Salary or minimum bonus guarantees also can ease concern about transition into a new compensation environment.At a minimum, you can use retention

agreements to be sure key employees stay with you long enough to get through the transition period after the deal closes.

Communicate Your Retention Offers Early. Retention packages are more effective tools when deployed rapidly and when their benefits are communicated effectively.Deal with this immediately after announcement of the pending merger.Don't wait until closing.Headhunters will waste no time starting to recruit the most valuable employees from your target company.The last thing you want is for the dominant voices to be those of recruiters calling in and reinforcing the natural fears of employees whose company is being acquired. "[T]he period following the announcement of the takeover is one of intense personal risk analysis,in which the individual decides whether s/he will leave the organization or stay."Gunter K. Stahl & Sim B. Sitkin, "Trust in Mergers and Acquisitions", in *Mergers and Acquisitions: Managing Culture and Human Resources* (G.K. Stahl & M. Mendenhall, eds., Stanford University Press 2004).Effective retention packages offer sufficient financial inducement for employees to remain on board, and ideally are communicated before the headhunters are out in full force.You know the announcement is coming before they do.Take advantage of that head start -- don't announce until you are ready to convey information about retention packages almost simultaneously.

Employee attrition will always be a risk factor in mergers and acquisitions, but careful attention to restrictive covenants and retention packages can go a long way toward minimizing those risks.

Related People

Michael R. Greco
Regional Managing Partner
303.218.3655
Email