M&A BuildingBlocks

Social Issues

This building block deals with the all-important "people issues". Sometimes, while the parties focus on financial analysis and pricing, structuring, and process matters, issues that are close to home for the individuals involved can be left to the end and then prove to be difficult to resolve. Some of these issues are discussed in this issue.

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Key Issues/Process Points

1 What are "Social Issues"?

Social issues are those aspects of an M&A transaction having to do with people and their relationships with the parties to the transaction. These include:

- Who will be the CEO? Who will hold other offices post-transaction?
- Composition of the post-transaction board of directors and related issues
- Employment agreements, including change of control and retention provisions
- Employee relations
- Dealing with customers
- Dealing with the communities in which the parties operate

2 Directors and Officers

Of course, the nature of a transaction will generally dictate the overall approach to dealing with officers and directors: in a successful hostile take-over, the target's executives and directors are not generally in a position to negotiate for continued participation in the combined business. By contrast, in a friendly acquisition or a merger of equals, agreement on the roles to be played by executives from each party is a critical element in obtaining support for the transaction. Even in a hostile situation, it may be important for the acquiror to retain key executives of the target in order to preserve the value of the target's business.

A few of the key points for consideration are set out below:

- **Employment agreements** – As a matter of due diligence, employment agreements with executives of the target must be carefully reviewed, particularly for change of control provisions that require termination payments upon completion of an acquisition or accelerate awards under compensation plans.
- **Post-transaction executive suite** – While in many cases the identity of the CEO following the transaction will be obvious, in other cases it may not be so clear and the choice of the CEO will be a delicate issue to be dealt with. In some circumstances, having co-CEOs may make sense, or an alternative role may be needed for one of the parties' CEOs. Duplication within the new executive suite may have to be dealt with. Uncertainty and insecurity around their future can be distracting to executives and create problems in the transaction process. While it may not be possible to make final decisions early in the process, it can help to acknowledge the issues and to at least ensure that they are not left to the last minute when they could upset the entire deal.
- **Retention** – Because of the problems described above, it sometimes makes sense, particularly for a target, to have in place retention agreements with key executives to ensure they will stay throughout a sale process. Retention agreements provide for payments to executives for continuing to stay with a company through a change of control event.
- **Collateral benefits** – One area that requires care, particularly for acquirors who are anxious to keep management of a target company in place, is that of collateral benefits. The issue arises from the general requirement that all shareholders of a target company be paid the same consideration for their shares and that no shareholders receive any side payment or collateral benefit over and above payment for their shares in order to "buy" their support for the deal. Where executives who are also shareholders of a target enter into new employment agreements with the acquirer, the concern arises that the new employment arrangement could be a collateral benefit designed to "buy" the executives' support for the transaction regardless of the fairness of the price paid for their shares. If collateral benefits are conferred, the recipient may be excluded from voting on the transaction or in a second stage squeeze-out transaction. There are exemptions available for benefits conferred through employment relationships, but there are limitations and they may require specific review by the target board, so early attention is important.
- **Board composition** – In a merger of equals, the composition of the merged company's board may be contentious since simply combining the parties' boards may result in a board that is too large and expensive. Factors to be considered in selecting directors, in addition to the qualifications of the individuals themselves, include meeting corporate law Canadian content requirements, meeting stock exchange and securities law requirements for independent directors, addressing proxy advisory firms' expectations in relation to matters such as over-boarding, ensuring candidates have the expertise needed to fulfill roles on the audit and other committees, and meeting shareholder and regulatory expectations relating to gender representation and diversity. Sometimes the CEO of the target or acquiror who will not be CEO of the combined entity is a good choice to be the new Chair of the combined entity's board.

- **Indemnities/D&O Insurance** – It is a matter of good corporate housekeeping to have director indemnities in place at all times. Sensitivities are heightened in the context of M&A, however. Departing directors will want assurance that they continue to be covered by director and officer insurance after they leave. It is normal for the target company to be permitted to purchase a "tail" policy which will continue to provide coverage for the directors against claims arising after the acquisition closes.

3 Employees

Employees who are below the level of the executive suite are in an awkward position. At the beginning of an M&A process, due to concerns about confidentiality and guarding against leaks, such employees are likely to be in the dark about what is going on. As time passes, and particularly if due diligence is to be conducted in earnest, certain employees will need to be brought into the deal team. As the circle expands, the potential for rumours increases. Since employees may have limited roles and will not be at the bargaining table, their knowledge will be incomplete and misinformation can spread.

Managing the information flow to employees is important. Just as parties should be ready to make public disclosure in the event of a leak, they should also be ready to deal with employees. The two may go hand in hand.

Another reality (and employees are all too aware of this) is that an M&A transaction will likely result in job losses.
Key points in this regard for the parties to the transaction are:

- **Cost** – While synergies and cost savings are likely to be top of mind in considering the work force of the combined entity, the elimination of employees carries its own costs. Due diligence is required to determine termination costs by virtue of employment agreements, statutory requirements and common law. It must also be remembered that sometimes a change in an employee's title, responsibility or reporting responsibility, as well as a change in compensation, may be considered to be constructive dismissal with potential liability to the employee.
- **Share-based compensation** – An acquisition or merger is likely to trigger issues around option plans and other share-based compensation. In an acquisition scenario, the acquirer will want to ensure all rights to acquire target securities are terminated to ensure the target becomes 100% wholly-owned. Often, the target's share-based compensation needs to be replaced with a plan based on shares of the acquirer.
- **Effective Communication** – Consistent, accurate and timely communication is necessary to minimize disruption.
- **Implementation** – While a time lag between the announcement of a transaction and its implementation is inevitable, once the transaction closes it usually makes sense to implement organizational changes as soon as possible.

4 Customers

Customers frequently find out about an M&A transaction from the press, along with the investing public. While often there is nothing wrong with this, in other cases this may be too late. For example, the parties may need to approach a major customer whose continued business is critical to the combined entity to ensure there is no objection to the deal. In some cases, such a customer may well be approached by the Competition Bureau or the Investment Review Division of Investment Canada in connection with their approval processes. Anticipating and preparing for such an approach may help smooth the review process.

5 Communities

As we are increasingly seeing, provincial and municipal governments can have a big impact on business transactions, from pipelines to take-overs. Anticipating and preparing for potential reactions in this regard may not make the issues go away, but it may be possible to steer the relationship toward one of dialogue rather than of confrontation.

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