SQUIRE PATTON BOGGS

Employment issues in M&A transactions

Common red flags for buyers to be aware of

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In Australia, employment-related issues are becoming increasingly important for buyers in M&A transactions – and not only in the due diligence stage, but also in the negotiation of transaction documents (particularly in the warranties and indemnities) and post-completion items.

The employment landscape in Australia is complex, heavily regulated and constantly evolving. When employers are noncompliant (even inadvertently), it can give rise to serious legal, commercial and/or reputational risks. In such an environment, employment due diligence is no longer just a "box-ticking" exercise, and it is important that buyers "look under the hood" to better understand what workforce risks may need to be identified and addressed as part of the transaction, and proactively managed post-completion, to achieve a sustainable and successful business.

The risks that could become relevant for the buyer will depend on the type of transaction (i.e. whether it is an asset purchase, a share purchase, or a combination of both). This article explores some of the common red flags that buyers need to be aware of.

Notice periods and restraints

Whether it is an asset purchase or a share purchase, a buyer's ability to retain key employees and restrain their post-employment conduct will be critical in protecting the value a buyer has paid for its newly acquired business.

Buyers should ensure that key employees are subject to notice periods that provide sufficient protection in the event the key employee resigns post-completion. At times, we come across employment agreements that contain a notice period of, say, one or two months, or in accordance with the minimum statutory notice periods under the National Employment Standards. These notice periods are unlikely to adequately protect the business in the case of key personnel.

Further, buyers should not assume that post-employment restraints are enforceable just because they are included in an existing employment agreement. In Australia, post-employment restraints are only enforceable to the extent they are reasonably necessary to protect the employer's legitimate business interests. More often than not, restraint provisions are poorly drafted, omitting cascading or "menu" style definitions of "restraint periods" or "restraint areas", and, in some cases, are not subject to any geographical or temporal limit. Outside of NSW, a court will not read down an unenforceable restraint to render that restraint enforceable. Absent any clauses that allows for alternative/lesser restraint periods and restraint areas to be applied to a restraint, if a particular restraint is found to be unenforceable, that restraint will fall away, leaving the buyer with no other restraint protection available.

Given these nuances, we strongly recommend that employment agreements of key employees are reviewed by an employment counsel, to ensure key deficiencies are identified and appropriately addressed either before or after completion. The risks may be sufficiently important as to consider making the key employees sign up to new employment agreements (with adequate notice period and restraints) on completion.

Contractor misclassification

Another important issue to highlight is the potential for misclassification of contractors and employees. In Australia, following the second tranche of "Closing Loopholes" amendments in the *Fair Work Act* 2009 (Cth) (FW Act) in August 2024, the meanings of "employer" and "employee" under the FW Act are determined by reference to the "real substance, practical reality and true nature of the relationship between the parties", rather than just the written contractual terms.

This means, for example, if a business engages a "contractor" who works regular hours, is paid an hourly rate and has reporting lines within the business, there is a real risk that the "contractor" may be found to be an employee, even if they are engaged on a written "independent contractor" agreement. This risk is heightened for contractors who are engaged in their individual capacity, rather than via a corporate vehicle. We do see transactions where members of the C-suite are engaged as a "contractor" that we are likely to consider to be a red flag.

A buyer could face liability if a contractor seeks to challenge their contractor status and claim employee entitlements (such as statutory leave and superannuation) post-completion. If a contractor is found to be an employee, they will have unfair dismissal rights (subject to the eligibility criteria under the FW Act) and be entitled to, at a minimum, the statutory notice period and, in the case of redundancy, redundancy pay.

As such, buyers should review the target's contractor arrangements to assess whether there is any risk of an employment relationship and, where required, place the contractors on a more robust contractor agreement that better reflects a "true" contractor relationship, or even consider offering them employment.

Work health and safety

Unsafe worksites make headlines for all the wrong reasons. This is especially true in mining and trade-based industries, where workplace injuries remain a persistent and all-too-common reality.

In Australia, all "persons conducting a business or undertaking" (PCBUs) (which includes employers) have an obligation under work health and safety (WHS) laws to ensure the health and safety of their workers, as far as reasonably practicable. This obligation extends to "psychosocial hazards", requiring employers to manage safety risks that may arise from things such as excessive workloads, lack of role clarity, workplace bullying and sexual harassment. A breach of an obligation under WHS laws can result in a variety of enforcement actions by safety regulators, including investigations, notices or cautions, and even prosecution. Directors and certain officers also have a duty under WHS laws to ensure the health and safety of workers, and may become personally liable for a breach of this duty.

This issue is particularly important in a share purchase context as, once the target is purchased, the target may still be prosecuted for any WHS incident that occurred pre-completion. The individuals responsible for the target at the time of the incident (such as the directors and other officers) can face personal criminal liability, which may pose risks to the buyer if such individuals will remain in the business post-completion (e.g. as continuing directors).

It is therefore crucial for buyers to conduct a thorough WHS diligence, including:

- Reviewing the target's WHS policies/procedures to assess whether WHS risks are adequately managed
- Assessing any ongoing WHS risks in the target's business in relation to any safety incidents and/or enforcement actions by a safety regulator

Where significant risks are identified, buyers should seek appropriate protections in the transaction documents to mitigate loss in the event that enforcement action is taken against the target post-completion for any pre-completion conduct. Depending on the circumstances, it may be appropriate for buyers to seek specific indemnity protection or even an escrow or adjustment to the purchase price as a further layer of protection. That said, it should be noted that under WHS laws, directors cannot be insured or indemnified for any penalty imposed by a court against them in an individual capacity – another issue to be alive to.

Underpayment of wages: Award covered employees

Against the backdrop of cases like *Fair Work Ombudsman v Woolworths Group Limited & Ors*[1] (*FWO v Woolworths & Ors*) (see related article), employers in Australia are facing heightened risks where they have underpaid their employees, especially in respect of award covered employees.

Notably, just because an employee is paid an annual salary that exceeds their award entitlements over the course of a year, does not mean an underpayment risk is eliminated. Underpayments can still arise through:

- **Ineffective set-off clause** – A set-off clause in an employment contract allows an employer the contractual ability to pay an annual salary and set off the salary against any amounts payable to the employee at law (e.g. under a modern award). A set-off clause must be drafted in a specific way to be effective – particularly, there must be a "close correlation" between the salary and the nature of the relevant entitlements at law being set off. Set-off clauses in employment agreements do not always meet this requirement.
- **Set-offs across pay periods** – Even where a set-off clause is effective, set-offs can only be effective within the same pay period, as per the Federal Court's decision in *FWO v Woolworths & Ors*. This means an employee must be paid their entitlements at law in full each pay period, i.e. even if the employee is paid more than their minimum entitlements at law over the course of a year, if they are underpaid in a particular pay period, the employer must, strictly speaking, top up the employee's pay for that pay period. This risk is especially heightened for employees who work fluctuating hours or significant amounts of overtime hours.
- **Incorrect award classification** – Assessing award coverage is a complex exercise and it is easy for employers to get it wrong. Where an employee has been classified under an incorrect award, there is a risk that they have not been paid their minimum entitlements for the correct classification under the correct award.

1 *Fair Work Ombudsman v Woolworths Group Limited; Fair Work Ombudsman v Coles Supermarkets Australia Pty Ltd; Baker v Woolworths Group Limited; Pabalan v Coles Supermarkets Australia Pty Ltd* [2025] FCA 1092

A breach of a modern award, and some other breaches of the FW Act, can give rise to civil penalties being imposed on the employer (up to AU$495,000 per breach, or AU$99,000 for "small business employers") or individuals involved in the breach, such as directors (up to AU$19,800 per breach). Further, where a breach relates to an underpayment, employers may be liable for civil penalties of up to three times the underpayment amount (if that amount exceeds AU$495,000).

Given the above complexities, underpayment risks are not always obvious from a high-level review of diligence materials. We have been involved in many deals that required us to assess this risk by way of "requests for further information" (RFIs) alone, but upon a closer look at the data room materials, we have identified hidden underpayment risks that would not otherwise have been reflected in the seller's response to the RFIs. As such, it is important for buyers to give due consideration to any underpayment risks as part of its employment diligence, to ensure any underpayment risks are identified and, where possible, quantified early with appropriate warranty and indemnity protection negotiated.

Casual employee misclassification

The second tranche of the Closing Loopholes amendments to the FW Act changed the way in which casual employees can become permanent employees. From August 2024, casual employees have a right to request conversion to permanent employment after they have been employed for six months (or 12 months if employed by a small business employer) if they believe they no longer meet the definition of a casual employee under the FW Act (known as the "employee choice pathway").

As the choice to convert to permanent employment is in the hands of the casual employees, this creates a level of uncertainty for buyers as to the potential liability that may arise if casual employees decide to exercise their choice to become permanent post-completion. For a buyer inheriting a large cohort of casual employees, this liability could be substantial.

To avoid any surprises, buyers should closely assess as part of employment diligence whether there is the potential of any casual employee no longer meeting the definition of "casual employee" under the FW Act, as well as the duration of their employment, to identify whether they likely have a right to request conversion to permanent employment under the FW Act.

Transfer of business and redundancy

Unlike the UK and EU countries where the Transfer of Undertakings, Protection of Employment regime applies, in Australia, employees do not automatically transfer from one employer to another as a result of a transfer of business and assets. Rather, employees will need to resign from their employment with their current employer and accept employment with the new employer.

Under the transfer of business provisions in the FW Act, if an employee is offered employment with the new employer on less favourable terms, and that employee does not accept this offer, if their employment with the target terminates as a result, this may be considered a redundancy resulting in the employee being entitled to redundancy pay. In an asset deal, buyers will therefore need to consider the terms on which the target's employees will be offered employment (particularly if they receive substantial additional benefits, such as bonus/commission entitlements – will the buyer grandfather these arrangements?). Buyers should also ensure that transaction documents clearly set out the parties' respective obligations in relation to the transferring employees, including the target's obligation in respect of any redundancies and associated payments.

At times, employment agreements may also contain transfer of business provisions, including when an employee may be entitled to redundancy pay or some benefit under a change of control provision under the terms of the contract. Buyers should review these terms carefully and consider whether they give rise to any additional liability.

Key takeaways

Each business has a unique workforce with unique employment issues. As such, in M&A transactions, it is important for buyers to involve their employment counsel from early stages of the deal.

Our Labour & Employment team is in constant dialogue with our Corporate team about employment issues (including those discussed above) to drive solutions that both protect our clients while achieving a commercial and practical outcome.

If you would like any more information on any of the employment issues discussed above, please contact our Labour & Employment team or Corporate team for assistance.

Our colleague, US partner Jill Kirila, explores similar workforce issues that commonly get overlooked in M&A transactions in the US, in her recently published article. If you have operations based in the US, you may also find this article insightful.

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