Employee Benefits in Acquisitions

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This outline provides an overview of special employee benefits issues that are frequently presented in the context of mergers and acquisitions. The discussion includes legal, business and plan design considerations. A complete analysis of employee benefits issues in the merger and acquisition context is beyond the scope of this outline. Moreover, many of the issues might have different results depending on the specific transaction in question. Practitioners should, therefore, be sure to fully analyze any of the specific issues in light of their specific factual situation. The outline is written primarily from the perspective of a buyer in any specific transaction, but also includes considerations important to both parties.

One issue in the acquisition context relates to when and how to involve employee benefits specialists. Often, the deal team will not consult with employee benefits counsel early enough in a transaction. In other cases, the information provided to the benefits advisor is something like this dialogue:

Deal lawyer:  “We are doing a deal, so what benefits issues do we need to consider?”

Benefits lawyer:  “What type of deal is it?”

Deal lawyer:  “We aren’t sure. It might be a stock deal but it might be an asset deal. Does it matter?”

Benefits lawyer:  “Yes. But maybe we can figure something out. What type of benefits are relevant in this deal?”

Deal lawyer:  “I don’t know. That’s why I am asking you. I guess the typical benefits would be relevant. You know, they probably have a 401(k) plan, medical, deferred comp, bonuses, etc. They also have stock options. The target’s CEO has been asking about those.”

Benefits lawyer:  “Can I ask our client’s HR people what type of benefits they offer and what they’d like to do for the acquired group?”

Deal lawyer:  “No. Right now it is top secret and on a ‘need to know basis’. HR has no idea the deal is going on and we cannot let them in on it yet. Don’t worry, there is an electronic diligence room and we are expecting them to load benefits/HR information. Just tell us what you need.”
Benefits lawyer: “So let me make sure I understand. I need to advise you on benefits issues for a deal that is not structured. And I need to advise you about risks and other issues about unspecified benefits issues raised by an acquired entity for a client where I can’t find out what benefits they already offer.”

Deal lawyer: “Is that a problem?”

In many deals, the benefits issues can raise some very tricky and costly problems. The best way to address them is through early discussion and planning. The following outline is intended to help practitioners work through many of the common issues and questions.

1. Early considerations
   a. Transaction structure: The transaction type will impact how the parties analyze employee benefits issues.
      i. Stock sale: The buyer purchases the selling shareholders’ stock directly, obtaining ownership in the legal entity. The buyer generally assumes the seller’s employee benefit plans and liability for those plans as a matter of law. The seller’s employees become employees of the buyer at closing.
      ii. Asset sale: The buyer purchases selected assets from the seller. The buyer generally does not assume the seller’s employee benefit plans or liability for those plans, unless it agrees otherwise. The seller’s employees become employees of the buyer only if the buyer offers them employment and they accept. The buyer will need to address these employees’ benefits needs based on the employees’ pre-acquisition benefits relative to the buyer’s plans. This may require including transferring employees in the buyer’s plans (typically with past service credit and prior credit for health plan deductibles and out of pocket costs). It might also involve assumption of the seller’s (or selling entity’s) plans.
      iii. When liabilities and obligations related to employee benefits plans are significant, these issues may determine the structure of the transaction and otherwise impact negotiations. For example:
         A. The seller may prefer a stock sale if it participates in a multiemployer plan and would be subject to withdrawal liability if the transaction were structured as an asset sale.
         B. If the seller sponsors an underfunded, single-employer defined benefit plan, and will continue to exist after the transaction (e.g., the seller is selling the assets of a separate trade or business), the buyer may prefer an asset sale.
   b. Business issues: It’s important to understand how business and economic issues impact the transaction and the deal process.
      i. Consider the following: (1) Does the seller or the buyer have the leverage in this transaction? (2) What is the timeline for the deal? To signing? To closing? (3) What are the client’s thoughts about costs? (4) Does the client or the deal team have
specific precedent (e.g., transaction agreements, diligence memos, etc.) that should be considered? (5) What is considered “material” in the transaction and for the client?

ii. The deal team may or may not include a labor and employment lawyer. If there is one, the benefits lawyer will want to work closely with that person on overlapping issues. If not, the deal team may expect the employee benefits practitioner to address employment law issues in diligence and in negotiating the transaction agreement. Practitioners should manage these expectations and recommend getting a labor and employment lawyer involved when significant issues come up (e.g., employee misclassification, labor unions, terminating employees in connection with the transaction, labor unions, and significant employment-related litigation or government investigations).

c. Benefit plan sponsor: The buyer should understand the seller’s corporate structure.

i. It is very important to know which of the seller’s entities sponsor the benefit plans. When there are multiple affiliated entities in the seller group, questions will arise as to whether the specific entity being acquired is actually sponsoring a benefit plan in question. For example, as explained below, it is typical to insist that the seller terminate any 401(k) plan covering the affected employees before closing. However, if the affected employees are covered by a 401(k) plan maintained by a parent company, and the deal involves a sale of the subsidiary, this strategy is not feasible.

ii. Identify members of the selling entity’s controlled group. The Internal Revenue Code (the “Code”) and the Employee Retirement Income Security Act (“ERISA”) treat two or more related entities as one employer for certain purposes. The seller’s liabilities may include liabilities for qualified plans sponsored by members of its controlled group, which may become liabilities for members of the buyer’s controlled group (generally based on 80% ownership threshold) after the transaction. See Code §§ 414(b), 414(c), 414(m) and 1563.

iii. In evaluating and identifying members of the controlled group, it is often important to know specifically which entities in the controlled group have adopted which benefit plans (combine the concepts in (i) and (ii) above). Remember, even if the buyer is not acquiring the entity sponsoring a plan, the target may have potential residual liability for other plans maintained in the controlled group. This could include pension plan liability (including multiemployer liability) as well as potential controlled group penalties for non-compliance with statutory obligations (e.g., prohibited transactions, health care reform, COBRA, etc.). So it will become important to identify risks and plan for indemnification where appropriate.

iv. If there are “affiliated” employers but not at the statutory “controlled group” (80% ownership) threshold, the benefit plans covering employees of those entities might be multiple employer plans. In the health plan context, they might constitute multiple employer welfare arrangements (“MEWAs”) and have separate compliance and filing obligations. These issues also arise in the “joint venture” context where the deal is not a full acquisition by the buyer, but the creation of a joint venture (e.g., a 50/50 joint venture with a separate entity).
v. A word about joint ventures. This outline focuses on an acquisition (generally either a stock or asset transaction) where the buyer will be the sole owner of the target’s business. An entirely separate analysis might apply if the parties are entering into a joint venture where the buyer and the seller (or some other unrelated party) will own the business and employ the employees after the transaction.

A complete discussion of joint venture issues is beyond the scope of this outline. Nevertheless, many of the issues discussed below can be relevant for a joint venture. Also, here are some specific issues to consider in the joint venture context: (1) Where will joint venture employees come from (Each party? One of the parties? Off the street? Any or all of those options?)? (2) Will the joint venture maintain its own benefit plans or will employees continue to participate in the plans of the joint venture parties? (3) If the joint venture will have its own plans, which types of plans? Will the employee benefits and applicable plans be like one of the joint venture partners or will they be entirely new? (4) If the employees will stay in plans of the joint venture partners, consider the status of employees sent down to the joint venture (secondments, etc.) and the benefit plans the new hires will participate in at the joint venture, if any. These are just a few of the many issues to consider in the joint venture context. In many of these situations, there are no clear “best practices” and it is important to consider all available options.

vi. Determine whether the seller’s employees are subject to a collective bargaining agreement (“CBA”). This may dictate which benefits or benefit plans must continue and whether benefit plans may be amended or terminated by the seller after closing. It also means that labor lawyers should be involved to help analyze the labor law implications and strategies.

d. Options for the seller’s plans after closing: The buyer and the seller should determine whether any plan amendments or board resolutions are required prior to closing.

i. The buyer assumes the seller’s plans. This will require resolutions by the buyer (adopted before closing) and amendments to the seller’s plans.

ii. The seller’s tax-qualified retirement plans merge into the buyer’s plans, or assets and liabilities are transferred from the seller’s tax-qualified plans to the buyer’s plans. See Code §§ 414(l) and 411(d)(6) for requirements on plan mergers and consolidations or transfers of plan assets. This might require government filings (including advance filings) and actuarial certifications, as well as adopting appropriate resolutions and amendments.

iii. The seller’s tax-qualified plans are cloned for affected employees after closing, and then the assets and liabilities are allocated between plans followed by assumption of the plans by the buyer.

iv. The seller terminates (or freezes) its plans prior to closing. See Code Section 411(d)(3) for requirements on termination or partial termination. The buyer may require termination if plan liabilities are significant, or if the buyer is concerned about qualification and/or administration issues. It is typical for a buyer to insist that the seller terminate the 401(k) plan before closing so distributions can be made to
affected employees who may then roll over their funds to the buyer’s plan (or another IRA or tax-qualified plan).

v. In the health and welfare plan context for active employees, buyers typically amend their plans to cover the acquired group of employees and provide credit for deductibles and out-of-pocket expenses previously paid by the affected employees. Do not overlook the formal documentation of these issues. If the buyer’s plan is insured, consideration must be given to notifying the insurer.

e. Foreign benefit plans: Engage specialists in jurisdictions where the seller has employees.

2. Single-employer tax-qualified retirement plans (defined benefit and defined contribution plans)

a. Issues applicable to both defined benefit (DB) and defined contribution (DC) plans

i. Determine whether there are qualification or other compliance issues related to any tax-qualified retirement plan. There could be significant tax consequences or audit penalties if a plan is determined not to be qualified under Code Section 401(a). Many, if not most, of these issues can be resolved either through self-correction or by filing with the IRS or DOL through their correction programs.

ii. Buyers are rarely (if ever) able to conduct a full audit of employee benefit plans, so must rely on representations in the transaction agreement as to compliance with applicable law. However, a better practice is for a buyer to conduct a basic compliance review of the seller’s plans before closing to determine whether there is risk and whether the risk can be managed. In all events, a buyer will want to require the seller to represent that each employee benefit plan is administered in accordance with its terms and applicable law, and that any tax-qualified retirement plan is so qualified.

iii. Diligence for tax-qualified retirement plans often includes the following steps:

A. Request copies of the most recent determination letter or opinion letter, and confirm plan documents have been updated to comply with changes in plan qualification requirements since the letter.

Note that the IRS has announced that it will eliminate the IRS determination letter program and 5-year remedial amendment cycles for individually designed plans effective January 1, 2017. See IRS Announcement 2015-19. Plan sponsors may submit a determination letter application for an individually designed plan on initial plan qualification, and for qualification on plan termination, and in other limited circumstances. However, this will impact the diligence process as it is unlikely that a determination letter would be received prior to closing. Buyers (and their advisors) will need to identify alternatives to assess plan qualification once determination letters are no longer available. It is expected that this change will not impact prototype or volume submitter plans, which still should have opinion letters.
B. Identify qualification issues related to plan administration. Review testing results for qualified plans to identify minimum participation issues under Code Section 401(a)(26) (for DB plans), minimum coverage issues under Code Section 410(b), nondiscrimination issues under Code Section 401(a)(4) (including ADP/ACP testing results for 401(k) plans). Review the plan’s Form 5500 Annual Reports, including schedules, attachments, and audit reports.

Note that minimum participation, coverage, and nondiscrimination issues may arise for plans that continue following the transaction. Limited transitional relief is available under Code Section 410(b)(6)(C). In appropriate cases, a buyer might consider using the “qualified separate line of business” rules under Code Section 414(r) if separate tax-qualified plans for the acquired employees need to be maintained after the closing.

C. Confirm compliance with reporting and disclosure obligations. Review plan documents, summary plan descriptions and summaries of material modifications, and other applicable notifications, including summary annual reports, annual funding notices, safe harbor notifications for 401(k) plans, and participant fee disclosures.

D. Review any voluntary correction program (“VCP”) filings under the IRS’s Employee Plans Compliance Resolution System (“EPCRS”) and confirm compliance with any compliance statement. If a VCP filing is pending, determine which entity will be responsible for completing the correction and the buyer should understand the potential costs related to the filing and consider whether to negotiate for indemnification, the seller placing funds for correction in escrow, or a purchase price reduction. Request a description of any correction under the self-correction program under EPCRS. In addition, review any filings made under the comparable correction programs maintained by the DOL (such as the delinquent filer program or the voluntary fiduciary correction program).

E. Review plan documents and operations for ERISA fiduciary issues. Identify plan fiduciaries (e.g., trustees, plan administrators, investment committee members, investment managers, and other service providers), and review fiduciary liability insurance policies, service provider agreements, investment policy statements, and committee meeting minutes.

Confirm that there are no prohibited transactions among the plan, the seller or any plan fiduciary. Prohibited transactions may trigger civil and criminal penalties under ERISA, excise taxes under Code Section 4975, and raise qualification issues under Code Section 401(a).

Prohibited transactions include transactions between the plan and a party in interest (defined under ERISA Section 3(14)), transactions between the plan and a fiduciary, and a transfer of real or personal property to the plan by a party in interest. See ERISA § 406, the statutory exemptions from prohibited transaction rules in ERISA § 408(a), and the DOL’s Prohibited Transaction Exemptions (PTEs).
F. Determine whether the plan has been (or is currently being) audited or investigated by the IRS, the DOL or the PBGC, and review any audit closing agreements or findings.

G. Determine whether the plan will be terminated or partially terminated in connection with the transaction. Upon termination or partial termination of a plan, affected participants will be fully vested. See Code § 411(d)(3). The plan must be amended for all qualification requirements under Code Section 401(a) as of the date of termination.

Whether a partial plan termination has occurred is based on a facts and circumstances analysis. A common rule of thumb is that a partial termination occurs if plan participation decreases by 20% or more. See IRS Revenue Ruling 2007-43. Diligence may include determining whether a partial termination of a plan has occurred in the past.

b. Defined benefit pension plans

i. DB plan funding can be a significant source of liability for a seller (and, consequently, for the unsuspecting buyer). These plans are subject to minimum funding standards under Code Sections 412, 430 and 436. Liabilities for contributions required to satisfy the minimum funding standards are joint and several for the plan sponsor and members of its controlled group. Excise taxes under Code Section 4971 apply if the minimum required contributions are not met, which are also joint and several for the controlled group. Also, the PBGC may impose a lien on property of members of the controlled group if unpaid contributions exceed $1 million. See ERISA § 303(k).

Request and review actuarial reports that calculate the plan’s funding shortfall (if any), and the minimum funding contributions. Estimates of funding can vary significantly depending on actuarial assumptions used in the calculations, including interest rates, so buyers should consult an actuary to understand the calculations. Liabilities are valued in different ways for different purposes (e.g., funding rules pre-PPA, post-PPA, using MAP-21 interest rates, and for PBGC and financial accounting purposes).

ii. A buyer may require that the seller terminate any DB plan prior to closing, particularly if the buyer does not otherwise maintain (or want to maintain) a DB plan. In general, a DB plan may be terminated under a “standard termination” if the plan is fully funded and participants and the PBGC are notified of the termination. A number of notices are required in connection with a plan termination (both before and after the termination). The plan sponsor must pay all plan benefits to participants and beneficiaries, either as a lump sum (if permitted by the plan) or by purchasing an annuity from an insurance company. If a termination is not feasible, buyers may request that the plan be frozen. Then, the buyer will end up maintaining a frozen DB plan.
DB plans may also be terminated in a “distress termination,” if the plan is underfunded and the plan sponsor and members of its controlled group meet specified distress criteria, or in an “involuntary termination” initiated by the PBGC.

Termination liabilities are joint and several for the plan sponsor and members of its controlled group. The buyer may request that the seller provide an estimate of termination liability for the plan, including any PBGC filing submitted under ERISA Section 4010. Section 4010 requires that certain controlled groups with underfunded DB plans file annual reports with the PBGC containing financial and actuarial information to the PBGC, including termination liabilities.

### iii. Request copies of the seller’s PBGC premium filings. PBGC premiums are a joint and several liability of the plan sponsor and members of its controlled group.

### iv. Consider other filing obligations under ERISA that may be implicated in connection with a transaction (see below). Request copies of any prior filings in diligence.

A. At least 30 days before assets of a plan are transferred, the plan sponsor must file IRS Form 5310-A Notice of Plan Merger or Consolidation, Spinoff, or Transfer of Plan Assets or Liabilities, which includes as an attachment an actuarial statement of valuation showing compliance with Code Section 414(l). There are exceptions from this filing requirement for most DC plans and many DB plan transactions. Review the instructions and applicable regulations under Code Section 414(l) carefully.

B. ERISA and the Code require that notice be provided to participants before the plan is amended to provide for a significant reduction in the rate of benefit accruals, or significantly reduces an early retirement benefit or retirement type subsidy. This ERISA 204(h) notice generally must be provided at least 45 days before the amendment becomes effective (15 days for small plans with fewer than 100 participants with accrued benefits).

C. ERISA Section 4043 requires plan sponsors to report certain corporate and plan events to the PBGC. Reportable events generally must be reported within 30 days, although advance reporting is required for nonpublic employers with underfunded plans that meet a specified underfunding test.

Determine whether the transaction, or events related to the transaction, will result in a reportable event filing obligation, and when that filing is due. Request reportable event filings for past events in diligence.

Reportable events include: tax disqualification of the plan and noncompliance with Title I of ERISA; amendment decreasing benefits payable; active participant reduction; termination or partial termination; failure to make required minimum funding payment; inability to pay benefits when due; distribution to a substantial owner; plan merger, consolidation, or transfer; change in contributing sponsor or controlled group; liquidation of controlled group member; extraordinary dividend or stock redemption; transfer of benefit liabilities; application for minimum funding waiver; loan default by a controlled group member for a loan with an
outstanding balance of $10 million or more; and bankruptcy or similar settlement involving a controlled group member.

c. Defined contribution plans, including 401(k) plans

i. Buyers often require sellers to terminate their 401(k) plans as a closing condition. If a 401(k) plan is terminated without the establishment or maintenance of another DC plan (other than an ESOP), lump sum distributions may be made following a plan termination. See Code § 401(k)(1) and Treas. Reg. § 1.401(k)-1(d)(4). Determine which entity will shut down the plan and distribute plan assets. This would typically fall to the seller, but the seller may not exist following the transaction, leaving the responsibility to the buyer.

ii. Note that the 401(k) plan termination option is realistic only where the acquired entity maintains the plan. If the employees of the acquired entity participate in a separate plan maintained by an affiliated entity, it will not be feasible to terminate that plan before closing because the plan covers a number of other employees of the selling entity’s affiliates. Instead, in this situation, the more feasible solution is to require that the seller’s plan offer distributions to the affected employees so they can roll over their balances to the buyer’s plan. Alternatively, assets and liabilities of the seller’s plan could be transferred to the buyer’s plan. Distributions and rollovers are preferable, however, because direct asset transfers will mean that any “taint” in the seller’s plan caused by administrative errors will carry over to the buyer’s plan. In addition, the buyer will have to evaluate any distribution options in the seller’s plan that would have to be maintained in the buyer’s plan under Code Section 411(d)(6).

iii. If the transaction results in a distribution of 401(k) plan balances, 401(k) plan loans may become due and payable (or be deemed to be distributed), with potentially adverse tax effects. To avoid plan loan defaults, buyers often permit plan loans to be included as part of the rollover from the seller’s plan to the buyer’s plan. If “in-kind” rollovers are not otherwise permitted, the buyer might have to amend its plan. Also, the buyer will want to coordinate any plan loan rollover with the plan’s third-party administrator and payroll provider. Another alternative is for the buyer to offer a bridge loan to participants to pay off the old plan loan, until the account can be rolled to the buyer’s plan and a new participant loan is made. This would mean that the buyer has to manage these employer-employee loans (and consider whether they can be provided on a favorable interest rate basis). Often, buyers are reluctant to undertake the administrative challenges of offering bridge loans.

iv. Employee stock ownership plans (ESOPs)

A. An ESOP is a tax-qualified DC plan that is designed to invest “primarily” in employer securities. See Code § 4975(e)(7). ESOPs can be adopted as a stand-alone plan, but ESOP components may also be included in other DC plans (such as a 401(k) plan).

B. A number of special qualification requirements apply to ESOPs under the Code, including pass-through voting, and distribution form and timing requirements. See Code Sections 409(e), (h) and (o). Diligence should evaluate whether these
requirements have been complied with. For publicly-traded companies, there are SEC requirements that apply, including the requirement to file a Form S-8 registration statement for the shares and the related prospectus and other document disclosure requirements, and the requirement to file an annual report with the SEC for the plan. See SEC Form S-8, Section 10(a) of the Securities Act of 1933 (the “Securities Act”), and Rule 428 under the Securities Act.

C. The seller may consider (or the buyer may require) engaging an independent fiduciary to replace the trustee or other plan fiduciary as the decision maker for the ESOP in connection with a transaction. The appointment of an independent fiduciary is beneficial where there is a conflict of interest between the employer or plan fiduciaries and the ESOP participants. These issues arise in any situation where (1) there are stock valuation issues that could be impacted by the transaction and the stock must be sold, or (2) the transaction is a corporate spinoff and the buyer and the seller plans will end up with stock of each entity in their respective ESOPs. An independent fiduciary can assist with valuing the company’s shares, evaluating the transaction from a financial perspective, advising the plan fiduciary during negotiations, and acting as an independent advisor to render valuation opinions and fairness opinions. If the ESOP ends up with other assets (i.e., buyer stock) in connection with the transaction, the independent fiduciary can also assist in liquidating those assets.

D. Code Section 409(e) gives ESOP participants the right to instruct the trustee with respect to a vote in a merger or sale of assets. The ESOP trustee then votes the shares in accordance with those instructions. Consider the ESOP terms and legal requirements to determine whether ESOP participants will vote, and the logistics of any such vote. Determine how shares that are unallocated or for which participants fail to provide instructions should be voted. Similar issues arise for tender offers that must be passed through to ESOP participants.

E. There are additional acquisition-related considerations for leveraged ESOPs. An ESOP is a “leveraged ESOP” when the ESOP borrows money from the plan sponsor or a third-party lender to fund the purchase of employer stock and the stock is pledged as collateral for the loan. If an ESOP is terminated following a transaction, the ESOP must use the sales proceeds to repay the debt and allocate excess proceeds to ESOP participants’ accounts; however, the transaction might trigger some event-based make whole provisions in the loan documents, which will require additional allocations to participant accounts. There are also considerations related to how ESOP assets are distributed to participants.

3. Multiemployer pension plans

a. If the buyer is (or has been) a contributing employer to a multiemployer plan (a Taft-Hartley Plan), withdrawal liability can be a significant issue in a transaction, both because liabilities can be significant and also because the transaction and transaction-related events may result in a withdrawal. Contributions to multiemployer plans are required by a CBA between an employer and a union, so a buyer may be obligated to continue contributing after the transaction whether it wants to or not.
When a contributing employer withdraws from a multiemployer plan, the employer is liable to the plan for its share of the plan’s unfunded vested liabilities. These liabilities can be quite significant and require careful attention. Withdrawal liability is joint and several for the contributing employer and its controlled group members.

i. A “complete withdrawal” occurs when the employer no longer has an obligation to contribute to the plan or stops all covered operations under the plan. See ERISA § 4203. Special withdrawal liability rules apply to plans and employers in certain industries, including construction, trucking, entertainment and retail food industries.

ii. A “partial withdrawal” occurs when there is a decline in the employer’s contribution base units (i.e., the level of work for which contributions are based) over a period of time, or a partial cessation of the employer’s obligation to contribute. See ERISA §§ 4205, 4206 and 4208.

iii. A mass withdrawal occurs when all contributing employers withdraw.

c. Review statements from the plan trustee of estimates of withdrawal liability for the seller’s controlled group. Understand whether the plan is in critical status or endangered status, which signals that the plan is underfunded by a significant amount. Trustees of plans in critical status are required to adopt rehabilitation plans to improve its funded status, which may include requiring participating employers to pay a surcharge in addition to required contributions. Under the Multiemployer Pension Reform Act of 2014, severely troubled plans in “critical and declining status,” may suspend benefits for participants in pay status and accrued benefits for participants not in pay status if certain requirements are met.

d. The potential for withdrawal liability may also dictate how the transaction is structured. The seller may insist on a stock sale if it would be subject to withdrawal liability as a result of the transaction.

i. In a stock sale, the buyer steps into the seller’s status as a contributing employer and the seller’s contribution history, and there is no withdrawal liability as long as there is no interruption in the employer’s obligation to contribute to the plan. See ERISA § 4218(1). The buyer should have a very good understanding of the seller’s obligations to contribute to the plan, and its potential withdrawal liability, as the buyer will be subject to the liability if the buyer withdraws from the plan after the transaction.

ii. An asset sale may result in a withdrawal if the sale eliminates the seller’s obligation to contribute, unless certain requirements are met. A seller may avoid withdrawal liability if the transaction complies with ERISA Section 4204. This section requires that (A) the buyer have an obligation to contribute to the plan for substantially the same number of contribution base units (the units by which contributions are measured, e.g., hours worked) for which the seller had; (B) the buyer purchases a bond in a specified amount to protect the plan for a period of 5 years; and (C) the transaction agreement provides that the seller is secondarily liable for any withdrawal liability it would have had to the plan if the buyer withdraws in a complete or partial withdrawal in the first 5 years after the sale.
iii. Consider case law applying successor liability for withdrawal liability or other obligations to a multiemployer plan (e.g., unpaid contributions) to a buyer in an asset sale. Courts have found buyers in an asset sale liable for withdrawal liability if the buyer had notice of the claim before the transaction, and the buyer maintains “substantial continuity in the operation of the business before and after the sale.” See, e.g., Chicago Truck Drivers, Helpers and Warehouse Workers Union (Independent) Pension Fund v. Tasemkin, Inc. (7th Cir. 1995).

e. Parties may not avoid withdrawal liability if a principal purpose of the transaction is to evade or avoid liability. See ERISA § 4212(c).

4. Health and welfare plans

a. Diligence generally starts with understanding which health and welfare benefits that the seller offers to its employees. In addition to identifying legal compliance issues and understanding potential liabilities in diligence, the buyer will be assessing these arrangements to determine how to provide benefits to the seller’s employees after the closing. For insured benefits, consider how the transaction will impact the insurance contract and consider whether notice to the insurer is necessary. This insurer notification point could also be relevant if a buyer self-insures its health benefits and uses stop-loss coverage for large liabilities under the plan.

b. Confirm compliance with tax and ERISA requirements applicable to health and welfare plans, including reporting and disclosure obligations. Confirm that IRS Form 5500s have been filed for welfare plans that cover more than 100 participants. Review plan documents, summary plan descriptions and summaries of modifications, summary of benefits and coverage and notices of modification, COBRA notices, HIPAA policies and business associate agreements, and claims. Request nondiscrimination testing results for self-insured health plans (see discussion below) and cafeteria plans.

c. If the seller’s medical plans are self-insured, review stop loss insurance policies, and request schedules for reserves and unpaid claims, particularly runoff claims that have been incurred but will be unpaid at closing. The buyer should also confirm that health plans do not discriminate in favor of highly compensated employees as to participants or benefits. See Code § 105(h). If a self-insured plan is found to be impermissibly discriminatory, benefits provided to highly compensated employees could be taxable. The Affordable Care Act (“ACA”) also extended some of the Section 105(h) rules to insured plans; however, the consequence of a finding that the plan is discriminatory is a $100 per day, per nonhighly compensated employee who is discriminated against tax penalty (up to $500,000 per taxable year) rather than income inclusion. The IRS has not issued regulations on the new ACA nondiscrimination provisions and implementation of these new rules is on hold until guidance is issued.

d. The ACA has raised additional concerns for parties in corporate transactions.

i. Because the regulatory landscape around the ACA is complex and changing, and employers and their service providers are still navigating how to implement the ACA,
diligence is particularly challenging. Review plan documents and the seller’s administrative procedures to become comfortable that the seller has taken a reasonable approach to implementing the ACA’s rules.

To avoid penalties under the ACA, large employers (employers with 100 or more full-time employees in 2015, 50 or more in 2016), must offer its full-time employees an opportunity to enroll in minimum essential coverage under an eligible employer-sponsored plan that provides minimum value and is affordable.

As an initial matter, determine whether the seller is a large employer. Review information on employee headcounts, hours worked, and the methodology by which the seller determines who is a full-time employee.

For additional comfort, buyers may request that sellers represent that they have operated their plans in compliance with the ACA. After the transaction, buyers may need to focus on getting the plans into compliance.

ii. Pay careful attention to the method that the seller uses to identify full-time employees and to obtain data about the seller’s employees before the closing, as the buyer may have to count those hours when determining whether those employees are considered full-time employees under the look-back measurement method (an averaging of employees’ hours over a specified period of months, called the “measurement period”). The employee’s status as full-time or part-time then applies for a specified period called the “stability period.”

The buyer should follow the IRS’s guidance under Notice 2014-49 on applying the rules of the look-back measurement method to identify full-time employees in an acquisition. The guidance analyzes different approaches depending on the situation, but generally speaking, an employee who is in a stability period at the time of the closing retains his or her status through the end of the stability period. If the employee is not in a stability period, the buyer determines the employee’s status using its own measurement method, taking into account the employee’s hours with the seller pre-closing. Notice 2014-49 also provides a defined transition period for the buyer to measure the transferred employee’s full-time status using the seller’s measurement period and stability period. Notice 2014-49 applies until December 31, 2016.

iii. Confirm that the seller is obligated to provide the information that the seller will need to complete the reports that are required under Code Sections 6055 and 6056. These sections require employers, plans, and health insurance issuers to report health coverage information to the IRS and to participants annually. Reporting under these sections will be conducted on IRS Forms 1094-B and 1095-B, and Forms 1094-C and 1095-C.

e. Retiree medical and life insurance benefits: These benefits, particularly retiree medical benefits, raise the possibility of substantial financial liability. In addition, amending or terminating those benefits for affected employees (including former employees) can raise significant legal issues. Therefore, if a transaction can impact retiree benefits, consider carefully whether these plans can be amended or terminated, giving the buyer the right to discontinue or reduce benefits after closing. Alternatively, the buyer may require that the
seller amend or terminate the benefits before closing. Formal plan documents, summary plan descriptions and other plan communications should be carefully reviewed. However, even if the plan permits these changes, it may be difficult to terminate the benefits based on case law. These challenges can be particularly challenging in a collectively-bargained environment where a CBA might require that retiree benefits be maintained for the life of covered employees. A recent Supreme Court case rejected the long-standing inference (known as the Yard-Man inferences, after the name of a 6th Circuit case allowing the inference) that parties to a CBA intend to vest retirees with lifetime health benefits in the absence of a specific contractual provisions or extrinsic evidence to the contrary. M&G Polymers USA, LLC v. Tackett (U.S. Jan. 26, 2015). However, this does not mean that employers will prevail in litigation if their decision to terminate retiree health plans is challenged. The determination will depend on the specific facts and the jurisdiction.

f. Flexible spending accounts (“FSAs”): Consider FSAs in transactions that close mid-year due to the “use it or lose it” operations of an FSA. IRS guidance approves two ways of handling FSAs in connection with mid-year transactions: (1) the seller retains the FSA and the buyer transmits contributions from transferred employees to the seller for the balance of the year after the closing; or (2) transferred employees contribute to the buyer’s plan but carry over their elections and account balances (generally involves an asset transfer between the buyer and the seller at closing). See IRS Revenue Ruling 2002-32.

g. COBRA: Determine which entity is responsible for providing COBRA coverage to qualified beneficiaries. The parties can designate which entity is responsible for providing COBRA. However, the regulations assign responsibility for providing coverage based on multiple considerations (including whether the transaction is a stock sale or an asset sale) if the responsible party does not perform. See Treas. Reg. § 54.4980B-9.

h. MEWAs: The parties, particularly the buyer, may be concerned about providing health coverage to active employees where the buyer is not quite ready to cover the seller’s affected employees as of the closing. In these cases, the question arises as to whether the seller (which remains in existence) can keep the employees in the seller’s health plans for a certain period after the closing. The concern raised is that, because the seller and the buyer are not related to each other, covering employees of an unrelated entity might cause the seller’s plan to be a MEWA. That could trigger possible state law registration or compliance issues. It can also force the seller to start filing a Form M-1 with the DOL identifying the arrangement as a MEWA. State law compliance and enforcement against MEWAs can be troublesome and parties typically want to avoid MEWA characterization. The good news is that, the Form M-1 instructions provided by the DOL include a “deal” exception. Under this exception, no filing of Form M-1 is required if an entity provides coverage to the employees of two or more employers due to a change in control of businesses (such as a merger or acquisition) that occurs for a purpose other than avoiding Form M-1 filing and is temporary in nature (i.e., it does not extend beyond the end of the plan year following the plan year in which the change in control occurs). Pay close attention to two key points: (1) this exception applies only until the end of the plan year (not necessarily the same as the calendar year or tax year) following the plan year in...
which the deal happens; and (2) it is only an exception from the Form M-1 filing requirement; it is not an exception from being a MEWA. Although the exception is only from Form M-1 filing, practitioners regularly rely on this for support that the temporary coverage should not be treated as a MEWA.

Another way to argue that MEWA status is not implicated is to make sure that each party (buyer and seller) is responsible for the actual claims for its employees. In other words, if there is no cross-subsidization of benefits from the buyer to the seller (or vice versa), the argument can be made that there are two separate plans (not one MEWA) being administered by the seller for a temporary period. (One possible concern in the latter case is whether the seller then needs to be registered as a third-party administrator of the buyer’s plan for any state law licensing rules.)

5. Nonqualified deferred compensation plans

a. Diligence should address the following:

i. Nonqualified deferred compensation plans are unfunded and the employer pays benefits out of its general assets at the time payments are due. Some employers earmark assets for the payment of these benefits in a “rabbi trust” or company-owned life insurance, where assets are set aside but still remain subject to claims of the employer’s creditors. Understand what the liabilities are for payments and who participates in the plans, and request documents related to any rabbi trust.

ii. Request copies of “top hat” plan statements filed with the DOL for nonqualified plans, which are required so that a top hat plan (i.e., a nonqualified deferred compensation plan maintained for the benefit of a select group of highly compensated employees) is exempt from certain ERISA reporting and disclosure requirements. See DOL Regulations Section 2520.104-23. If the statement is not filed for a nonqualified deferred compensation plan and a formal Form 5500 filing has not been made, there could be significant reporting penalties. The DOL’s delinquent filer program can be used to correct any filing deficiencies at a much lower cost than failure to file penalties.

iii. Confirm that nonqualified plans comply with the requirements under Code Section 409A. Section 409A is potentially implicated when a service provider earns or becomes entitled to compensation in one tax year that is paid or payable in a future year.

Section 409A is a complex and complicated law, and requires that a plan or agreement that provides for deferred compensation satisfy specific requirements regarding the time and form of payment and must prohibit acceleration of payments or further deferral of payments, except in limited circumstances. Section 409A also has special timing rules that apply to certain employees employed by public companies who receive payments subject to Section 409A on a separation from service. Failure to satisfy the requirements of Section 409A for deferred compensation results in full taxation on the employee when the deferred compensation amounts vest (whether or not those amounts are paid), plus an additional 20% excise tax and interest. The employer may also be required to pay a
penalty for its failure to appropriately withhold on payments that violate Section 409A.

There are two payment triggers that are frequently implicated in an acquisition: a “separation from service” and a “change in control” (both specifically defined for purposes Section 409A).

In some transactions, a technical separation from service for Section 409A purposes might occur and trigger distributions under a nonqualified plan whether the parties want that result or not. In other transactions, a technical separation from service will not occur even if the parties want the transaction to be treated as a separation from service. Separately, the transaction might (or might not) constitute a change in control for Section 409A purposes triggering vesting or payment obligations under the plan in question. Therefore, it is crucial to carefully scrutinize the Section 409A regulations and the plan terms to identify and address any compliance issues.

Section 409A also applies to severance agreements, employment agreements, and some equity awards, which are discussed below.

b. Understand whether the transaction will trigger a requirement for vesting or payment under a deferred compensation plan, or whether it requires the employer to deposit assets in a rabbi trust.

The deferred compensation plan will often include a definition of “change in control” (or similar term) that triggers vesting or payment. Note, however, that Section 409A specifically defines a change in control, which may differ from the plan’s definition and is often stricter. See Treas. Reg. § 1.409A-3(i)(5). If the plan provides for payment on a change in control, Section 409A must be considered if the parties wish to avoid adverse tax consequences for affected employees.

c. Sometimes the parties might want to permissibly accelerate the time and form of payment by providing for a lump sum payout on termination of the nonqualified deferred compensation plan in connection with the transaction. If so, the plan termination must comply with Section 409A. See Treas. Reg. § 1.409A-3(j)(4)(ix). Among other things, the regulations require that the plan be terminated within the 30 days before or 12 months after a change in control, and that all similar plans be terminated. Waiting until after closing to terminate the plan may raise issues because the buyer’s deferred compensation plans may also have to be terminated in order to meet this requirement.

d. Understand whether a “separation from service” (under Section 409A) is a payment trigger and whether the seller’s employees will separate from service as a result of the transaction. In a stock sale, there is generally no separation from service. In an asset sale, the transfer of employment to the buyer may be a separation from service. Under the 409A regulations, the seller and the buyer in an arm’s length transaction may specify whether a transferred employee has experienced a separation from service in connection with the transaction. All employees must be treated the same. However, a corporate spinoff is generally not a separation from service for these purposes. See Treas. Reg. § 1.409A-1(h)(4).
6. Equity compensation plans and awards

a. Diligence should address the following:

i. Identify the type of awards outstanding, and details of each award including participant name, grant date, number of shares, vesting schedule, including acceleration provisions, exercise price, and expiration date. Review all equity plan documents and award agreements.

ii. Confirm that awards comply with the tax requirements to preserve the intended tax treatment of the awards.

A. For stock options that are incentive stock options ("ISOs"), the award should comply with requirements under Code Section 422, including granting the award under a stockholder-approved plan, granting only to employees, limited post-termination exercise periods, 10-year term and exercise price not less than fair market value on the grant date (5-year term and 110% of fair market value for 10% stockholders), and dollar limits as to amounts of awards that can be treated as ISOs.

B. Options intended to be exempt from Section 409A must have an exercise price equal to or greater than fair market value on the grant date, not more than a 10-year term, and no additional deferral feature. See Treas. Reg. Section 1.409A-1 (b)(5). Review the exercise prices of awards to identify potentially discounted stock options and, for private companies, request information as to how the value of the stock is determined, including copies of any independent valuation report.

C. For equity awards other than options, stock appreciation rights ("SARs") and restricted stock – i.e., for restricted stock units – review the terms of the award to confirm that the awards are exempt from or comply with Section 409A.

iii. Confirm that applicable federal and state securities laws are satisfied. For public companies, review the Form S-8 registration statement for the shares and the related prospectus. For private companies, determine whether state blue sky requirements, including any filing requirements, have been satisfied.

iv. Review board resolutions or other governance documents to confirm that awards were granted as required under the plan (including any share limits), and that the grant date of the award matches the date of board approval.

b. Parties also spend a considerable amount of time addressing and negotiating the treatment of equity awards in connection with the transaction.

i. Review any award agreements to determine whether vesting or payment is accelerated in connection with the transaction. The plan will generally include a definition of "change in control" (or similar term) that triggers vesting or payment. If awards are subject to Section 409A, the change in control definition under Section 409A should be considered.
Accelerated vesting is either single trigger (the transaction triggers vesting), or double trigger (the transaction plus another event, generally involuntary termination of employment within a specified period of time after closing triggers vesting).

ii. The equity plan and award agreements may also specify how awards must be (or can be) treated in connection with a transaction. Generally, awards are terminated, assumed or substituted in the transaction. The transaction agreement often includes detailed descriptions of the treatment of outstanding equity awards.

A. If awards are terminated, holders will receive the economic value of the award in exchange for the termination (frequently called a “cash out”). The value of the award is the excess (if any) of the per share purchase price in the transaction over the per share exercise price or purchase price (if any). In a stock sale, consider and address the mechanics of any pre-acquisition exercise of an option or a cash out.

If options are underwater (the per share exercise price is greater than the per share price in the transaction), determine whether the awards can be terminated without consideration or whether optionholders must consent to the cancellation.

B. If awards are assumed or substituted, determine how the awards will be adjusted after the closing. Be careful not to modify any award in a manner that would be considered a grant of a new award under Section 409A or that may disqualify an ISO (if ISO treatment is desired), including by satisfying certain economic tests. See Treas. Reg. §§ 1.424-1(a)(2) and (5) and 1.409A-1(b)(5)(v).

C. In a transaction (particularly an asset sale), the seller may wish to extend the post-termination of a stock option. In general, this may disqualify an ISO and it cannot be extended beyond the earlier of the expiration date of the award or the tenth anniversary of the grant date for purposes of Section 409A.

D. The parties should determine whether the award holders must consent to any action impacting the equity awards.

7. Other executive benefits, including change in control benefits, employment agreements, severance benefits, and bonuses

a. In advance of the transaction, or in connection with the transaction, the seller may have agreed to make change in control payments to provide incentives to executives and employees to assist with the transaction and to stay employed through the transaction. Understand the cost of these benefits and when the benefits are to be paid, and which party will be responsible for making the payments. The buyer should also understand these benefits to help analyze whether it should offer additional retention incentives to executives or employees after the transaction to get them to stay.

b. Review employment agreements, as they may provide for change in control incentives, severance, and enhanced severance after a change in control. In a stock sale, the buyer will be responsible for these payments and may require the seller to terminate the
agreement (including by terminating the executive’s employment) or enter into a new agreement with these individuals.

c. Review the seller’s severance practices, or any severance plan, including analyzing whether the benefits are subject to ERISA. A severance plan is subject to ERISA if it is a “plan, fund or program” under ERISA Section 3(1). The standard for determining whether a severance plan is subject to ERISA has been established through case law, which relies heavily on the Supreme Court’s decision in *Fort Halifax Packing Company, Incorporated v. Coyne* (U.S. 1987). In *Fort Halifax*, the Supreme Court held that ERISA does not apply to “one time, lump sum payments triggered by a single event requiring no administrative scheme whatsoever.” This standard has been applied inconsistently by courts, meaning that the determination is largely based on the facts.

If the seller’s severance practices are subject to ERISA as an employee welfare benefit plan, confirm that the seller has filed Form 5500s for the plan (if there are 100 participants), and complied with ERISA’s disclosure requirements. Remember that the DOL’s delinquent filer program can be used to correct any filing deficiencies at a much lower cost than failure to file penalties.

More onerous requirements are apply under ERISA for severance plans that are employee pension benefit plans.

d. Review the seller’s bonus plans and informal bonus practices to assess the buyer’s potential liabilities in a stock sale. In any transaction, buyers will want to consider the seller’s bonus structure for employee-relations purposes after closing.

e. From a legal perspective, buyers should analyze any of these agreements for compliance with Section 409A.

f. From a business perspective, identify any obligation to gross up, indemnify or reimburse excise taxes, interest or penalties under Code Section 280G (discussed below) or Section 409A.

8. Parachute payments and Code Section 280G

a. In general, parachute payments are payments of compensation made by a company to its “disqualified individuals (including officers, stockholders and highly compensated individuals) that are triggered by a change in control. If change in control payments to a disqualified individual exceed 3 times the individual’s “base amount” (generally, the average annual compensation over the past 5 years), the individual has parachute payments. In that case, the disqualified individual must pay a 20% excise on all parachute payments that exceed one times the base amount and the company loses the tax deduction on those amounts.

b. What constitutes a change in control payment is very broad, and includes the more apparent change in control bonuses, and accelerated vesting of equity awards, but can also include severance payments, fringe benefits, and post-change in control retention bonuses. Parachute payments do not include payments that are reasonable compensation for personal services.
c. The parachute payment rules apply to both private and public companies, but generally do not apply to partnerships (excluding REITs and publicly-traded partnerships), tax-exempt organizations and certain “small business corporations” (determined based on requirements similar to the requirements to be treated as an S corporation). Also, under a special rule, if private companies obtain stockholder approval of change in control payments to disqualified individuals, the approved amounts are not treated as parachute payments. See Treas. Reg. § 1.280G-1 Q&A 6, and 7.

d. The rules for calculating parachute payments are complicated and detailed, and the seller may engage an accounting firm or actuary to complete the calculations.

9. Negotiating the transaction agreement

a. Employee benefits attorneys are also involved in reviewing and negotiating the transaction agreement. This includes review of employee benefits representations and warranties, interim operating covenants and post-closing covenants. Employee benefit and compensation issues may also be addressed in representations on capitalization (i.e., for equity awards) and on material contracts. The diligence process should inform the advisor’s review of the agreement. Complicated or costly benefits issues may result in more robust representations and warranties.

b. The employee benefits attorney should also pay careful attention to the escrow and indemnification provisions in the transaction agreement. For example, it is important to understand whether seller is required to indemnify buyer from dollar one for issues discovered after the signing and/or closing, or whether buyer must cover these expenses up to a certain amount before the indemnification provisions kick in. Also, it is important to know when indemnities don’t really matter (e.g., buyer is buying the entire company). In that type of situation, there is a greater premium on trying to identify those key liability points or cost drivers ahead of time and address them before a final purchase price is agreed to.

c. Disclosure schedules should also be reviewed for completeness and accuracy against the transaction agreement and based on what is discovered during diligence. Follow up with respect to any items that are disclosed in the schedules that have not been identified in diligence.

d. Parties use interim operating covenants to assign responsibility for events that must occur between the signing of the transaction agreement and the closing of the transaction. This may include assigning responsibility for filings or corrections, providing disclosures to employees, and the buyer may use these covenants to reserve the right to review any of these materials.

e. Post-closing covenants are frequently used by sellers to protect its employees after the transaction. For example, the seller may insist that the buyer provide severance payments if employees are involuntarily terminated within a specified period of time after closing. The seller may also request that the buyer credit the seller’s employees with pre-closing service for purposes of determining benefits accrual and eligibility, and credit the seller’s employees for claims and out of pocket costs.
f. Consider including a covenant in the transaction agreement stating that the agreement is not intended to create third-party beneficiary rights for any employees or other parties, and does not establish, amendment or modify any employee benefit plan, program, agreement or arrangement, require any entity to continue any employee benefit plan, or create any right to employment, compensation or benefits.