Mergers and Acquisitions (M&A) happen every day in this country, but many do not understand the complexities and unintended consequences from these deals. Unfortunately, employee benefits are not given adequate consideration which can cause chaos and confusion post-deal. Benefits lawyers understand these complexities and should be brought to the table as soon as possible. It is also helpful to include HR professionals in the conversations with access to the confidential data rooms so benefits like 401(k), ESOP, medical, compensation, and equity compensation are part of the conversation. It is important for the lawyers to understand the risks and benefit issues surrounding the benefits already offered by the target company.

Asset or stock sale?

In an asset sale the buyer just buys assets from the target company. It is attractive to acquirer’s because they usually do not assume the liability of the target’s employee benefit plans. The acquirer will have to compare their current benefits to that of the target. This frequently requires prior service credit for Plans and can get especially complex when it comes to medical plans which is beyond the scope of this article.

If the deal is a stock sale the acquirer purchases the stock of the target with full ownership of the legal entity. Typically, the buyer will assume the liability for the target’s benefit plans and the target’s employees become employees of the acquirer. If the obligations of these benefit plans are significant they can impact deal structure. The buyer should know if the target has or is undergoing a DOL or IRS audit. If there are findings or agreements with the regulators this could impact negotiations. Generally, acquirers will prefer an asset sale, but a stock sale could be best if there are multiemployer Plans involved.

Corporate Structure

It is always critical to know which of the target’s entities actually sponsor the employee benefit plans. Generally, the target’s 401(k) Plan will need to be terminating before closing the transaction. It can get complicated if the 401(k) is maintained by a parent company and the corporate transaction only involves a subsidiary. The Employee Retirement Income Security Act (ERISA) and the IRS treat two of more related entities as one employer for some purposes. The liabilities of the target may include liabilities for qualified plans sponsored by members of the controlled group. Two or more employers represent a controlled group when a “parent-subsidiary” or “brother-sister” relationship exists. A parent-subsidiary relationship exists when one company owns 80% or more of another company. A brother-sister controlled group is a group of two or more corporations, in which five or fewer common owners (a common owner must be an individual, a trust, or an estate) own directly or indirectly a controlling interest of each
It is important to understand who the members of the target’s controlled group is because target’s liabilities may become liabilities for members of the acquirer’s controlled group. Even if the acquirer is not buying the entity sponsoring the Plan, the target may have residual liability for other Plans maintained within the controlled group. Non-compliance including prohibited transactions audit/tax penalties can cause havoc for the parties involved, but can be resolved through IRS or DOL correction programs. The best practice is for the acquirer to take the time for a compliance review of the target’s Plans before closing. However, tight transaction timelines make it tough for conduct a full audit of employee benefit plans so the buyer may have to rely on compliance representations in the transaction document. No matter what the acquirer should require the target to represent that each employee benefit plan is administered according to Plan terms and regulations. Any tax-qualified retirement plan like a 401(k) or ESOP should be qualified.

Here is a diligence checklist for tax-qualified retirement plans:

1) Demand the most recent determination or opinion letter and confirm that the plan document has been updated to comply with any changes in qualification requirements since the last determination letter. 401(k) prototype or volume submitter plans should have opinion letters and should not pose issues, but determination letters are not issued quickly so if the target’s plan does not have one it will not be able to rush one before transaction close. Plan fiduciaries should also be identified. Service provider agreements, investment policies, Committee minutes, and fiduciary liability insurance policies should be reviewed. Special attention should be given to making sure there are no prohibited transactions between the Plan and any fiduciary.

2) Ensure reporting and disclosure compliance by reviewing Form 550 and all Related Schedules, plan documents, Summary Plan Description (SPD), Summary of Material Modifications (SMM), Summary Annual Report (SAR), contribution activity, 401(k) safe harbor notices, fee disclosures and other important plan documentation.

3) Review plan administration carefully. All plan compliance testing should be reviewed such as 410(b) coverage testing, 401(a)(4) nondiscrimination, ADP/ACP testing for non-safe harbor 401(k) plans, 415 annual additions, late 401(k) deposits, and distribution reports. It is important to ensure that a partial plan termination as a result of a past layoff or other event was not overlooked. There are many 401(k) volume providers that do no have an adequate review process which can create headaches in the future.

4) Ask if the Plan has ever been audited or investigated by regulators like the IRS or DOL. If the Plan ever went through a correction program under the IRS (Employee Plans Compliance Resolution System) or DOL (voluntary fiduciary or delinquent filer programs), compliance and resolution must be confirmed. If there is a pending investigation, the acquirer needs to understand the potential costs for the transaction negotiation.

5) Buyers frequently require targets to terminate their 401(k) plans as a closing condition. If a 401(k) plan is terminated without the buyer having their own defined contribution plan (other than an ESOP), participants will receive lump
sum distributions after termination. Determination should be clear as to which party will terminate the plan and make distributions. Usually this responsibility will be target’s which can be problematic if people leave or are let go post-transaction. If the employees of the target participated in a Plan maintained by an affiliated entity, it will usually not be feasible to terminate that Plan before the transaction closes because other employees of the affiliate could be impacted. In the case of an affiliate situation, the target’s participants can roll over their balances into the buyer’s Plan or a Plan to Plan transfer could take place. However, beware of the plan transfer. Direct transfers can carry over problems like administrative error into the successor plan. Therefore, distributions are a best practice. All parties must be careful to comply with the anti-cutback rule of IRS Section 411(d)(6) which protects benefits like early retirement and subsidies that may be in the target’s plan. If the Plan(s) will be terminated, impacted participants will become fully vested. The Plan(s) must be certified as being fully compliant within IRS Code Section 401(a) as of the date of termination.

6) Plan loans may become due and payable upon distribution and the tax impact should be fully understood and communicated as soon as possible. Acquiring parties frequently permit loans to be included as part of the rollover to avoid loan defaults. This could require the buyer to make a plan amendment and it is critical to coordinate with the Third Party Administrator (TPA) early on. Alternatively, the buyer could offer a “bridge” loan to participants to pay off the old Plan loan, execute the rollover and then set up the new loan in the buyer’s Plan. This would involve administrative hassles, interest rate considerations, and other hassles so it is not recommended.

7) There are filing required in these situations. An ERISA 204(h) notice must be provided to participants at least 45 days (15 days for plans < 100 participants) before the effective date. This puts the participants on notice for a possible reduction in the rate of benefit. The plan sponsor must also file IRS Form 5310-A at least 30 days before assets are transferred. This is a notice of Plan merger, consolidation, spinoff, or asset transfer. Attorneys typically handle this filing.

**ESOP Considerations**

An employee stock ownership plan, or “ESOP,” is a company-sponsored retirement plan that invests primarily in employer stock. In a typical ESOP, the employer’s cash outlay for the ESOP benefit occurs when ESOP participants receive a distribution. At this time, the ESOP will either distribute stock and the employer will purchase that stock or the employer will make a cash contribution to the ESOP to fund a cash distribution. This contribution and/or distribution and purchase are the “repurchase obligation.” Because the repurchase obligation is delayed, an ESOP can be a tax-efficient corporate financing tool for mergers and acquisitions. When using an ESOP in a merger or acquisition, it is important to consider certain administrative issues that influence the cost of the transaction and the ongoing combined company responsibilities and culture.

There are special qualification, distribution timing/form, and pass through voting requirements involved with an ESOP so diligence is even more extensive. The vast
majority of ESOPs are privately-held, but additional SEC requirements, registration statements, Securities Act compliance, prospectus and disclosure requirements can take legal costs through the roof.

If the corporate transaction is a merger or sale of assets, ESOP participants must be given the right to vote on the transaction. In this situation the participants will be instructing the Trustee who will then vote the shares on their behalf. A tender offer is a loophole that does not typically require a vote pass through. Some experts feel this was an oversight by lawmakers years ago.

When an ESOP is terminated, whether in conjunction with a merger or acquisition, the law mandates that all actively employed participants, and all formerly employed participants who have not yet received a full distribution of their vested balance or incurred a five-year break in service, must become fully vested. It is usually essential for the ESOP attorney to make amendments to the distribution provisions of the plan document before the plan is terminated. Working with an experienced ESOP attorney and a real ESOP TPA who understand distribution policies is critical to assess if and when distributions should be accelerated.

If an ESOP continues after a merger or acquisition, the ability to extend the vesting schedule is limited. For any participants at the time the vesting schedule is changed, the new vested percentage at each year of service must be at least equal to the old vested percentage at each such year of service. For example, if, under the original vesting schedule, a participant is 100% vested after three years of service, under the new schedule, all individuals who are participants on the date the vesting schedule is amended must be 100% vested after three years of service.

In a merger of two ESOP companies and their Plans, prior service and vesting must be credited for all participants. When a non-ESOP company and ESOP company combine, the surviving company may discontinue or retain the ESOP. When the ESOP survives, participants cannot lose the years of vesting and eligibility service they earned prior to the acquisition. If employees of the non-ESOP company become eligible to participate in the ESOP, the sponsoring company should consider whether such employees’ service before the acquisition should count toward eligibility and vesting. Granting past service credit can be beneficial because it gives current employees an immediate benefit that is probably fully vested. It is important this is communicated effectively by real ESOP experts who know who to motivate people and keep the employees from leaving post-transaction. Crediting past credit service can prevent jealousy and create a team atmosphere, but this vested ESOP benefit has a price. It would increase the repurchase obligation and accelerate the cash flow demands of distributions for this ESOP benefit.

If a seller defers taxation by electing Section 1042 rollover treatment, the ESOP must retain the stock for at least three years from the date of sale, and the ESOP may not be terminated during that three-year window. If the plan is terminated within three years, the employer must pay a 10% excise tax on the fair market value of the stock acquired in a 1042 transaction.
The tax laws also require companies to test their qualified plans, such as ESOPs, on a combined basis. When ESOP companies are bought out, allocations may be accelerated and the Section 415 Annual Additions limits (currently $55,000 for 2018) may be exceeded. The IRS issued a Technical Advice Memorandum (TAM) 9624002 in 1996 declaring that the allocation of these excess amounts will not be considered an Annual Additions violation. The ESOP plan document usually outlines how these excess amounts should be allocated. All qualified plans, including ESOPs, must cover a minimum number of employees. This Section 410(b) compliance test is required individually for each qualified plan. In a merger or acquisition, this test could cause issues. Fortunately, a provision in the law grants a grace period before newly combined companies must deal with coverage testing on a combined entity basis. The grace period allows plans to postpone coverage testing based on the newly combined enterprise until the first day of the second plan year following the transaction. To take advantage of the grace period, the qualified plans must have individually met the coverage requirement before the acquisition and the coverage must not have significantly changed during the grace period. If multiple plans are involved, and if they have different plan year ends, the first plan year end after the transaction determines the end of the grace period. Corporate transactions will usually affect ownership percentages, and any new synthetic equity awards (Stock Appreciation Rights and warrants are typical in an ESOP transaction) to key employees will change compliance testing results. For S corporations, it is important to run a Section 409(p) anti-abuse compliance test before the transaction. This complex compliance test is one that plan sponsors cannot fail, so including your ESOP TPA early on is essential.

It is typical for an independent Trustee to be involved with a corporate transaction involving an ESOP since valuation is under a microscope by the DOL. This independent Trustee Legal advice is needed to determine how unallocated shares are to be cast and other procedural matters. ESOPs are special Plans that allow leverage. The ESOP is permitted to borrow money from the plan sponsor or third-party lender to fund the purchase of company stock and the stock is pledged as collateral for the loan. If the ESOP is terminated as a result of a corporate transaction, the ESOP must use the sales proceeds to repay debt and allocate the stock to participant accounts. Participants usually becomes vested at this time. Leveraged ESOPs add another layer of complexity for the deal team and it is important to work with a bank that has ESOP experts on staff that can understand ESOP loan documents and the implications of the transaction.

Several ESOP administration issues arise as a result of a merger or acquisition. These issues should be considered early on when structuring the transaction to avoid unintended consequences and repurchase obligation surprises. Dealing with real ESOP experts will ensure smooth sailing and ESOP success.

**Equity Compensation**

The 2017 Tax Cuts and Jobs Act includes new regulations that make it easier for employees of privately held companies with illiquid stock options or Restricted Stock Units (RSUs) to exercise and not pay tax until a transaction or other liquidity event. Now
these employees have up to five years after termination to sell their shares granted under these plans before paying tax. There is a 30 day election requirement similar to the 83(b) election rules, but the major advantage is that they could have left the company. However, the awards must be broad-based and available to 80% of the workforce which could limit the application since most private companies do not issue equity compensation in a broad-based manner. Neither restricted stock or Synthetic equity like Stock Appreciation Rights (SARs) or phantom stock are covered under the new tax reform bill.

Due diligence of equity compensation programs is just as important as the other plans. All equity plan documents and agreements must be reviewed by an attorney experienced in equity compensation. A full census of outstanding awards and details including shares, grant date, vesting schedule, strike price, acceleration provisions and expiration dates for each employee with an award must be examined. Restricted stock, RSUs and SARs should all be reviewed for Code Section 409A compliance. Stock options must have an exercise (strike) price equal to or greater than fair market value on the date of grant to be exempt from 409A. Incentive Stock Options (ISOs) are automatically 409A compliant since their exercise price is always at fair market value per the rule under Code Section 422. The equity attorney should make sure ISOs are compliant with all of the 422 rules, including granting only to employees, 10 year term, special 5 year term and 110% of fair market value for 10% shareholders, and ISO split dollar limit rules. For private companies, the independent valuation report should be examined to verify that the ISOs were not discounted. There are also filing and state “blue sky” requirements for private companies. Public companies should have an S-8 registration statement and prospectus available for review. Finally, board resolutions should be read to make sure that the grant dates match the board approval dates and that share limits were not violated.

Extra attention should be paid to the “change in control” definition in the equity compensation plans to determine if vesting and payment is accelerated. The transaction could be the sole trigger or there could be another event beyond the transaction like an involuntary termination within a specified time period triggering vesting and payment. Transaction agreements usually specify how equity compensation awards will be handled. If the awards are terminated, the employee will usually be cashed out at the transaction purchase price net any exercise or strike price. If the transaction is a stock sale, then documents should be clear how pre-transaction stock option exercise will be treated. If stock options are underwater (transaction price is less than the exercise price), a value determination should be made. If no payment is given for the underwater options, the employee may still have to consent to the option being canceled. If the equity awards are assumed by the buyer and not terminated, there is usually adjustment in the terms. This could result in accounting modification or ISO disqualification and is probably not worth the hassle and consequences. In asset sales, the target may want to extend the life of a stock option. Proceed with caution because this could disqualify an ISO. Lawyers need to decide if any of the actions surrounding equity compensation require employee consent.
Nonqualified Deferred Compensation Plans

Typically, nonqualified deferred compensation plans are not funded and the company pays benefits out of cash flow. Some are protected by a “rabbis trust” with corporate owned life insurance (COLI) with assets segregated, but they are still subject to creditor claims. It is important for the deal team to gather these documents and statements so they can fully understand the potential liabilities for the negotiation. Reporting and disclosure compliance with these plans must also be reviewed to avoid potential penalties.

Careful attention should be paid to Section 409A compliance that involves compensation in one tax year that is paid in a future year. Evidence of the specific 409A requirements in time and form of payment must be shown to the deal team and special attention is applicable for public companies. Failure to satisfy 409A for deferred compensation can result in full tax at vesting for the employee plus a 20% excise tax, interest and possible withholding penalties. In the world of 409A with M&A, there are two typical triggers: (1) change in control and (2) separation from service.

Most deferred compensation plans will include a definition of “change in control”. If the transaction is deemed a change in control for 409A purposes, immediate vesting is typical, but careful review by the attorney is essential to make sure that the 409A definition is the same as the plan’s definition. The 409A definition is often more strictly defined than in the plan. Beware of adverse tax consequences to the employee in the event that distribution payment is necessary. Regulations require that the plan be terminated within 30 days before or 12 months after a change in control and that all similar plans be terminated so there is no discrimination. If termination occurs after the deal closes it could create problems because then the buyer’s deferred compensation plans would have to be terminated too.

If employees are “separated from service”, distributions will probably be triggered. Employment and severance agreements will need to be reviewed thoroughly to avoid unintended consequences. It is important to understand if a separation from service under 409A is a payment trigger. In an asset sale, employment transfer to the buyer may be a separation from service. A stock sale does not usually trigger a separation from service. All employees must be treated the same, but 409A does allow the parties involved to specify if the transaction causes a separation from service. Spinoff transactions are usually not considered a separation from service.

Healthcare and other Plans

It is important to have attorneys involved in any corporate transaction who understand health and welfare benefit plans. The buyer needs to pay similar attention and care given to retirement plans to health and welfare plans involved. Compliance problems or
liabilities need to be identified before closing. Notice to insurance companies of the
transaction is important and the insurance contract needs to read in detail before
negotiations are settled. Plan documents, nondiscrimination testing, Form 1095-B and C,
1094-C, Form 5500 and Related Schedules, SPDs, SMMs, summary of benefits and
modification notices, COBRA notices, HIPAA agreements and claims should all be
reviewed by the benefits attorney and issues should be discussed pre-transaction. There
could be traps for the unwary if the seller’s medical plans are self-insured so full
disclosure is important. The Affordable Care Act (ACA) involves steep fines of up to
$100 a day for noncompliance so additional time care is necessary now that did not exist
pre-ACA. ACA policy and procedure manuals should be reviewed and evidence of
compliance should be documented.

Retiree medical and life insurance benefits must also be examined by the benefits
attorney and could involve significant liability. Sometimes the buyer has to require the
seller to amend or terminate these benefits before closing which could trigger additional
fees or penalties. Flexible Spending Accounts (FSAs) must also be reviewed and often
involve use it or lose it implications for employees. The IRS permits two methods for
managing FSAs when a transaction is mid-year: a) employees contribute to the buyer’s
plan, but carry over their account balances using an asset transfer method or b) the seller
retains the FSA and the buyer makes contributions from employees to the seller for the
balance of the year post-closing. It must be determined which entity is responsible for
providing COBRA coverage too. Regulations dictate which party is responsible based on
the structure being an asset or stock sales. There are many other tips and traps involved in
this area which are beyond the scope of this article.

It seems like every company has little “secrets” with some employees. Secrets could
include special severance agreements or special bonuses. Employment agreements should
be reviewed to comply with specified change in control instructions. Target companies
may have to make change in control payments to key employees to assist with the
transaction and stay engaged throughout the process. The buyer needs to understand these
special deals and they may have to offer retention incentives to these same employees
post-transaction. Bonus programs need to be understood and possibly kept in tact for
retention and morale post-transaction. The buyer will be responsible for severance
payments in a stock sale transaction which usually prompts negotiation with the target
and could involve terminating or amending employment agreements. If the target’s
welfare benefits plans are subject to ERISA, all reporting and disclosure Form 5500 and
all Related Schedules must be reviewed. If filings are delinquent, immediate efforts
should be made to enter a DOL delinquent filer program. Parachute payments and
Defined Benefit plans are rare these days and beyond the scope of this article.

**Lawyer Up**
The transaction team should include at least two additional lawyers to make sure
employment law issues and separate employee benefit issues are considered during due
diligence. It is unusual to find a lawyer with knowledge that broad. Employment law
issues could include termination implications, union issues, litigation or future DOL/IRS
audits. A timeline with responsible parties identified is always helpful. Timelines and
accurate cost estimates for transactions should include milestones for each discipline to avoid future problems and surprises.

Everyone involved including the attorneys should determine if plan amendments or board resolutions are required before closing the transaction. If the target’s qualified plans merge into the acquirer’s plans and assets are transferred in, filings are required and it is important to get the Third Party Administrator (TPA) involved. There are specific requirements for the target’s Plan termination and the buyer usually wants that to happen before the transaction closes. Distribution processing is typically accelerated so employees impacted can roll over assets into the new Plan or to an IRA.

It is important to have employee benefits lawyers review the transaction agreement’s employee benefits representations and warranties, operating covenants, and post-transaction covenants. Expensive employee benefits matters could add up and result in enhanced representations and warranties. The indemnification and escrow provisions in the agreement are very important. The target could be required to indemnify the buyer for problems discovered after the deal closes. Expenses could be covered up to a certain limit before the indemnification provisions apply. However, if the buyer is purchasing the entire company, these indemnification provisions may be moot. In this situation it is critical to identify and quantify these liabilities early on in the process before the purchase price is set. It is usually helpful to have full disclosure schedules drafted and compared side by side to the transaction agreement to ensure all items are included and accurate. Target attorneys should ensure that employees are protected in post-closing covenants. It is clearly a lot of work and takes a village to ensure a corporate transaction is successful long-term, but with careful planning and staffing a mutual “win” is achievable.