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Employee Benefits in Mergers and Acquisitions: Buyer Beware

by Andrea L. Bailey and Nicholas C. Tomlinson

Imagine this scenario: You are the vice president of human resources for your company. One Friday morning, you awaken, go through your usual routine and, on your drive into work, you take a moment to think about the day ahead. It is not open enrollment, year end or 5500 season. So, not expecting anything unusual, you look forward to the weekend's start. Mid-morning, a call comes down from your boss. "Get ready," he says. "We are in negotiations to acquire XYZ, Inc., and their employees are coming, too."

Hearing this news, your easy Friday just got much more stressful. Immediately, you think about the additional employees who will need your services. You look ahead on the calendar for dates for new employee orientations. You even place a call to a temp agency for short-term help because your department cannot complete the work ahead in the short period with your current staffing levels.

Alas, you have already forgotten a crucial piece of this acquisition's puzzle. What are you going to do with XYZ, Inc.'s employee benefit plans?

Nature of the Transaction

Before deciding how to manage the due diligence process (the review of the selling company's employee benefit plans) and the target company's employee benefit plans, a buyer must understand the nature of the transaction through which the target will be acquired. Businesses are acquired through one of two ways:

- Stock purchases; or
- Asset purchases.

Stock Purchases

A stock purchase occurs when the buyer purchases the target's outstanding stock.¹ The target's



shareholders may receive cash or buyer stock in exchange for their target stock. Absent termination prior to the transaction's closing, by operation of law, the target's employees and benefit plans will continue post-transaction as liabilities of the buyer.

Although the purchase agreement may indemnify the buyer for liabilities due to events occurring prior to the transaction's closing, for purposes of the government [e.g., the Internal Revenue Service (IRS)] and plan participants, the buyer is the responsible party. Therefore, due diligence is especially critical in stock purchases so that the buyer may be fully apprised of any problems or hidden liabilities with respect to the target's benefit plans.

1 Stock acquisitions may also occur in the form of mergers, which, for purposes of this article, will be treated the same as stock acquisitions.

Because every acquisition is unique and will require individualized assessment, this article is intended to serve as a starting point for such an assessment and, depending upon the responses or the information provided, further questions may be generated or further information may be necessary.

Asset Purchases

An asset purchase occurs when the buyer purchases some or all of the target's assets. Where the majority of a business is being acquired or even a line of business, frequently the target's affected employees will be terminated on the closing date and subsequently hired by the buyer. The target's employee benefit plans generally remain under the sponsorship and control of the seller post-transaction, unless the parties agree otherwise. The key advantage that buyers enjoy in asset purchases is that, with only a couple of exceptions, they may choose which of the target's liabilities, if any, they wish to assume. As set forth more fully below, even if the buyer does not assume the target's plans, applicable law may subject the buyer to liability for pension underfunding for "multiemployer" plans and for continued health coverage for certain "M&A Qualified Beneficiaries" under the Consolidated Omnibus Budget Reconciliation Act of 1985, as amended (COBRA).

Due Diligence Checklist

Employee benefit plans are important negotiating points in acquisitions. A buyer should require the target to disclose all information about various benefit plans during the due diligence process in order to determine whether it is necessary to continue those benefit plans post-closing and identify risks or outstanding issues that need to be corrected pre-closing or indemnified by the target if problems arise in the future. Employee relations also play a role, as the buyer will want to manage the target employees' expectations as they concern employee benefits.

This article is intended to highlight critical areas from an employee benefits standpoint pertaining to the acquisition of another business' stock or assets. Because every acquisition is unique and will require individualized assessment, this article is intended to serve as a starting point for such an assessment and, depending upon the responses or the information provided, further questions may be generated or further information may be necessary. However, as a starting point, items and information the buyer should generally request for each employee benefit plan include the following:

1. Identify any employment related agreements, whether oral or written, such as:
 - Employment Agreements;
 - Independent Contractor Agreements;
 - Consulting Agreements; and
 - Union or Collective Bargaining Agreements (CBA) (including side letters or letters of understanding).

2. Identify every employee benefit plan [within the meaning of Section 3(3) of the Employee Retirement Income Security Act of 1974, as amended (ERISA)] (e.g., pension, profit sharing, 401(k), non-qualified deferred compensation, executive benefit, SERP, medical, dental, EAP, LTD, AD&D, life, short-term disability with insured benefits, cafeteria plan/flexible spending account plan, dependent care reimbursement account plan, health care reimbursement account plan, etc.).
3. Request for each plan identified in Item 2 above, where applicable, the trust instruments and plan documents and any amendments thereto, summary plan descriptions, summaries of material modification, IRS favorable determination letter (only applicable to tax-qualified retirement plans), most recent three years of Form 5500 filings, including all schedules and audit report and actuarial report, if applicable.
4. Identify any benefits-related complaints filed with any federal, state or local agencies [e.g., United States Department of Labor (DOL), IRS, Office for Civil Rights] during the last three years or which remain unresolved.
5. Have the target confirm whether it has been a signatory or successor to any CBA and whether the target participated in any multiemployer pension plan within the past six years and, if so, has there been any assessment of withdrawal liability by any multiemployer pension plan within the past six years?
6. Have the target provide a schedule of the wages, benefits and obligations of the target to its officers and other key personnel and identify any contracts, written or oral, with those personnel or engagement letters that could be construed to be employment contracts.
7. Have the target identify any change of control agreements which provide for additional payment or accelerated vesting of certain benefits upon contemplated transaction.
8. Request copies of administrative forms for all benefit plans identified in Item 2, including COBRA and the Health Insurance Portability and Accountability Act of 1996, as amended (HIPAA) administration forms, where applicable.
9. Identify all individuals who are "qualified beneficiaries" for purposes of COBRA, their qualifying event date, COBRA election date and premium history.
10. Request all information, both formal and informal, concerning benefit entitlements to retirees existing during the last five years.

11. Request the identity of any employees presently on any type of leave of absence, along with a statement of the type of leave and its duration.
12. Have the target verify whether any type of temporary agency, employment agency, contract labor provider or other alternative to traditional employment arrangements has been used in the last three years and the identity of such provider.

Assessing the Due Diligence

Once the buyer has received responses to its requested due diligence, it will begin the process of analyzing the potential risks and costs associated with the target's benefit plans. The remaining portion of this article addresses the diligence concerns by considering each of the three types of benefit arrangements:

- Tax-qualified retirement plans;
- Health and welfare plans; and
- Executive deferred compensation and benefits.

Tax-qualified Retirement Plans

Tax-qualified retirement plans are traditional company retirement plans that are available to most, if not all, employees. They come in three forms:

- Defined contribution plans;
- Defined benefit plans; and
- Multiemployer plans.

Defined Contribution Plans

Defined contribution plans are the most prevalent retirement plan form. Their name derives from the concept that the retirement amount a participant receives is defined by the contribution amounts the participant, or the company on the participant's behalf, makes to the plan during the participant's years of service to the company. Profit-sharing plans, 401(k) plans, employee stock ownership plans (ESOPs) and stock bonus plans are defined contribution plans. Participants receive benefits from defined contribution plans through one time lump sum distributions, installments or annuities.

Defined Benefit Plans

Defined benefit plans are aptly named because the participant's target benefit at retirement defines the contribution amount the plan must receive annually over the participant's years of service. Traditional pension plans, cash balance plans and simplified employee pension plans (SEPs) are types of defined benefit plans. Benefits are usually paid in joint and survivor annuities for married participants and single life annuities for single participants. These plans must meet minimum

funding obligations annually and may incur significant liabilities if the plan's obligations come due all at once.

Multiemployer Plans

Multiemployer plans are sponsored by labor unions, not employers. They are usually pension plans and cover more than one company's employees. Contribution obligations for each employer are determined through collective bargaining. With multiemployer plans, the target remains liable for its portion of the plan's unfunded liabilities. The target, therefore, generally wants the buyer to assume liability on its behalf.

Retirement Plan Document Review

Any retirement plan review should begin with the current IRS determination letter, the IRS' confirmation that the plan qualifies under the Internal Revenue Code of 1986, as amended (the Code) requirements. The buyer should review the current plan document and any required amendments to ensure compliance with current laws and regulations. It should audit each plan's operations to ensure the operations comply with the written plan document.

Plan Operations

Analysis of past regular distributions, loans, withdrawals and hardship distributions is necessary to determine proper reporting through IRS Form 1099-R has occurred, necessary taxes were properly withheld and the plan complied with all rollover rules. The reviewer should verify that participant 401(k) deferrals and employer contributions were timely deposited into the trust account. For plans permitting participant loans [commonly found in 401(k) plans], the review should identify those loans which are outstanding at closing. In addition, the buyer should determine whether the loans will be continued post-closing, treated as participant distributions or become immediately due and payable at the closing. The buyer should ensure the plan passes nondiscrimination testing and no participant has contributed, nor has the company contributed on the participant's behalf, more than the allowable contribution limits.

Fiduciary Obligations

The review should examine the plan's fiduciary standards compliance. In doing so, the plan's trustees, investment managers, administrators and investment committee members must be identified. Any fiduciary liability insurance should be examined, and the buyer should confirm the necessary individuals are bonded. Each retirement plan should have an investment policy statement

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available for review, along with investment committee meeting minutes, to substantiate that the committee's members properly exercised their fiduciary obligations by reviewing investments before making selections and, thereafter, monitoring such investments' performance. The buyer should confirm that there were no prohibited transactions among the plan, target company or plan fiduciaries, such as a loan from the plan to the company. Finally, the review should determine that the plan is not currently subject to an IRS or DOL audit, nor is it engaged in any threatened or filed lawsuits.

Plan Funding for Defined Benefit Plans

Defined benefit plan reviews require steps in addition to those above. Defined benefit plans are required to maintain certain funding levels. As such, the buyer should review actuarial reports to ensure defined benefit plans are adequately funded, with no current or past due contributions. The review should confirm compliance with all PBGC filing requirements and premium payments and that potential union plan withdrawal liability was considered.

Funding Issues for Multiemployer Plans

Multiemployer plans are created through collective bargaining between employers and unions. Covered employees are generally hourly wage earners, and contributions are typically made on a per unit of work basis, such as a specified amount per hour of work or per employee per month. Benefits are generally based on length of service and hours of work, rather than being pay related. Contributions are made to an entity distinct from the contributing employers and unions—the plan's trust fund. The plan trustees oversee the investment of plan assets, and administrative expenses are paid from these assets. Usually, the plan is governed and administered by a joint board of trustees, with equal representation appointed by the employers and the union(s). When a contributing employer leaves a multiemployer plan, the employer is liable to the plan for a share of its unfunded vested benefits. The law sets out rules for determining the withdrawing employer's liability, with special provision for industries, such as construction, where employers may come and go as they start and complete projects, without impairing the plan's financial base. Various provisions limit withdrawal liability, including a *de minimis* rule and special limits for employer liquidations. Withdrawal liability can flow through to the buyer of a former contributing employer, even for asset purchases. Therefore, if the target has contributed to a multiemployer plan, careful

calculations must be performed to determine what, if any, withdrawal liability may be assessed.

Options for the Target's Retirement Plans

Once due diligence is complete, the buyer may utilize various strategies for the target's retirement plans.

Representations and Warranties: The buyer will want the target to make representations and warranties based on the due diligence findings. The target should affirm that all retirement plan documents and information requested was made available for review. The target should warrant that it will indemnify the buyer for undisclosed liabilities that arise over a certain period subsequent to closing. Potential liabilities discovered during due diligence are typically separately negotiated in the purchase document or are accounted for in the sales price.

Plan Adoption: In addition to negotiating responsibility for potential liabilities, the buyer must decide if it will continue the target's retirement plans. In some cases, the buyer may be able to adopt the plans as they are in effect with the target.

For asset purchases, the buyer usually assumes the liabilities incurred post-closing; therefore, strong indemnification provisions for pre-closing liabilities may be required. For defined benefit plans, the parties should delineate the responsibility of each party for that year's funding obligations. For any retirement plan, the target company often remains responsible for contributions up to the closing.

In stock purchases, the buyer will be responsible for the plan's pre-closing operations, making indemnification provisions even more important than in asset purchases. The buyer is normally responsible for all contributions in the acquisition year, and this should factor into the purchase price. If, after conducting due diligence, the buyer determines that the plan's risks and liabilities are too numerous, it may consider requiring the plan's termination pre-closing.

Plan Spin-offs: In asset purchases, buyers often do not acquire the entirety of the target's business. The buyer may, instead, acquire only a certain division or operation of the target. Here, the parties may split the target's plan into separate plans so the buyer assumes the plan's operations for the acquired employees, while the target remains responsible for the remaining employees. Spin-offs are fairly straightforward for defined contribution plans. However, for defined benefit plans, the

buyer must carefully consider the actuarial calculations as both plans resulting from the spin-off must meet minimum funding obligations.

Plan Merger: For administrative ease, buyers, regardless of transaction type, often merge the target's plans into their own. This merger combines assets of both plans, making due diligence critical because, if the target plan's operations jeopardize its tax-qualified status, a merger will taint the buyer's plan assets, jeopardizing its tax-qualified status also. When mergers occur, certain aspects of both plans must be preserved, and, for defined benefit plans, participants must be guaranteed certain benefits if the plans are terminated within five years of the merger.

Plan Termination: Regardless of transaction type, the parties may agree to terminate the target's retirement plans. Often, termination occurs when the buyer, after conducting due diligence, determines the target plan's potential liabilities are too great or the target's plans are outside the scope of the buyer's current plans. In either case, these terminations are best done pre-closing, as current regulations limit the ability to terminate plans post-closing. Additionally, retirement plans must fully vest all participants upon termination.

Partial Termination: When the buyer purchases a target's division or operation or when a certain number of the target's employees (usually 20% of the employees not fully vested) is terminated, a partial termination occurs. Here, all participants terminated must be fully vested in the plan. Additional liabilities due to increased benefit obligations may result.

Health and Welfare Plans

Along with retirement plans, health and welfare plans play an important role in a company's benefit package. Most consider the medical and prescription coverage (often referred to collectively as the "health plan") the centerpiece of a health and welfare plan package. However, companies increasingly offer other health and welfare benefits, including dental and vision coverage, life insurance, disability insurance, cafeteria plans containing health care and dependent care flexible spending options, medical expense reimbursement plans (MERPs), employee assistance programs (EAPs), long-term care insurance and specialty insurances covering certain diseases like cancer. Some companies also provide retiree medical insurance.

Fully Insured Plans

A company's health plan may be fully insured or self-funded. Fully insured health plans are insured by an insurance company. The insurance policies are not subject to ERISA, but, instead, must comply with various state insurance laws where the insurance company operates. Grandfathered plans (plans in effect prior to enactment of health care reform on March 23, 2010) that are fully insured are not required to pass nondiscrimination testing, but plans established after health care reform's enactment must pass such testing.

Self-funded Plans

Self-funded health plans are those for which the company is responsible for the payment of claims, though an insurance company commonly administers the plan. Companies with self-funded plans usually maintain stop/loss coverage to cover a participant's claims that rise above a certain level in a plan year. (Note that a plan is self-funded even if it has a stop-loss or reinsurance policy.) Self-funded plans are subject to ERISA and must pass nondiscrimination testing regardless of their grandfather status.

Health and Welfare Plan Review

A health and welfare plan review (including reviews of cafeteria plans and MERPs) should begin with the plan documents and SPDs to ensure compliance with all laws, including older laws like COBRA and HIPAA and newer laws like the Genetic Information Nondiscrimination Act (GINA) and the Mental Health Parity Act. Depending on the plan year and grandfather status, health plans must comply with various health care reform provisions at different times, and any review should determine the plan's compliance with such requirements.

For self-funded plans and cafeteria plans, the buyer should confirm the plan has passed all nondiscrimination testing and the Forms 5500 have been filed, as necessary. A fiduciary review is necessary to ensure no fiduciary breaches, like prohibited transactions, exist. In a self-funded arrangement, the buyer should confirm timely deposit of employee contributions. Any operational audits or dependent eligibility audits should be analyzed to ensure benefits were adequately paid or denied, as applicable. The buyer should also determine that the target did not improperly deny any claims.

For all plans, including those outside the health plan scope like specialty care insurance and EAPs, all insurance contracts and service provider

Potential liabilities discovered during due diligence are typically separately negotiated in the purchase document or are accounted for in the sales price.



contracts must be reviewed to ascertain each contract's obligations. Some contracts will require the other party's (e.g., the insurance company or the administrator) consent before the buyer assumes the contract. This is a particular concern in asset purchases because the buyer assumes the contract in its name, while the same company would continue the contract in a stock purchase.

Retiree Medical Coverage

If the health plan provides retiree medical coverage, the buyer should ensure reporting compliance. The buyer should determine whether the plan allows the employer to terminate the retiree medical coverage. If the transaction is an asset sale, negotiation of these liabilities is important as the target will want the buyer to continue the coverage, while the buyer will want to limit its liability.

COBRA Rights

COBRA rights should be examined for the target's employees who are terminated prior to, or in connection with, the acquisition. Their individuals and their covered dependents are referred to as "COBRA M&A Qualified Beneficiaries." For stock purchases, the buyer must offer COBRA to such employees if the target terminates all health plans due to the transaction. In asset purchases, the buyer must extend COBRA coverage if the buyer is a "successor employer" (a company that continues the target's business) and neither the target nor any member of its controlled group of companies maintains any group health plan. The party responsible for providing COBRA coverage may be negotiated in the purchase document. Also, to the extent the buyer will be assuming COBRA coverage for M&A Qualified Beneficiaries, it may want the target to escrow funds to reimburse the buyer for the difference between the COBRA premiums and the actual medical expenses by the buyer's health plan.

Disability Benefits

For companies providing disability benefits, the buyer must determine the extent of the benefits provided. Often, parties will negotiate to share disability claims through a certain period because disabilities may, at least partly, arise due to the target's operations.

Options for Target's Health and Welfare Plans

A buyer's options for the target's health and welfare plans are minimal. The buyer may continue the target's

health plans and allow the acquired employees to continue to participate, or it may have the target's health plans terminated and allow participation in its own health plans. COBRA coverage may be required in certain circumstances. The buyer will not jeopardize its grandfather status if it admits the acquired employees into its health plan. Other considerations with respect to the target's health and welfare plans include whether to provide credit to the target's employees for year-to-date deductible and out-of-pocket medical expenses and how to handle health care reimbursement account amounts.

Executive Benefits

Many agreements contain deferred compensation. Golden parachutes, supplemental executive retirement plans (SERPs), change-of-control agreements and employment and severance agreements are common for executives and management-level employees. Stock option plans, phantom equity plans and other equity grants are deferred compensation arrangements available to particular employee classes or certain hand-picked employees. Deferred compensation is not subject to nondiscrimination testing, but must meet strict requirements imposed by Code Section 409A. These arrangements are unfunded, payable only from the employer's general assets.

Deferred Compensation

Deferred compensation arrangements are not necessarily concentrated in single plans. Instead, these arrangements may be in numerous contracts between the company and single employees. The buyer should review all these contracts.

The most significant issue for deferred compensation arrangements concerns Code Section 409A. The buyer should review such arrangements to evaluate potential liability or indemnification provisions for arrangements that are not Code Section 409A compliant. Additionally, key employees of public companies are subject to a waiting period before they may receive compensation. The examination should consider any arrangements that provide for a change-in-control, as either transaction type may cause a change-in-control to occur and trigger payment provisions.

The buyer should also confirm that top hat plans (those deferred compensation plans for a select group of management or highly compensated employees which seek to be exempt from Title I of ERISA) meet the DOL's top hat filing requirements. For public companies,



financial statements should be reviewed to determine whether executive compensation is properly accounted for under FAS 87 and FAS 88.

Options for Target's Deferred Compensation Arrangements

The buyer's options for the target's deferred compensation arrangements are limited. Often, change-of-control provisions will trigger payments when the transaction closes, terminating such agreements. In stock purchases, the buyer should consider the arrangements that may continue post-closing and negotiate the purchase price accordingly.

Other Executive Benefits

Aside from deferred compensation arrangements, many executives receive additional benefits and protections, such as payments upon a "change in control," stock options, long-term incentive or bonus plans and restricted stock. All agreements between the target and its executives should be examined to determine if the contemplated transaction will trigger additional payment or accelerated vesting of options or restricted stock. There are also two serious tax complications to consider. First is Code Section 280G which contains "golden parachute" provisions. Target corporations may not deduct excess change in control payments made to executives and Code Section 4999 imposes a 20% excise tax, in addition to ordinary income tax, on the executive who receives the payment. Many change-of-control agreements contain "gross up" provisions whereby the company agrees to gross up the executive for any parachute payment excise taxes. Both the parachute payment and the gross ups can be costly items which the buyer should consider in evaluating the price of the target.

The other serious tax consideration for executive payments applies only to public companies. Code Section 162(m) limits deductible compensation to \$1 million for each of the five most highly compensated officers, unless the compensation is considered "performance-based." As a general rule, performance goals may not be changed during the performance period. It may be possible to change performance goals for stock-based compensation in connection with the transaction, but there is no such authority for other types of performance-based compensation. Additionally, Section 162(m) requires certain aspects of performance-based compensation to be approved by shareholders and the buyer will want to carefully consider how those shareholder approval requirements apply to the transaction.

Conclusion

To be sure, human resources are important for integrating new employees resulting from an acquisition. However, it should serve an important role in the due diligence process and negotiation of the acquisition. Typically, a company's human resources professionals are the in-house experts on the operations of the buyer's plans, and they can aid in the process of determining how similar the target company's benefits are and identifying potential pitfalls. Therefore, human resources personnel, particularly at the director level, should be involved in an acquisition as early as possible. ↗



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