

Merger and Acquisition Issues

Massachusetts Earned Sick Time Law - whose responsibility is it?

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Background

As of July 1, 2015, a new law applying to Massachusetts employers requires virtually all private employers to offer paid or unpaid sick leave to their employees. Employees accrue sick time roughly at the rate of one hour for every hour worked, and may use this time to miss work for illness, scheduled medical appointments, circumstances related to domestic violence, and other causes. In all cases, these situations may apply to the employee him/herself or certain family members.

Employers with eleven or more employees must pay the employee for sick time used; employers with fewer than eleven employees must grant the time but do not have to pay the employee.

Most importantly for this discussion, employees may accrue up to forty hours of sick time, may use up to forty hours of sick time per year, and may carry over up to forty hours of sick time from one year to the next. Employers are not, however, obligated to reimburse employees for unused sick time upon voluntary or involuntary termination from the company.

Refer to Massachusetts General Laws c.149 §148C

Take-away: This new law creates an expectation among employees that they may miss time for covered absences and may accrue a block of sick time for use at a later date.

How does this affect business acquisitions?

The vast majority of small business acquisitions are transacted in a purchase of tangible (e.g. furniture, fixtures, equipment and vehicles) and intangible (e.g. customer lists, intellectual property, *employee relations*) assets, usually free from all or most liabilities. In far fewer instances, an acquisition may be transacted in a purchase of the equity of the acquired company, which includes all assets and liabilities on the books at the time of closing.

For this discussion, the difference is significant. In a purchase of assets, employees transferring to the acquiring company are terminated from the company whose assets are being purchased and re-hired as new employees by the acquiring company. In a purchase of equity, the employees remain employed by the company being acquired and their tenure is transferred in an uninterrupted manner.

Regardless of the form of transaction, the employee base is often the most valuable asset transferred in an acquisition. The experience of the employees, their current relationship with customers and their institutional knowledge of the company's past practices are critical to on-going success. As with any acquired asset, the employee base must be transferred without any degradation in value, or the value of the enterprise is likewise diminished.

A business acquisition is a stressful time for employees, as they may be worried about organizational changes, additional or new job responsibilities, and integration into a different corporate culture. These unknowns can create a nervous and highly vigilant workforce, closely monitoring their new job environment, benefits, and work rules.

In this analysis, we will focus on the more common purchase of assets but many of these principles apply equally to a purchase of equity.

***Take-away:** It is in the Seller's best interest to maximize value by ensuring that ALL assets, including the workforce, are transferred as seamlessly as possible. It is in the Buyer's interest for employees to have their accrued sick time transfer to the new company and then to accrue additional sick time going forward.*

Whose liability is it?

Strictly speaking, employees do not carry accrued sick time from one job to another, relieving the acquirer from any liability for the acquired employee's sick time. In order to maintain strong employee relations and a happy workforce, however, the acquirer may wish to start employees with accrued sick time. But if that is the acquirer's choice, is there any liability for the acquired company?

If the employee asset is to be fully valued, the workforce must transfer completely (or as completely as desired by the acquirer) and in a healthy state of mind. If a reduction or elimination of accrued sick time damages that mindset, or leads to employees accepting positions elsewhere, the asset is damaged and the value diminished. So the acquired company certainly has a financial motivation to ensure that accrued sick time is preserved.

But in the end, it is the acquirer's choice to grant accrued sick time to the employees. This is obviously beneficial to the acquirer to maintain employee loyalty and to start off on the "right foot" with these employees. Plus, this accrued sick time is also ultimately replaced by sick time accrued under the new employment.

***Take-away:** Both the acquiring company and the acquired company realize benefit from the transfer of accrued sick time and both parties should contribute in some form to the expense related to this accrued sick time. This sets up an interesting and potentially difficult negotiation for the measurement and sharing of this liability.*

Can the liability be limited?

Under the law, employees may use up to 40 hours of sick time per year, may carry up to 40 hours of sick time over from year to year and accrual may be "suspended" once an employee accrues 40 hours of sick time. It would seem, therefore, that the transferred accrual should not exceed 40 hours of sick time per employee.

But, in fact, many employers do not bother to formally cap the accrual at 40 hours and may, in fact, report higher accrual quantities in employee payroll reporting. Since the parties are trying to keep employees happy despite the fact that transfer of accrued sick time is not mandatory, all hours perceived by the employees to be accrued will need to be transferred. So it is important that companies formally institute a

cap on accruals, in keeping with the legislation, in advance of an acquisition. This sets a limit to the hours measured by the liability.

***Take-away:** Follow the law strictly and suspend accrual once an employee has reached 40 hours. Accrual begins again once the employee has used sick time to fall below 40 hours of accrual.*

How do we measure the liability?

Further complicating the negotiation around accrued sick time is the determination of the amount of financial exposure resulting from the transfer of accrued sick time. The fact is, most employees will accrue sick time but not use it all. Some may never use sick time, but nonetheless are reassured by knowing that the accrued hours are there if they are needed.

In a recent transaction, we examined the past history of sick time use at the acquired company. The measurement period was quite small, as the transaction was completed in January, 2016 and the law went into effect in July, 2015. During those six months, employees used on average just 6%-7% of their accrued sick time. The Sellers felt that was a good starting point for negotiating the maximum liability forecasted to be actually used related to transferred sick time.

On the contrary, argued the Buyer, the employees were not fully informed as to the new law and usage rates would surely increase over time, as employees understood better when the sick time could be used. What's more, the measured period did not include cold and flu season, which would logically increase the usage rates.

How is it possible to settle on a negotiated figure that is fair to both parties?

***Take-away:** All companies, regardless of if or when they plan to be acquired or to acquire another company, should carefully track sick time usage over time. This data will bolster arguments for sharing less than 100% liability for transferred sick time.*

Replacement of hours

In addition to the usage rate of sick time, one must remember that hours accrued under the old company "fall off the table" as hours are accrued under the new company. Accruing at the legislated rate of one hour of sick time for every 30 hours of work, a full-time (40 hours/week) worker would reach the maximum accrual of 40 hours after just 30 weeks of work. Long before that time, however, this accrual rate will start to replace the transferred hours, essentially eliminating the Seller's liability and replacing it with the Buyer's liability, which would exist whether or not hours were transferred at Closing.

This sets up a very difficult and complex dimension to the negotiations of shared liability, and to identifying which company is responsible for sick time actually taken.

***Take-away:** The Seller's liability clearly diminishes over time as employees earn accrued sick time (or would accrue sick time) under the acquiring company's employment.*

Possible solutions

Other than arm-wrestling or flipping a coin, how do we resolve this conflict between Buyer and Seller in an amicable and equitable manner?

It clearly begins with a data-driven quantification of the financial liability. Taking employees one-by-one, determining their accrued hours (looking forward to the date of closing as best estimated) and multiplying by hourly rate will give the overall transferred balance. Providing data on draw-down history will further enlighten both sides to the likely level of possible exposure.

However, one side is likely to look at the rosier scenario and pronounce it highly likely, and the other will probably look at the most dire possibilities – including the maximum usage in the minimum amount of time – and pronounce that as their acquired liability. These positions help to set the “goal posts” within which the negotiated amount should lie. Admittedly, they may be far apart, but reasonable participants can often get to a level of comfort.

In the above referenced transaction, the sides could not come to agreement. The issue surfaced just a week before scheduled closing, leaving precious little time to reach an agreed upon amount. With a company of approximately 100 employees, the potential liability (accrued over just six months) was nearly \$100,000, but at the measured six to seven percent usage rate the actual amount was likely to be much less. Ultimately, the parties agreed to measure actual used sick time for one year, to share equally that used sick time up to the transferred balance amount for each employee, and for the Sellers to reimburse the Buyers in that amount. Importantly, the Buyer did not require an escrow fund to cover these future reimbursements, preferring instead to trust that the Sellers would honor the agreement. This was an unexpected but important concession on the part of the Buyer.

***Take-away:** The issue of sick time should be negotiated very early in the purchase process, preferably during the initial discussion of offer price, terms, financing, and due diligence process. This is too thorny of an issue and potentially too emotionally charged to wait until the eleventh hour to address.*

Conclusion

This new facet of acquisition negotiation owes its complexity to the uncertainty around future usage and differing viewpoints on just who owns the necessary but ultimately optional liability.

It takes cool heads, compromise and a determined attitude to reach a solution. So start tracking data now, negotiate this point early, and avoid the sickening feeling of last minute negotiations!

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