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Employment Issues Commonly Missed in M&A Transactions

Hidden Workforce Risks That Can Erode Deal Value

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Introduction

In most mergers and acquisitions (M&A), employment issues are rarely the headline drivers of valuation. Buyers tend to focus on revenue growth, intellectual property, market share and operational synergies. Yet in many transactions, workforce-related liabilities become some of the most significant sources of post-closing exposure.

Over more than two decades of partnering with corporate deal teams on transactions and employment diligence, I have advised on the employment issues that are unavoidably present in almost every deal. Fortunately, my corporate partners involve their employment colleagues from the inception of the deal, or at least at the start of due diligence. In fast-moving deals, however, employment diligence is sometimes treated as routine or administrative, or not worthy of specialist attention. In reality, it can uncover issues that materially affect valuation, integration planning and long-term competitive positioning.

When employment diligence is scoped properly and employment counsel brought in early, many of these issues can be identified and mitigated. When it is not, they often surface shortly after closing, sometimes with costly consequences.

Below are some of the bigger employment-related risks that investors and acquirers frequently underestimate during transactions, along with lessons drawn from real deal experience.

Restrictive Covenants That Turn Out To Be Unenforceable

One issue that frequently arises in transactions involves assumptions about the enforceability of executive noncompete agreements.

Buyers often assume that key executives are bound by enforceable noncompete, confidentiality and non-solicitation agreements. However, the enforceability of these agreements varies significantly by state, and depends heavily on how the agreements were drafted and implemented.

In one post-closing matter I worked on, a prominent New York corporate firm handled the deal documentation, but their employment counsel had clearly not been involved in reviewing the target company's executive restrictive covenant agreements under the relevant state law.

Shortly after the transaction closed, several senior executives left the company and quickly launched a competing business. When the buyer attempted to enforce the noncompete agreements, it became clear that the agreements were unlikely to be enforceable under the governing state law due to several structural and statutory issues. In that case, the executives worked in a "red pencil" noncompete review state, where the judge can throw out the entire noncompete if it is drafted overbroadly. Furthermore, certain executives had not received adequate consideration under the applicable state law.

As a result, the buyer had limited practical ability to prevent key executives from competing directly with the business only weeks after closing, an outcome that significantly undermined the value of the acquisition. Had employment counsel advised during the due diligence phase, the buyer could have required execution of new legally compliant executive noncompetes as a deal term and closing condition.

Hidden Wage and Hour Exposure Embedded in Payroll Systems

Another issue that frequently surfaces during employment diligence involves wage and hour compliance, particularly in companies with complex payroll systems.

In one transaction I worked on, the target company appeared to have relatively routine payroll practices. However, when we conducted a deeper review of payroll data and compensation practices, we discovered a systemic issue involving the calculation of the overtime regular rate.

Specifically, the company's payroll system was failing to properly incorporate certain incentive compensation into the regular rate used to calculate overtime.

Because the issue was embedded in the payroll system configuration itself, the error had gone unnoticed internally for several years. Once the payroll data was analyzed, it became clear that the improper calculations were affecting a significant number of employees.

Based on preliminary modeling, the potential class action exposure for unpaid overtime alone approached US$1 million in back wages, before considering potential statutory penalties or attorneys' fees.

Importantly, this issue was not obvious from high-level diligence materials. It required reviewing payroll records and understanding how the payroll system was actually performing its calculations. Fortunately, in that deal, our client was able to insert a special indemnification rider for that liability.

Independent Contractor Misclassification

In another acquisition involving a services-based business, the buyer initially viewed the target's reliance on independent contractors as an operational advantage.

However, a closer review of the contractor relationships revealed that many workers were functioning in roles that closely resembled employees under applicable state classification tests.

The workers performed core operational functions, the company controlled scheduling and work methods and many contractors had long-term, exclusive relationships with the company.

Under several applicable state law tests (e.g., the ABC test), these factors created a meaningful risk that the workers could be deemed employees rather than independent contractors. If that occurred, the company could have faced exposure for unpaid overtime, payroll taxes, benefits eligibility claims, workers' compensation obligations and other employee-based claims.

Because the issue was identified during diligence, the buyer was able to plan for remediation and structure the transaction accordingly. Without that review, the company could have inherited substantial classification exposure embedded in the business model.

Unresolved Employee Complaints

Not all employment risks appear in contracts or payroll records.

In another transaction involving a fast-growing operating company, diligence revealed that several internal complaints had been raised against a senior manager that alleged inappropriate workplace conduct.

Although the company had documented receiving the complaints, it had never conducted a formal investigation or documented a clear resolution. From a diligence perspective, this created potential exposure for harassment or retaliation claims.

Because the issue was identified prior to closing, the buyer was able to evaluate the potential exposure and address the situation during integration planning. Situations like this demonstrate that employment diligence must also consider employee relations issues that may not be visible from standard policy reviews.

Worker Adjustment and Retraining Notification (WARN) Act Exposure in Asset Transactions

Another area where buyers sometimes underestimate risk involves the federal WARN Act and similar state laws.

In one transaction I worked on, the buyer structured the deal as an asset purchase and initially assumed that WARN obligations would not be triggered because it would likely hire most employees, even though it did not want to commit to any hiring of employees.

However, a closer analysis revealed that the seller was planning to terminate a large number of employees that did not receive offers from the buyer three days after closing. In the draft asset purchase agreement, the buyer had no contractual obligation to hire enough of those employees to avoid a WARN Act trigger, which meant that the WARN "sale of business" exception would not apply. Because the WARN Act deems those employees of the seller employed *on the day of closing* to be employees of the buyer for WARN purposes, the buyer would have unexpectedly taken on the WARN liability for that mass layoff effected by the transaction.

Because the issue was identified during the diligence and drafting phase, the parties were able to address it through transaction structuring and planning so that WARN was not triggered.

Without that review, the WARN implications could have emerged only after closing, creating huge potential liability tied to the workforce reduction.

Conclusion

For investors and acquirers, these examples illustrate a broader point: many employment-related risks are not visible from standard diligence summaries or policy reviews.

Instead, they often require deeper analysis of payroll practices, workforce classifications, executive agreements, restrictive covenants and employee relations history.

When these issues are identified early, buyers can address them through transaction structuring, indemnities, pricing adjustments or remediation plans. When they are discovered after closing, however, they often become costly surprises that affect deal value.

For that reason, employment diligence should not be treated as a routine compliance exercise. Done properly, it is an important component of protecting the long-term value of an acquisition.

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