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Employee Benefits Issues in Purchase and Sale of Privately Held Business

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EMPLOYEE BENEFIT ISSUES
IN
THE PURCHASE AND SALE
OF
PRIVATELY-HELD BUSINESSES

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1. INTRODUCTION

A. Importance of Addressing Employee Benefit Issues Early in Transaction

1. Transactions involving the purchase and sale of privately-held businesses are almost always undertaken with strategic business objectives in mind; however, working through personnel and employee benefits issues while the transaction is being negotiated is very important because often the Buyer is purchasing the goodwill associated with the products or services generated by the Seller's employees, and the Seller's employees may have certain expectations about benefits that will be provided, all of which may impact the Buyer's decision about how Seller's benefit plans should be handled.

2. Certain types of employee benefit plans can involve "hidden" or contingent liabilities, which need to be discussed and addressed by the parties early in the transaction, so that appropriate adjustments to purchase price and post-closing indemnification obligations can be negotiated.

3. Resolving issues about the kinds of benefit plans that will be offered to Seller's workers after closing often takes time, because third-parties like insurance carriers and other vendors are involved. Therefore, it is more efficient if these issues are addressed promptly and are not left to last-minute negotiations.

4. For purposes of this outline, it is assumed that general issues regarding employees, labor and employment matters, collective
bargaining agreements, and the hiring of Seller's employees as part of the contemplated transactions will be handled elsewhere.

B. Importance of Transaction's Structure

1. The structure of the transaction—stock purchase or merger vs. asset purchase—can determine how certain employee benefits issues will be addressed by the parties.

   (a) In a stock or merger transaction, Buyer acquires the stock of a target corporation ("Seller" or "Target"), or Seller/Target is merged into Buyer or an acquisition subsidiary. Results:

      (i) The Target's legal identity and status as the "employer" for benefit plan purposes does not change.

      (ii) Buyer assumes liability and responsibility for all of Target's benefit plans, by operation of law.

   (b) In an asset transaction, Buyer acquires specific assets—and sometimes all assets—of the Seller.

      (i) To the extent that Buyer hires any of Seller's employees, there has been an official termination of employment from the Seller, and a rehiring by the Seller. This may trigger:

         i. Severance pay

         ii. Acceleration of nonvested rights under stock option, deferred bonus or other plans

         iii. "COBRA" continuation rights under health insurance plans

         iv. The ability to receive a distribution of benefits under qualified retirement plans

      (ii) If the Buyer hires all, or virtually all, of the employees of Seller, there is a risk that Buyer will nevertheless be deemed to be the "successor employer", notwithstanding that the transaction is structured as an asset purchase rather than a stock purchase. The traditional concept that there is no
successor liability in an asset transaction, except to the extent that such liability is explicitly assumed—does not necessarily hold true for employment and benefit issues, where courts and agencies have looked beyond legal formalities to assign successor employer liability to the entity that continues the business operations associated with those assets. See e.g., Central States, Southeast and Southwest Areas Pension Fund v. Wiseway Motor Freight, Inc., 2000 WL 1409825 (ND Ill. 2000); Chicago Truck Drivers, Helpers & Warehouse Workers Union v. Tameskin, 59 F.3d 48 (7th Cir. 1995); Treas. Reg. Section 4980B-9.

Regardless of the structure of the transaction, there is the risk of liability to the Buyer; therefore, the due diligence process, and the content and negotiation of representations and warranties, will remain largely the same in both asset deals and stock deals.

C. Comprehensive Definition of "Benefit Plans" in Transaction Documents

1. Most transactions include representations and warranties regarding the Seller or Target's "benefit plans".

2. Definition in most forms is very broad, to include references to the definitions of "pension plans" and "welfare plans" under ERISA, but also to include the following:

   (a) Insurance arrangements

   (b) Deferred compensation and nonqualified retirement arrangements

   (c) Severance pay policies

   (d) Vacation, holiday, or sick leave policies, often referred to as "PTO" ("paid time off") policies

   (e) Bonus arrangements

   (f) Stock option or stock purchase plans

   (g) Other employee benefits, policies, plans or arrangements, whether in writing or oral
3. First step in negotiating representations and warranties is to tackle this definition and make sure that it is clearly articulated:

(a) Seller: make definition as narrow as possible

(b) Buyer: make definition as broad as possible

4. Sample definition: "All written and unwritten 'employee benefit plans' within the meaning of Section 3(3) of ERISA, and any other written and unwritten profit sharing, pension, savings, deferred compensation, fringe benefit, insurance, medical, medical reimbursement, life, disability, accident, post-retirement health or welfare benefit, stock option, stock purchase, sick pay, vacation, employment, severance, termination or other plan, agreement, contract, policy, trust fund or arrangement (each, a 'Benefit Plan')."

5. Typically, employee benefits analysis in transactions will not involve any stock-based compensation plans, deferred compensation arrangements, or golden parachute arrangements that are triggered by a change in control, because the financial ramifications of those arrangements are typically handled at the outset of the business negotiations.

II. ISSUES INVOLVING QUALIFIED RETIREMENT PLANS

A. General Overview

1. "Qualified" retirement plans are plans that meet the numerous requirements of the Internal Revenue Code; they are governed by the IRS; the Department of Labor; and, in some cases, by the Pension Benefit Guaranty Corporation.

2. The type of potential liability depends upon the type of qualified plan maintained by Seller/Target. For example:

(a) Defined benefit plans in particular have a high potential for significant "hidden" liabilities, depending on the sufficiency of plan funds, the accuracy of the plan's actuarial assumptions; and the structure of the plan.

(b) ESOPS maintained by closely-held businesses can present real practical challenges in getting a transaction approved, because of the requirement under Internal Revenue Code Section 409(e) to "pass-through" any
approval vote to plan participants, to the extent that state law requires stockholder approval of the transaction.

3. Categories of qualified retirement plans

(a) "Defined benefit pension plans" are traditional pension plans, involving actuarial calculations and projections of a benefit to be paid upon retirement.

(b) "Money purchase pension plans" are defined contribution plans where the sponsoring employer contributes a fixed percentage of pay for each participant every year—usually in the 5%-10% range.

(c) "Profit-sharing plans" are defined contribution plans where the employer has full discretion about whether, and how much, money should be contributed into the plan for any given year.

(d) "401(k) plans" are defined contribution plans where employees elect to contribute a portion of their own salary, before taxes, to the plan, and the company may (or may not) provide for matching or other types of contributions to the plan.

(e) "Stock bonus plans" or "ESOPs" are defined contribution plans where the company usually contributes shares of company stock—and sometimes dividends on that stock—to the plan, rather than cash, and benefits are often paid out in the form of shares of company stock, rather than cash. In the context of closely-held businesses, ESOPs are often used as a tax-efficient exit vehicle for a majority stockholder, because of the ability to defer the recognition of any capital gain that the stockholder realizes from the sale of his stock to the ESOP.
B. Due Diligence Regarding Qualified Retirement Plans

1. **Documents to be reviewed**—for EACH qualified retirement plan:

   (a) Plan document and all amendments.

   (b) Trust agreement, and all investment-related documents, including group annuity contracts; investment policy statement; investment management agreements; custodial agreements, etc.

   (c) Summary plan description.

   (d) IRS determination letters.

   (e) Prior IRS or DOL plan audits or inquiries, and documents indicating how those audits or inquiries were resolved.

   (f) Forms 5500 for the last 3 years, with all attachments. For plans with more than 100 participants, this should include an audit report. For defined benefit plans, also obtain copies of PBGC-1 forms reflecting payment of premiums.

   (g) Summary annual reports for the last 3 years.

   (h) Most recent financial statements, investment reports and actuarial reports.

   (i) For defined benefit pension plans only, reportable event filings with the PBGC and copies of PBGC forms for the last 3 years, reflecting payment of premiums.

   (j) Copies of nondiscrimination testing and top-heavy testing for 3 most recent years, and copies of current census and allocation/contribution report.

   (k) Quantitative analysis showing the amount of accrued but unfunded contributions to be made to the qualified plans and a projected date on which contributions will be made.

   (l) Copy of fidelity bond (which is required) and any fiduciary liability insurance.
(m) For defined contribution plans offering participant loans, a sample of loan documentation and a report showing outstanding balances on loans.

(n) Sample distribution forms provided to participants when they request a payment of their plan benefits.

2. Issues to focus on in due diligence process:

(a) Qualified status of the plans

(i) Importance of qualified status:

i. The potential financial impact of disqualification can be disastrous. If a retirement plan purports to be qualified, but is not, there is a risk that tax deductions taken in prior years can be retroactively disallowed; the plan’s tax-exempt trust fund will be retroactively taxed; and employees could be taxed on contributions made during the period of disqualification.

ii. Uncertainty about the qualified status of retirement plans will also limit the number of planning options that are available to Buyer, who will not want to assume the Seller/Target's plans, or merge those plans into its own plans after the deal closes.

(ii) Possible reasons for disqualification

i. Documentation failures

1. Updates. The plan may not have been updated, as necessary, to reflect recent changes in the law. Due diligence should include checking to be sure that the plans have been amended to conform to "GUST" and "EGTRRA".

2. Determination Letters. The plan may not have a recently-issued favorable determination letter, which indicates that the form and terms of the plan have been reviewed and approved by the IRS as
meeting the technical requirements of the Internal Revenue Code.

(I) Due diligence should include a review of determination letters, including analysis of whether the letter was conditioned on the timely adoption of a "qualifying amendment" and verification that such qualifying amendment was in fact appropriately adopted.

(II) Be especially careful of prototype plans. Until recently, IRS approval or opinion letters on "nonstandardized" master and prototype plans were not equivalent to a determination letter, but many plan sponsors have mistakenly thought they were.

ii. Operational Failures

1. Generally. Even if the plan has a recently-issued favorable determination letter from the IRS, and the plan documents do not raise a qualification issue, the plan may nevertheless have a qualification problem if it fails to satisfy the tax-qualification requirements of the Internal Revenue Code in operation.
2. **Nondiscriminatory benefits, rights or features.** Qualified plans cannot discriminate in favor of highly compensated employees in terms of the amount of benefits or contributions provided to participants, or in terms of the other rights or features offered under the plan. Internal Revenue Code Section 401(a)(4). Due diligence should include review of plan terms and nondiscrimination testing results.

3. **Minimum coverage and participation requirements.** All qualified retirement plans must meet certain statistical tests demonstrating that the plan does not favor highly compensated employees. These tests include minimum coverage standards set forth in Internal Revenue Code Section 410(b) and, for defined benefit pension plans, certain minimum participation standards set forth in Internal Revenue Code Section 401(a)(26). Due diligence requires review of annual nondiscrimination testing to determine if these standards have been satisfied.

4. **Statutory Limits.** Each qualified plan is subject to a number of statutory limits which try to ensure that qualified retirement plans do not discriminate in favor of highly-compensated employees or owners. These limits include:

   (I) Limitations on the overall level of contributions or benefits that can be provided to any participant in a given plan year under Internal Revenue Code Section 415. The satisfaction of these limits can be verified in the due diligence process by
reviewing a "Section 415 test" and verifying that any excess limitations were handled according to the terms of the plan.

(II) Limitations on the amount of elective contributions that an individual can make to a Section 401(k) plan under Internal Revenue Code Section 402(g). The satisfaction of these limits can be verified in the due diligence process by a review of the 401(k) nondiscrimination test, called the "ADP" ("average deferral percentage") test, ascertaining whether any excess contributions had to be returned to participants, and verifying that such excess amounts were, in fact, timely disbursed to the affected participants.

(III) Limitations on the amount of compensation that can be taken into account under a plan under Internal Revenue Code Section 401(a)(17). The satisfaction of these limits can be verified in the due diligence process by reviewing a report showing plan allocations.

(IV) Certain top-heavy limitations under Internal Revenue Code Section 416 must be satisfied. These requirements are especially important for plans maintained by closely-held
businesses. The satisfaction of these rules can be verified in the due diligence process by reviewing an annual top-heavy test.

5. **Anti-cutback rules.** Failure to follow the anti-cutback rules under Internal Revenue Code Section 411(d)(6) can cause disqualification of a plan. These rules protect accrued benefits and certain optional forms of benefits from being reduced or eliminated. This is especially important in the context of plans that have been terminated or merged with other plans. This can be verified in the due diligence process by careful review of the plan documentation, especially addenda or amendments to master/prototype plans.

6. **Minimum distribution rules.** Disqualification can be caused by a plan’s failure to follow the required minimum distribution rules under Internal Revenue Code Section 401(a)(9), which generally require that individuals start to withdraw funds from a qualified retirement plan once they turn age 70-1/2. This can be verified in the due diligence process by reviewing a distribution report and any excise tax returns that may have been required to be filed because of failure to comply with these requirements.

7. **Minimum funding rules.** For defined benefit plans in particular (and to a lesser extent money purchase pension plans), failure to adhere to the minimum funding requirements of IRC Section 412 can expose the plan to excise taxes and threaten disqualification and the imposition of a lien on the property of the employer. This is especially serious
if the plan sponsor is a member of a "controlled group" of corporations, because of joint and several liability for these funding obligations. Compliance with these requirements can be verified by review of the Forms 5500 and annual plan reports.

8. Failure to follow the terms of the plan can also cause disqualification. This can be verified in the due diligence process by reviewing a census report (which will show whether eligibility criteria have been applied appropriately); an allocation report (which will show whether plan contributions have been allocated according to the terms of the plan); and distribution forms, to be sure that they conform to the terms of the plan.

(iii) Techniques to cure disqualification problems

i. Because the financial consequences of disqualification can be costly to the Seller, it may be in the Seller/Target's best interests to cure any disqualification problems that are discovered during the due diligence process.

ii. IRS has established a comprehensive program – referred to as “EPCRS” – or “Employee Plans Compliance Resolution System”, enabling plans to correct defects – some independently (as long as full correction is made); some with the approval by the IRS and payment of a penalty fee. See Rev. Proc. 2002-47.

(b) Breaches of fiduciary duty regarding qualified plans

(i) Generally: qualified plans are subject to the fiduciary standards articulated in Title-1 of ERISA, so plan operations must be reviewed during the due diligence process to determine if any potential exposure exists.
(ii) Areas of particular concern include:

i. **Plan investments**: whether they satisfy ERISA standards of prudence and diversification. This can be determined during the due diligence process by reviewing the trust documents, investment management agreements, and any investment policy statements adopted by the plans.

ii. **Related party and prohibited transactions.** Any contractual obligation, sale, exchange or lease with respect to the plan, in which either Seller/Target, or its principal shareholders or related parties, have a direct or indirect interest. Failure to adhere to these rules exposes the plan sponsor, and other(s) involved in the transaction, to excise taxes. This can be determined during the due diligence process by reviewing the Forms 5500.

(iii) Technique for correcting fiduciary violations: Department of Labor has instituted "Voluntary Fiduciary Correction Program", which enables plan fiduciaries to admit errors; pay penalties and get a compliance statement protecting them from future audit.

(c) **Reporting and disclosure obligations**

(i) Each qualified plan is required to file reports with governmental agencies and provide documentation (at least annually) to plan participants. Failure to do so exposes the plan sponsor to monetary penalties, which can mount up quickly.

(ii) This can be verified during the due diligence process by reviewing Forms 5500.

(iii) If the reporting and disclosure obligations have not been satisfied, the plan sponsor can utilize the Department of Labor's "Delinquent Filer" program, which enables filings to be made with the payment of penalty taxes.
C. **Negotiating Representations and Warranties Regarding Qualified Retirement Plans**

1. **Generally.**

   (a) The negotiation of representations and warranties regarding qualified plans will be characterized by the typical positions that Buyer's counsel and Seller's counsel will take in negotiating other representations and warranties in the transaction—that is, Buyer's counsel will seek to get the broadest possible reps and warranties, while Seller's counsel will try to narrow those reps and warranties to the greatest extent possible.

   (b) As noted above, there is little substantive difference between reps and warranties regarding benefit plans in asset purchase documents compared to stock purchase or merger documents.

   (c) As with other matters, any items discovered in the due diligence process that contradict the rep and warranty will need to be set forth on disclosure schedules to the transaction documents, or carved out of the rep and warranty in some fashion.

2. **Commonly-requested reps and warranties regarding qualified retirement plans**

   (a) **Comprehensive listing of benefit plans**

      (i) The rep and warranty proposed by Buyer:

      "Schedule ___ discloses all written and unwritten Benefit Plans (as defined), whether or not funded and whether or not terminated, (1) maintained or sponsored by Seller, or (2) with respect to which Seller has or may have any liability or is obligated to contribute, or 3) that otherwise covers any of the current or former employees of Seller or their beneficiaries, or (4) in which any such current or former employees or their beneficiaries participated or were entitled to participate or accrue or have accrued any rights thereunder (each being referred to as a 'Seller Plan')."
approval vote to plan participants, to the extent that state law requires stockholder approval of the transaction.

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(b) **Breaches of fiduciary duty regarding qualified plans**

(i) Generally: qualified plans are subject to the fiduciary standards articulated in Title-I of ERISA, so plan operations must be reviewed during the due diligence process to determine if any potential exposure exists.
(ii) Areas of particular concern include:

i. **Plan investments**: whether they satisfy ERISA standards of prudence and diversification. This can be determined during the due diligence process by reviewing the trust documents, investment management agreements, and any investment policy statements adopted by the plans.

ii. **Related party and prohibited transactions.** Any contractual obligation, sale, exchange or lease with respect to the plan, in which either Seller/Target, or its principal shareholders or related parties, have a direct or indirect interest. Failure to adhere to these rules exposes the plan sponsor, and other s involved in the transaction, to excise taxes. This can be determined during the due diligence process by reviewing the Forms 5500.

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15
C. Negotiating Representations and Warranties Regarding Qualified Retirement Plans

1. Generally.

(a) The negotiation of representations and warranties regarding qualified plans will be characterized by the typical positions that Buyer's counsel and Seller's counsel will take in negotiating other representations and warranties in the transaction—that is, Buyer's counsel will seek to get the broadest possible reps and warranties, while Seller's counsel will try to narrow those reps and warranties to the greatest extent possible.

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"Schedule ___ discloses all written and unwritten Benefit Plans (as defined), whether or not funded and whether or not terminated, (1) maintained or sponsored by Seller, or (2) with respect to which Seller has or may have any liability or is obligated to contribute, or 3) that otherwise covers any of the current or former employees of Seller or their beneficiaries, or (4) in which any such current or former employees or their beneficiaries participated or were entitled to participate or accrue or have accrued any rights thereunder (each being referred to as a 'Seller Plan')."
(ii) Seller's position: Narrow scope to plans maintained within the last 3-5 years, and narrow concept of "liability" to contributions.

(b) Qualified plan matters

(i) Rep and warranty proposed by Buyer: "Schedule ___ discloses each Seller Plan that is intended to be qualified under Section 401(a) of the Internal Revenue Code and exempt from United States federal income tax under Section 501(a) of the Internal Revenue Code (a 'Qualified Plan'). With respect to each Qualified Plan, a current determination letter (or opinion or notification letter, if applicable) has been received from the Internal Revenue Service stating that such plan has been determined to be qualified under Section 401(a) of the Internal Revenue Code and exempt from federal income tax under Section 501(a) of the Internal Revenue Code. All amendments and actions required to bring each Seller Plan into conformity with the applicable provisions of ERISA, the Internal Revenue Code and other applicable laws since the date of such determination letter have been timely made or taken, except to the extent that such amendments or actions are not required by law to be made or taken until after the Closing Date and are disclosed on Schedule ___. No member of the Seller Group (as defined), nor any fiduciary of any Qualified Plan, has done or failed to do anything that would adversely affect the qualified status of the a Qualified Plan or the tax-exempt status of any related trust."

(ii) Seller's position: qualify rep by knowledge regarding any actions that would adversely affect the qualified status.

(c) Operational compliance

(i) Rep and warranty proposed by Buyer: "Each Seller Plan and all related trusts, insurance contracts and funds have been created, maintained, funded and administered in all
respects in accordance with all applicable laws and in accordance with their terms."

(ii) **Seller's position:** qualify compliance by materiality.

### (d) Contributions

**Rep and warranty proposed by Buyer:** "All contributions to Seller's Plans that were required to be made under such Plans will have been made as of the Closing Balance Sheet Date (as defined), and all benefits accrued under any unfunded Seller Plan will have been paid, accrued, or otherwise adequately reserved in accordance with GAAP as of such date, and Seller will have performed by the Closing Date all obligations required to be performed as of such date under any Seller Plan."

### (e) Controlled group matters

**Rep and warranty proposed by Buyer:** "Neither Seller nor any entity that may be aggregated with Seller under Sections 414(b), (c), (m) or (o) of the Internal Revenue Code (the 'Seller Group') has any obligation to contribute to, or any liability under or with respect to, any Benefit Plan (as defined) under Title IV of ERISA. No accumulated funding deficiency (as defined in Section 302 of ERISA and Section 412 of the Internal Revenue Code) exists, nor has any funding waiver from the Internal Revenue Service been received or requested with respect to any Seller Plan or any Benefit Plan of any member of the Seller Group, and no excise or other tax is due or owing because of any failure to comply with the minimum funding standards of the Code or ERISA with respect to any of such plans. None of Seller's Plans is a defined benefit plan as defined in Section 3(35) of ERISA. None of Seller's Plans is a multiemployer plan within the meaning of Section 3(37 of ERISA)."

(ii) **Seller's position:** make affirmative statement that Seller is not a part of a controlled group and has
never maintained a defined benefit plan or a multiemployer plan, rather than having this long
rep and warranty.

(f) Prohibited transactions/fiduciary duties

(i) Rep and warranty proposed by Buyer: "No
prohibited transaction (within the meaning of
Section 406 of ERISA or Section 4975 of the
Internal Revenue Code) with respect to any Seller
Plan exists or has occurred which could subject
Seller to any liability or tax under Title I of ERISA
or Section 4975 of the Internal Revenue Code. No
member of the Seller Group, nor any
administrator or fiduciary of any Seller Plan has
engaged in any transaction or acted or failed to
act in a manner that will subject Seller to any
liability for a breach of fiduciary duty or other
duty with respect to a Seller Plan, under ERISA or
any other applicable law. No member of the
Seller Group has incurred any liability for civil
penalties assessed under Section 502 of ERISA,
and no 'reportable event' (within the meaning of
Section 4043 of ERISA) has occurred with respect
to any Seller Plan or any plan maintained by a
member of the Seller Group".

(ii) Seller's position: Qualify rep regarding prohibited
transactions by limiting it to "non-exempt
prohibiting transactions"; qualify rep regarding
liability by adding "materiality"; and qualify rep
regarding fiduciary duties to "best knowledge" of
Seller.

(g) Litigation

(i) Rep and warranty proposed by Buyer: "No suit,
action or other litigation, excluding claims for
benefits incurred in the ordinary course of plan
activities have been brought against or with
respect to any Seller Plan, and no suit, action or
other litigation is threatened by, against, or
relating to any Seller Plan, and Seller does not
have any knowledge of any fact that could form
the basis for any such suit, action or litigation.
No Seller Plan is presently under audit or
examination by the Internal Revenue Service, the Department of Labor, or any other governmental agency or entity, and no matters are pending with respect to any Seller Plan under the Employee Plans Compliance Resolution System, the Delinquent Filer Compliance Program, or the Voluntary Fiduciary Correction Program."

(ii) Seller's position: qualify rep regarding suits, actions or threatened litigation by actual knowledge.

(h) Full vesting of benefits

(i) Rep and warranty proposed by Buyer: "No Seller Plan contains any term or provision, or is subject to any law, that would prohibit the transactions contemplated by this Agreement or that would give rise to the vesting of benefits, payments, or liabilities as a result of the transactions contemplated by this Agreement, except to the extent that full vesting is required under Section 411 of the Internal Revenue Code."

(i) Right to terminate plans

(i) Rep and warranty proposed by Buyer: "Each of Seller's Plans may be amended or terminated by Seller in any manner and at any time, without the consent of any person covered by such Plan and without any further liability for benefits that may be accrued or expenses that may be incurred after the date of such termination or amendment, other than benefits that may be required under the terms of such Plan or benefits required under Internal Revenue Code Section 4980B."

D. Negotiating Post-Closing Covenants Regarding Qualified Retirement Plans

1. Generally

(a) Buyer needs to determine the overall compatibility of its plans with the plans of the Seller/Target, to determine the structure of its business; what will be combined with Buyer's pre-existing plans, if any, etc.
In making its decisions, Buyer must also focus on the impact of any decisions on employee morale, and the importance of employee communications of any benefit changes.

2. **Overview of Options**

(a) **Buyer's assumption of Seller's plans**

(i) Involves Buyer's agreement to assume sponsorship of all of Seller's plans, and assumption of all liabilities related to Seller's plans.

(ii) Preferred by Seller because there is no disruption for employees; resisted by Buyer because of "hidden liabilities".

(iii) Sample covenant: "On or after the Closing, Buyer agrees to take any and all steps necessary in order to adopt and become the sponsor of _______ Plans, as identified on Schedule _______".

(b) **Termination of Seller's plans; participation of Seller's employees in Buyer's plans**

(i) Involves complete termination of Seller's plans, including (1) advance notice of termination under ERISA Section 204(h) (if a money purchase pension or defined benefit pension plan); (2) full vesting of benefits under Internal Revenue Code Section 411; and (3) processing of benefit distributions.

(ii) Preferred by Buyer, because it is a "clean break".

(iii) Issues to be aware of:

   i. Some 401(k) plans have not been updated to reflect recent changes in the law and may still have plan language which prohibits individuals from receiving a distribution of their benefits if they do not experience a "separation from service"; this needs to be replaced with the new
legal standard, which permits distributions as long as there has been a technical "severance of employment"—a change which effectively eliminates the old "same desk rule" and permits distributions in the context of asset deals, even where the employee effectively just transfers employment from the Seller to the Buyer.

ii. There may be outstanding loans in defined contribution plans which may become accelerated and due upon plan termination. In situations where the Buyer is having Seller terminate its qualified plan but then rehiring Seller's employees and permitting them to rollover their funds into Buyer's qualified plan and take a new loan out under Buyer's qualified plan, Buyer and Seller may agree that Buyer will provide transferring employees with bridge loans, to enable plan loans under Seller's plan to be repaid.

(iv) Sample covenants:

i. Regarding the termination of Seller's Plans: "Prior to Closing, Seller agrees to take any and all steps necessary in order to cease all accruals of benefits or contributions under each Seller Plan, to terminate each Seller Plan as of the Closing Date, and to distribute to the participants of each Seller Plan their accrued benefits thereunder, in accordance with the terms of each Seller Plan and all applicable laws."

ii. Regarding participation of Seller's employees in Buyer's plans: "Buyer agrees to take any and all steps necessary so that any employees of Seller who become employees of Buyer immediately after the Closing Date, as a result of the transactions contemplated by this Agreement, shall be entitled to participate in any employee benefit plan, program, arrangement or payroll practice that is established, maintained or sponsored by Buyer, on the same terms as other similarly-situated employees of Buyer."

iii. Regarding service credit: it is prudent to provide for service credit explicitly, in an
affirmative covenant reflecting the understanding of the parties (even if the service credit is granted automatically, as is the case in a stock or merger transaction), because often in asset purchase transactions, the Buyer is willing to provide for service credit for eligibility and vesting purposes, but not for benefit accrual purposes. Sample covenant: "Buyer and Seller agree that any employees of Seller who become employees of Buyer immediately after the Closing Date will be credited with their years of service with Seller for purposes of eligibility to participate in, vesting of benefits under, [and optional, in an asset transaction: accrual of benefits under] each of Seller's Plans."

(e) Merger of plans of Seller with plans of Buyer

(i) Involves Buyer's plan assuming all assets and liabilities of Seller's plans, so it is highly contingent on the due diligence regarding both terms and operational history of Seller's plan.

(ii) Avoids full vesting, but it requires Buyer's plan to preserve all benefits, rights and features that are protected under Internal Revenue Code Section 411(d)(6).

(iii) This technique can be effective if there are defined benefit plans involved with different funding levels, and the transaction was structured as a stock/merger transaction, because the plan merger can be used so that an underfunded plan is consolidated to absorb an overfunded plan.

(iv) Sample covenant: "Seller agrees to take any and all steps necessary in order to cease all accruals of benefits or contributions under the (Seller's) Plan, and to transfer all of the assets and accrued benefits thereunder to (Buyer's) Plan, subject to the requirements of applicable law. Buyer agrees to take any and all steps necessary in order to effectuate a transfer of all assets and accrued benefits from the (Seller's) Plan to the (Buyer's) Plan, subject to the adoption of any
necessary amendments to the (Buyer's) Plan and the requirements of applicable law."

(d) Freezing Seller's plan

(i) Involves the permanent discontinuance of contributions to the plan without processing of benefit distributions.

(ii) While the plan is "frozen", the plan documentation will need to continue to be updated to reflect all changes in the law, and the plan fiduciaries continue to have responsibility for the oversight and investment of plan assets.

(iii) This technique is most commonly-utilized only when the due diligence process uncovers a number of operational issues that could potentially disqualify a plan or taint Buyer's plan, if there were to be a merger of Seller's plan into Buyer's plan. Under this scenario, Seller's frozen plan is separately maintained for at least 3 years until the statute of limitations has expired; then, after that time, it is merged into Buyer's plan.

(e) Continued maintenance of separate plans

(i) Can only be sustained over the long-term if applicable minimum coverage, minimum participation, and nondiscrimination testing standards are met, because of certain transitional rules that permit plans to be maintained independently until the last day of the plan year following the plan year of the transaction (as long as 24 months or as short as 12 months and 1 day after the transaction closes).

(ii) This technique is used with mid-year transactions, where merging plans would be too complicated (or is logistically unfeasible) until a new plan year starts, or where the Buyer intends to spin off newly-acquired assets in the short term and does not want to worry about consolidating plans for a brief period of time.
III. ISSUES INVOLVING WELFARE BENEFIT PLANS

A. General Overview

1. Welfare benefits include non-retirement benefits, such as:

   (a) Health insurance plans

   (b) Life insurance plans

   (c) Short and long-term disability insurance

   (d) Accidental death & dismemberment insurance

   (e) Cafeteria style plans that offer employees the ability to pay health insurance premiums before taxes and to be reimbursed for uninsured medical expenses

   (f) Dependent care expense reimbursement plans

   (g) Adoption assistance programs

   (h) Educational assistance or tuition reimbursement programs
(i) Split-dollar life insurance programs

B. Due Diligence Regarding Welfare Plans

1. Documents to be reviewed—for EACH welfare retirement plan:

   (a) Plan document and all amendments.

   (b) Trust agreement or other funding arrangements (if any).

   (c) Any contract between the Seller and the insurance company (or stop-loss insurance coverage)

   (d) Summary plan description or benefits booklets provided to employees.

   (e) Employee handbook or manual, describing benefits.

   (f) Copies of (or summaries of) any individual agreements or oral agreements regarding welfare benefits, especially the following:

      (i) Executive level benefits

      (ii) Lifetime health insurance

      (iii) Continuation of health insurance beyond termination of employment

      (iv) Reimbursement of uninsured medical expenses

   (g) Prior DOL plan audits or inquiries, and documents indicating how those audits or inquiries were resolved.

   (h) Forms 5500 for the last 3 years, with all attachments.

   (i) Copies of nondiscrimination testing for certain welfare plans subject to such testing (i.e., self-funded medical plans; cafeteria plans; dependent care assistance programs, etc.).

   (j) Quantitative analysis showing the duration and aggregate amount of the following:

      (i) Accrued but unpaid premiums
(ii) Penalties payable for early termination of the welfare benefit plans or insurance contracts on a date other than the anniversary or renewal date.

(iii) Any termination or runoff liability arising from the termination of a self-funded arrangement.

(iv) Commitments, if any, to provide retiree or lifetime coverage for any former employee.

(k) Schedule of former employees who are currently receive COBRA benefits, and those who are currently eligible to elect to receive COBRA benefits—including the amount of premiums due and the amount of time left on their COBRA coverage.

2. Issues to focus on in the due diligence process

(a) General concerns about compliance with ERISA, HIPAA and other statutory schemes that can expose the Seller to monetary penalties.

(b) The biggest issue is whether there are any obligations or commitments to provide continued health insurance coverage to retirees or other former employees (other than what may be required under COBRA).

C. Negotiating Representations and Warranties Regarding Welfare Plans

1. Generally. Many of the general concerns regarding compliance with the terms of the plans; compliance with all applicable laws; reporting and disclosure obligations; and breaches of fiduciary duty, are covered by the representations and warranties provided for all benefit plans, as noted above.

2. Commonly-requested reps and warranties regarding welfare plans

(a) Funding of welfare plans

(i) The rep and warranty proposed by the Buyer: "Seller has not prepaid or prefunded any Seller Plan that is a ‘welfare plan', within the meaning of Section 3(1) of ERISA), through a trust, reserve, premium stabilization, or similar account, nor does it provide benefits through a voluntary employee beneficiary association, as
defined in Internal Revenue Code Section 501(c)(9)."

(b) COBRA compliance

(i) The rep and warranty proposed by the Buyer: "All group health plans of the Seller Group have been operated in compliance with the requirements of Internal Revenue Code Section 4980B, and Seller has provided, or will have provided before the Closing Date, to individuals entitled thereto, all required notices with respect to any 'qualifying event' (as defined therein) occurring on or before the Closing Date."

(ii) Seller's position: qualify compliance by "materiality".

(c) Retiree medical coverage

(i) The rep and warranty proposed by Buyer: "No employee or former employee of Seller, or beneficiary of any such employee or former employee, is, by reason of such employee's or former employee's employment, entitled to receive any benefits, including, without limitation, death or medical benefits (whether or not insured) beyond retirement or other termination of employment, other than (1) death or retirement benefits under any one of Seller's Plans that is intended to meet the tax-qualification requirements of Internal Revenue Code Section 401(a), (2) deferred compensation benefits accrued on the Closing Date Balance Sheet, or (3) continuation coverage mandated under Internal Revenue Code Section 4980B."

D. Negotiating Post-Closing Covenants Regarding Welfare Benefits

1. Overview of options for determining what plans employees will be covered under

(a) Continuation or termination of welfare plans

(i) For medical plans, the issue of whether Seller's medical plans will be continued or terminated will
largely depend on whether the plans are fully-insured or self-funded, subject to minimum coverage considerations.

(ii) Termination mid-year may trigger penalties (under agreements with insurance companies), or large runoff liabilities.

(iii) If Buyer's plan is fully-insured: Seller's fully-insured plans will likely be continued independently, through the end of the year, in order to avoid having Buyer adopt Seller's plans or enroll many new participant's in Buyer's plans mid-year.

(iv) If Seller or Buyer's plan is self-insured: it is not likely that the plans will be able to be maintained independently, since each self-insured plan must cover 70% of all non-highly compensated employees of the overall workforce (and there is no transitional relief from these minimum coverage requirements, as there is for qualified plans). This minimum coverage requirement may require the self-funded plans to be terminated, but such termination could trigger runoff liability.

(v) For other welfare plans that are not subject to these minimum coverage standards, Buyer and Seller have more flexibility. More often than not, Seller's plans are continued through the end of their plan year—this avoids the administrative delays that would ensue from requiring Buyer to adopt the plans and coordinating all of the necessary paperwork with the different insurance carriers, and it avoids the risk of mid-year rate or premium adjustments that might be triggered by a change in plan sponsor.

(vi) Sample covenants:

i. Regarding the termination of Seller's welfare benefit plans: "Prior to Closing, Seller agrees to take any and all steps necessary in order to terminate each of its Benefit Plans that provide welfare benefits, as listed on Schedule ___, in accordance with the terms of each Plan and all
applicable laws. Seller agrees that it shall be solely responsible for the payment of all accrued premiums, fees or other amounts due and owing as a result of the termination of each such Plan."

ii. Regarding participation of Seller's employees in Buyer's plans: "Buyer agrees to take any and all steps necessary so that any employees of Seller who become employees of Buyer immediately after the Closing Date, as a result of the transactions contemplated by this Agreement, shall be entitled to participate in any employee benefit plan, program, arrangement or payroll practice that is established, maintained or sponsored by Buyer, on the same terms as other similarly-situated employees of Buyer."

(b) COBRA coverage

(i) Employees who lose coverage as a result of the transaction will be considered "M&A qualified beneficiaries". Treas. Reg. Section 54.4980B-9.

(ii) IRS regulations state that buyers and sellers can allocate by contract the responsibility to make COBRA continuation coverage available to those who lose coverage as a result of the transaction. However, to the extent that the party who has the obligation under the contract fails to perform its contractual commitments, the regulations provide that the seller will continue to have the obligation to make COBRA continuation coverage available to M&A qualified beneficiaries, so long as the Seller maintains a group health plan after the sale. If it no longer has a health plan, then the Buyer will be obligated to make COBRA continuation coverage available—even in an asset sale—where the Buyer continues the business operations associated with the purchased assets without interruption or substantial change, because the Buyer is considered the successor employer.

(iii) Proposed covenant: "/[Seller][Buyer] agrees to provide continuation coverage under its group health plan, to the employees of Seller who are terminated in connection with the consummation
of the transactions described in this Agreement, in accordance with the requirements of Internal Revenue Code Section 4980B and the regulations thereunder."

(c) Credit for service

(i) Seller will likely want to negotiate that Seller's employees receive full service credit for eligibility to participate in, vest, and accrue benefits under, Buyer's welfare plans.

(ii) This will be covered by the general covenant regarding service credit, described above.

(d) Credit for pre-existing condition exclusions, deductibles, out-of-pocket payments, and flex accounts under Seller's welfare plans

(i) If the transaction closes in the mid-year, Seller will likely want to negotiate that no pre-existing condition limitations will apply to its employees under Buyer's welfare plans, and that Seller's employees receive credit for any deductibles or out-of-pocket expenses paid under Seller's welfare plans—so that they don't have to "start from scratch".

(ii) Recent IRS guidance permitting cafeteria plan elections, and reimbursement accounts, to effectively be transferred from the Seller to the Buyer, in the context of an asset sale, as long as Buyer's cafeteria plan is amended. Rev. Rul. 2002-32.

(iii) Proposed covenant: "Buyer agrees to take any and all steps necessary so that the employees of Seller being transferred to Buyer as a result of the transactions contemplated by this Agreement shall not be subject to any exclusions under Buyer's welfare benefit plans for pre-existing conditions, and that the amounts paid, or withheld from, such employees before the Closing Date, under any medical plan or flexible spending arrangement of the Seller, shall be taken into account in applying the deductible, co-payment, out-of-pocket limits,
IV. ISSUES INVOLVING PAYROLL PRACTICES

A. General Overview

1. Payroll practices include vacation, sick or annual leave policies; bonus and incentive pay program’s and severance pay policies.

2. Generally not subject to ERISA—governed by terms of policies (in employee handbook or other policy statements), and by patterns of past practice.

B. Due Diligence Regarding Payroll Practices

1. List of documents to be reviewed:

   (a) Copies of policies and agreements, including Employee Handbook; individual agreements; and summaries of oral understandings

   (b) Inquire into unwritten policies and practices, which might create a pattern or expectation of payroll benefits such as severance payments or payment for accrued but unpaid bonuses or leave.

   (c) Quantitative spreadsheet analysis showing amounts of accrued liabilities and when amounts are due—these may result in:

      (i) Reduction in purchase price

      (ii) Negotiation about which party will pay these amounts, and when

      (iii) Negotiation for credit regarding some (or only a portion) of accrued benefits under Buyer’s plans

C. Negotiating Representations and Warranties Regarding Payroll Practices

1. Reps and warranties on other benefit plans and arrangements will be sufficiently broad to identify payroll practices and arrangements(as long as "Benefit Plan" is defined broadly); the
amount of accrued liabilities; and the timing of when those accrued liabilities are payable.

2. In an asset transaction, Seller should consider amending its policies (and disseminating such amendments to its employees) to provide that the transfer of employment from Seller to Buyer will not constitute a termination of employment triggering the payment of accrued vacation benefits; severance benefits, etc.

D. Negotiating Post-Closing Covenants Regarding Payroll Practices

1. Covenants providing for service credit for welfare and qualified plans should be sufficiently broad to address service credit issues for payroll practices (in terms of eligibility; vesting; and benefit accrual).

2. Detailed covenants may need to be used to refine how certain leave or severance benefits will carryover to Seller's plans.