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The healthcare M&A surge is here: what your compensation committee should be doing now

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In late 2022, *The Wall Street Journal* predicted that healthcare mergers and acquisitions (particularly in the biotech and biopharma space) would surge in 2023.[1] The prediction was based on the expectations that large pharmaceutical players would be looking to replace revenue from branded products losing patent protection in the next few years, earlier-stage pharmaceutical companies would be unable to access financing as cheaply as in recent years and there would be lower valuations in the public markets.

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The article has proven fairly prescient in that this year has already seen numerous sizable pharmaceutical acquisitions, which will likely continue. This note summarizes a few key human capital considerations for Boards of Directors and management of companies that may embark on a sales process.

As will become clear, all of these workstreams become harder to manage the later they are commenced, particularly when acquisition negotiations are already underway, so the time to begin that work is always sooner rather than later.

Retaining and protecting the workforce

An actual or rumored M&A transaction can be destabilizing for your workforce (both at the executive and more rank-and-file levels). This is particularly true where a potential acquirer may be interested in the company for its molecules, compounds or other intellectual property, as opposed to the enterprise as a whole. Employees unsure about their futures may begin to look for other opportunities and competitors may come calling.

This is particularly true in biotech and biopharma where the competition for scientific expertise is intense.

Developing appropriate retention programs

To mitigate the risk of employee flight, it is commonplace for companies that may become acquisition targets to take stock of key employee talent and design a retention program that may either be put in place preemptively when a sale process starts or that can be presented to a buyer as part of the overall deal negotiations. It is common to offer key employees the potential to earn a multiple of their base salary for staying in their roles through (or sometimes following) the closing of an acquisition.

Consideration should also be given to the timing and process for implementing any changes so as not to introduce the risk of deal leaks or trigger premature public disclosures.

Thoughtful consideration must be given to the overall costs of the program and the timing of rollout so as not to introduce risk of deal leaks or trigger premature public disclosures.

Market check of existing severance plans and programs

In addition to putting your best foot forward in retaining key employees, you also need to plan for any eventual redundancies. Again, this is particularly true in transactions where the asset sought is a product under development or intellectual property and not the business as a going concern.

As a result, it is important for your Board and management team to conduct an evaluation of how your severance plans and programs stack up against market practice, so that employees will be taken care of in the event of redundancies.

Our experience is that many biotech and biopharma companies have severance programs that lag the overall market in amount and design. For example, in the broader market it is not uncommon for a CEO or C-suite level executive to be entitled to two or three times his or her base salary and target bonus upon a termination event, yet some biotech companies offer only a fraction of this formula.

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This is yet another area where it becomes much more difficult to commence the process of modifying or enhancing your programs late in the game once negotiations have commenced. As a result, we recommend this evaluation begin as early as possible when a sales process is being considered.

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Planning for the infamous Section 280G executive tax penalties

Many executives are surprised to hear that the U.S. tax code contains a special penalty tax on executives who receive amounts over a certain threshold in connection with acquisition transactions. Although these rules are very complex, as a general matter the tax is implicated if an executive receives more than three times their historical average compensation (as reflected on their W-2) for the last five years.

Given that compensation at biotech companies skews heavily toward equity compensation, in particular stock options, and the premiums in healthcare deals tend to be relatively high, this tax is often implicated. Also, for more technical reasons, given the recent significant rise in interest rates, the tax is more often in play today than it was over the last few years.

While this may sound daunting, all hope is not lost, as there are a number of planning techniques that may be used to mitigate the impact of this tax. There is also the possibility of entering into "gross-up" arrangements whereby the company agrees to bear the impact of the tax.

While these arrangements can be costly and are considered to be "problematic pay practices" by governance firms like ISS and Glass Lewis, the sector in which they are most often implemented is indeed the pharmaceutical sector and this trend has continued in the deals signed in 2023.

Again, however, it is only possible to know how much mitigation will need to be done with respect to this issue if the company has proactively calculated the magnitude of the issue (which typically involves engaging an accounting firm specifically for this purpose).

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It is an exciting time in healthcare M&A, with many deals now under consideration. As noted, human capital considerations loom large in these transactions.

Notes

[1] Healthcare Deal Making Set to Surge in 2023, The Wall Street Journal, December 27, 2022, https://on.wsj.com/3MMo6vp.

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