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Mergers and Acquisitions

Strategies for Retaining Management in Auction Sales of Life Sciences Companies

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In auction sales of any kind, the excitement engendered by a bidding war can be intoxicating. Yet that same excitement may be the basis for the “winner's curse”—the unfortunate fact that the winning bidder often overpays for the asset. While ascertaining whether the winning bidder has overpaid can be difficult, there can be no doubt that as bidding heats up for a desirable asset, the focus among bidders tends to shift from the package of goods offered to just one component: the price.

Suppose you have just been declared the winning bidder in an auction for a prized life sciences asset, yet in the bidding frenzy you may not have been as focused as you might have liked on how you are going to retain management. (“First, win the auction, then figure out the rest,” as one bidder recently said.) Indeed, you may even have let your guard down a bit in order to be as “flexible” as possible with management to entice them to accept your bid. There was no ill-intent, just a desire to be accommodating. Yet you know that your hard-won prized asset could quickly diminish in value if you are not able to retain existing management. This is especially true for companies in the life sciences space, whose success often is attributable as much to the relationships and specialized expertise of top management as to the unique intellectual property assets.

Of the many issues that arise in any given merger and acquisition, ensuring the retention of a target company's key management personnel is one of the most important. An acquiring company may employ any number of strategies in order to provide the target company managers with an incentive to stay on with the company following an acquisition. The most common of these include management earn-outs, stock option plans, employee bonus thresholds, and clawback provisions.

In an earn-out, the target company sellers/managers receive additional purchase price consideration if the company meets certain predetermined financial goals in the months or years following the acquisition. This can often be a very significant jackpot prize for management, and the potential for additional compensation provides managers with an incentive to stay on the job. Because the sellers/managers have the promise of receiving potentially significant additional moneys if the company meets its financial targets, an earn-out also gives managers a double incentive to work diligently to ensure the company's long-term success.

Employee bonus arrangements are closely related to the management earn-outs. As with earn-outs, implementing employee bonus thresholds provides management with an incentive to continue working for the company with the prospect of being awarded additional compensation if the company meets predetermined financial or other targets. Often, bonus targets are stratified such that the employee will receive progressively higher bonus awards if more lucrative targets are achieved during the relevant period. Awarding higher payouts for meeting more demanding financial benchmarks obviously can provide an additional incentive for managers to remain with, and continue to work diligently for, a target company.

Stock option and stock incentive plans function in a manner similar to earn-outs and employee bonus thresholds. Just like earn-outs and bonus arrangements, these plans can be structured in various ways to give employees incentives to meet targets or remain with the company for certain time periods before vesting. Furthermore, they provide the same incentive to increase the company's earnings and profitability because their net payoff increases as the company's stock value increases.

Although these three strategies (i.e., earn-outs, stock option plans, and bonus thresholds) often are effectively utilized in a variety of acquisitions contexts, the situation can be more complex in the case of auction sales of life sciences companies. As noted above, bidders in auction sales may present offers with high dollar values and few restrictions on management in an effort to ensure they win the bidding war. How can a company that has already submitted an offer incite the target company's management to continue with the firm after it has already been awarded the bid? The classic solution, of course, is to require that designated managers sign negotiated employment agreements acceptable to the buyer on or prior to the closing of the deal.

In life sciences deals, however, it is very often the case that the managers identified by the buyer as essential to the company's business are also the sellers of the target company. How does the buyer ensure that the target sellers/employees will remain productive employees of the company after closing if they will also receive millions of dollars at closing in the form of purchase price proceeds? In such cases, the fear is that the sellers—who are vital to the past and future success of the company—can simply walk away and retire to the detriment of the new owners of the business. In hotly contested auction sales, the sellers may also be able to demand the purchase price in upfront proceeds and refuse to accept an earn-out or other delayed compensation mechanism. One way to address this challenge is that an acquiring company may be able to negotiate a clawback provision with existing management. Clawback provisions are the mirror image of earn-outs and bonus thresholds in that they threaten to take away stock or cash compensation that has already been awarded in the event that the company does not meet its financial targets following the acquisition.

For example, the deal might be structured so that the sellers would be required to give back a portion of the purchase price to the buyer if the target company does not meet designated performance or financial criteria after closing. Thus, in order to keep their money, the clawback provision would provide an incentive for the sellers to work diligently after closing in order to ensure that the performance targets are met and that the clawback therefore is not triggered. A second alternative might be to require the sellers to pay liquidated damages to the target company (equal to a percentage of the purchase price) if the sellers breach the terms of their employment agreements. From an economic perspective, this would achieve the same result as the clawback provision referred to previously. However, this structure also provides a “stick” that counter-balances the “carrot” (i.e., upfront purchase price proceeds) and thereby mitigates the risk that a seller will simply walk away and terminate his or her employment without cause after selling the company. That said, depending on the relevant jurisdictions, counsel would need to confirm that such liquidated damages provisions are enforceable under applicable state laws and that the tax consequences of such a structure would be consistent with the expectations of the respective clients.

In short, auction processes present unique opportunities and hurdles for buyers in the life sciences space. This is especially true today, where financial and strategic players are giving a lot of attention to good target prospects. The market can be very competitive and pressure for increased valuations can be high. In this context, buyers need to understand their business goals and structure their deals in a way that mitigates or averts risks associated with retaining management. To do this, it is critical for buyers to use seasoned and experienced advisers familiar with the legal terrain and knowledgeable about avoiding pitfalls. Armed with these protections, buyers will be able to maximize their value and achieve successful long-term results.

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