

# Employee Benefit Issues in Mergers and Acquisitions

John C. Hughes

Companies that are involved in merger and acquisition (M&A) activity should consider and address many issues to avoid assuming potentially substantial liabilities and to avoid creating new liabilities with regard to employee benefit plans.

This article looks primarily at M&As involving Internal Revenue Code (Code) Section 401(k) plans given that such plans present many concerns. The article explores other types of “qualified” plans, health care plans, and “nonqualified” deferred compensation plans.

In summary, it is critical that the buyer and seller engage in due diligence to understand the plans that exist and discover any problems, review and negotiate the terms of the purchase agreement, and take appropriate pre- and post-close actions to avoid creating problems and to facilitate any future plan mergers.

## Stock purchase versus asset purchase

Whether the transaction is structured as an asset purchase or stock purchase is a threshold issue that affects all pre-close and post-close activities.

In an asset purchase situation, the target company (i.e., the seller) remains intact, but sells all or most of its assets to the buyer; for example, its contracts, equipment, facilities, etc. The employees usually cease to work for the seller after the close of an asset sale, and are hired by the buyer. The buyer essentially takes over the seller’s operations, but the seller’s business form (e.g., the corporation) continues to exist on its own and is still owned by the sellers (at least in the short term, as

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often the remaining business entity is soon dissolved). The buyer does not actually buy the business entity, it buys the operations.

With a stock purchase situation, the buyer actually buys the target company; the buyer becomes the owner of the stock (or other ownership interests). While there are several complicated variations, a good example is the classic parent-subsidiary situation where the buyer is the parent and becomes the owner of all of the interests/stock of the seller’s business entity. This makes the two entities part of the same “controlled group,” and thus a single employer for many plan purposes.<sup>1</sup>

With an asset purchase, the employee benefit plans will generally stay with the seller (particularly, qualified plans). This is because it is that business entity who is the sponsor of those plans, and if the business entity itself does not go anywhere, then neither do the plans. In a stock purchase situation, the plans go to the buyer, or more precisely, they stay with the company whose stock is acquired by the buyer.

An asset deal can be structured so that the plans go along with the sale generally by amending the plans

to change the identity of the plan sponsor; however, this is atypical (although, sometimes the plans come along in an asset deal by accident; that is the buyer takes over operation of the plan thinking that it has acquired the company). A greater level of due diligence is usually necessary in a stock deal because the parent company buys the liabilities associated with its new subsidiary’s plan. If there are problems with a qualified retirement plan, the potential penalties will often be in the form of monetary penalties to be paid by the new owner based on a percentage of plan assets.<sup>2</sup> Even a small qualified plan will usually have several million dollars in assets. As such, the penalties to the buyer are potentially significant. It is the company that pays those penalties (or losses a plan suffers), not the plan. Also, sometimes a plan will have a problem that will require the employer to make corrective contributions to the plan participants.<sup>3</sup> It is not at all inconceivable that such corrective contributions could amount to millions of dollars. The plan and the employer (and individual fiduciaries) could also be sued for mismanagement.<sup>4</sup> This also will be the buyer’s liability (and that of the individual fiduciaries).<sup>5</sup>

## Due diligence and pre-close activity

When the owners of companies begin to negotiate a purchase or sale, the process that kicks off is referred to as “due diligence.” In general, due diligence involves a close review and analysis of the target company’s assets and liabilities. The potential buyer gathers massive amounts of information in an effort to gain a more complete understanding of the target company.

Typically, the process is initiated by the buyer submitting a very long list of questions and document requests. The list is aimed at all aspects of the target company’s operations, not just issues involving employee benefits. A portion of the questions and requests are aimed at discovering information about the buyer’s employee benefit plans; for example, plans that are “qualified” under Code Section 401(a) such as 401(k) plans and defined benefit plans.<sup>6</sup> The requests should also seek information regarding health plans and “nonqualified” deferred compensation plans.

The objective relative to employee benefit plans is to identify the plans that exist, as well as to identify potential problems and liabilities. Another objective is to gain an understanding of the plans so that actions can be taken to either properly integrate a seller’s plans with the buyer’s plans, or to properly avoid integrating the seller’s plans.

### Requests for information/ due diligence list

As mentioned, the due diligence process will begin with a long list of requests for information and documents. The requests will involve all aspects of the seller’s business. The list of due diligence requests relating

to employee benefit plans will generally include the following (the actual list will be more detailed):

- Identification of all plans, including employment agreements that might constitute nonqualified plans. A nonqualified plan allows a deferral of compensation, but is not subject to the main Code rules governing more common plans such as profit sharing or 401(k) plans. Instead, they might be subject to a different set of complex rules under Code Section 409A.

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- Signed and dated plan documents and amendments (and including older versions of the documents).
- Recent IRS Form 5500 filings. These are annual tax forms that report plan activity.
- Any IRS “determination letters.” These are letters that the IRS periodically might issue to a qualified plan approving the form of the plan (i.e., the language in the plan document).<sup>7</sup> These letters are only issued in response to applications.
- Various notices and disclosures to plan participants such as “summary plan descriptions,” “safe harbor notices,” and fee disclosures.

- Recent annual testing/valuation reports. These are reports issued relative to qualified plans reporting on a plan’s passing (or failing) of various IRS tests aimed at ensuring certain rules and limits are followed.<sup>8</sup>
- Information regarding any known qualification failures. A qualification failure is generally a retirement plan’s failure to comply with the plan terms and the law (specifically, the Code) governing plan operations.<sup>9</sup>
- Information about ongoing or past IRS or Department of Labor investigations or audits.
- Contracts with the various service providers to the plans.
- Information about restrictions associated with liquidating or transferring plan investments.

### The responses

The responses might be provided by email, regular mail, or through a depository where reviews may be made. Most frequently and recently, a “data room” is set up on the internet where the documents are deposited and accessible by the parties to the transaction, their attorneys, and their other advisors.

In many cases, nonresponsive information is provided, and/or several versions of the same unsigned, undated, and/or incomplete documents are provided. This might be an indication that the employer maintaining the plans is “asleep at the wheel,” and thus many problems lurk below the surface. Notwithstanding, it is usually worth going back and asking for the information again or having discussions so that the parties involved understand what exactly is sought and can respond appropriately (or to confirm that the documents requested do not exist).

In this regard, it is important for the buyer and seller to have the right people involved in the due diligence process. For example, a seller might not have someone as familiar with the plans as they could or should be responding to the requests. This will impede the process, and potentially give rise to suspicions regarding status of the plans. Getting the correct professionals involved up front will assist the buyer and seller resulting in a smoother and faster process, saving both parties time and money.

### Common problems and fixes

Review of the information provided through due diligence is primarily aimed at gaining a sense as to whether the plans are operating in compliance with the law. Often, it is apparent early on that the plans are not legally compliant. This can give rise to potentially significant liabilities. For example, if a 401(k) plan suffers from qualification failures, the buyer in a stock purchase will likely become responsible for such problems. The buyer could have several reactions such as seeking to correct the problem, adjust the purchase price, and/or obtain strong indemnities from the seller.

In general, there are a plethora of problems that can and do typically arise. There is a wide spectrum in terms of how to address certain issues. There are also actions that can be taken to correct certain problems under various government programs.

With regard to qualified retirement plans such as 401(k) or profit sharing plans, the types of issues that commonly present themselves include:

- Missing and/or unsigned plan documents and amendments.
- Operational failures. This is when a plans operations do not match the plan terms. For example, the plan document might require a “year of

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service” before an employee becomes a plan participant, but in practice the employer lets the employees in after 30 days of employment.

- Failed annual discrimination testing (or testing not performed as it must be).
- Exclusion of employees from a plan because they are considered part-time or temporary employees.
- Problems associated with related employers participating in a plan (or not participating).
- Issues involving “leased employees.”<sup>10</sup>
- Confirming that the employer does not participate in a “multi-employer” plan and potentially has incurred or will incur “withdrawal liability.” This is a relatively rare occurrence, but typically involves very large dollars.
- Improper previous plan mergers.

### Health plans

With regard to health care plans, the types of issues that commonly come up include:

- Lacking plan documents and/or summary plan descriptions.
- Missed Form 5500 filings. This issue comes up much more in the health plan context because many providers involved with these types of plans are simply unaware of the

requirement and so their clients are in the dark. It happens with even more frequency in connection with the flexible benefit portions of a Code Section 125/cafeteria plans, and with health reimbursement arrangements (HRAs).

- Coverage to retirees under health plans.

### Nonqualified plans

With regard to nonqualified plans, the types of issues that commonly come up include:

- The failure to recognize that the arrangement is subject to Code Section 409A, and the associated failure to then comply with Code Section 409A.
- Payment and deferral elections that are not in conformance with Code Section 409A. Code Section 409A is very strict in terms of deciding when deferred compensation will be paid and when that choice must be made.<sup>11</sup>
- The sale will oftentimes trigger a payment on account of a “change in control.”<sup>12</sup> This needs to be recognized and appropriately addressed.

The two problems that come up with the greatest frequency are missing retirement plan documents and failures to file Form 5500s. Missing

plan documents or documents that have not been updated timely (that is, amended) in response to changes in the law are qualification failures. Many problems can be addressed through government correction programs. These two problems are good examples of how these programs might work in a given situation.

The plan document issue is normally remedied under the IRS correction program known as the “Employee Plans Compliance Resolution System.”<sup>13</sup> The correction requires the payment of a fee to the IRS based on the number of plan participants, and the submission of an application identifying the failures and presenting retroactively effective plan amendments containing the appropriate detail. The fee for the program is far lower than the monetary penalty that the IRS might seek to impose if it discovers the failure itself.

The failure to file Form 5500 could result in monetary penalties of roughly \$1,000 per day that the filing was not made.<sup>14</sup> You do not need a calculator to recognize that several years of missed filings adds up pretty quick. The Department of Labor has a program in place known as the Delinquent Filer Voluntary Compliance Program (DFVCP).<sup>15</sup> Generally, DFVCP involves preparing and making the missed filings and paying a much reduced DFVCP fee. In exchange, the Department of Labor grants amnesty for having made those filings late.

Sometimes, the problems will be so numerous or the potential liability so great that it could prevent the deal from proceeding. Or, sometimes plans are terminated prior to close of the deal. In particular, if the plan involved is a 401(k) plan, if the plan is not terminated prior to close, it will create problems in terms of the later ability of the participants in such a plan to participate in a different plan of the buyer.<sup>16</sup>

### Purchase agreement terms

While due diligence is going forward, a draft of the purchase agreement should be reviewed. With regard to benefit plans it is generally the case that the plans will be identified and “representations and warranties” made by the seller to the effect that the plans are maintained in compliance with the law.

The contract should provide that in the event of a breach of the representations and warranties that the seller will defend, indemnify, and hold harmless the buyer relative to any liabilities that arise relative to

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such breaches. While those types of provisions will protect the buyer, it is still better to attempt to discover liabilities up front and address them. This is because it is usually easier and cheaper to solve problems the sooner they are discovered, and also because the seller may not have funds available later in order to live up to the indemnity provisions.

The purchase agreement might be written to identify a specific problem discovered during due diligence, and go on to provide how the issue will be addressed and who will address it. For example, as indicated above, a 401(k) plan may need

to be terminated before the close. The agreement might specifically provide for such action to be taken, which will decrease the buyer’s exposure to liability and make it easier to allow the employees to participate in the buyer’s own 401(k) plan.

The purchase agreement might contain limitations on the amount of any indemnity owed or when it is triggered. That is, there might be a deductible of sorts; for example, the purchase agreement might state that indemnity is not owed except as to amounts over \$100,000. There might also be a limitation with regard to how far into the future indemnity will be triggered, like a contractually agreed statute of limitations. The purchase agreement might provide for an escrow account or reserves whereby a certain amount of funds are set aside to address contingencies that arise in the relative near term. Obviously, there will be competing interests with regard to negotiation of these issues depending on whether you represent the buyer or seller.

### Post-close activity

Following the close, typically, where the buyer and seller both have 401(k) plans, there will be a desire to merge those plans within about a year. The buyer’s plan usually absorbs the seller’s plan such that only one plan survives. There are specific actions that must be taken to legally complete a plan merger.<sup>17</sup> It is not simply a matter of transferring funds from one plan to another. If plans are not merged within about a year, the two plans could face challenges in terms of passing a nondiscrimination test under the Code known as “coverage” testing.<sup>18</sup>

Additionally, prior to the close, the terms of both plans must be reviewed to ensure that one company does not end up inadvertently participating in the other plan after the close. For example, the seller’s plan might provide that all related com-

panies automatically will participate in the plan. Accordingly, unless the plan is amended, upon the close when the buyer and seller become part of the same “controlled group” under the Code, the buyer’s employees might become participants in the seller’s plan. This is not desired and can lead to qualification failures and other problems given that the buyer’s employees will normally already be participating in the buyer’s plan.


### Conclusion

A multitude of employee benefit plan related issues must be explored by the buyers and sellers involved in M&A activity so that it is understood which parties might be undertaking certain liabilities, and so that the appropriate actions may be taken pre- and post-close to mitigate or avoid problems.

### Endnotes

1. 26 U.S.C. §§ 414(b) and (c).
2. See IRS Rev. Proc. 2013-12, Section 14.
3. See IRS Rev. Proc. 2013-12, Appendix A.
4. 29 U.S.C. § 1132(a)(2).
5. 29 U.S.C. § 1109(a).
6. 26 U.S.C. § 401(a).
7. See, e.g., IRS Rev. Proc. 2007-44.
8. See, e.g., 26 U.S.C. § 410(b).
9. See IRS Rev. Proc. 2013-12, Section 1.
10. 26 U.S.C. § 414(n).
11. See, e.g., Treas. Reg. § 1.409A-2.
12. See Treas. Reg. § 1.409A-3(i)(5).
13. IRS Rev. Proc. 2013-12.
14. See, e.g., 2015 Instructions for Form 5500, page 7.
15. 67 Federal Register 15052.
16. Treas. Reg. § 1.401(k)-1(d)(4).
17. See, e.g., 26 U.S.C. § 411(d)(6) and Treas. Reg. 1.414(l)-1.
18. 26 U.S.C. 410(b).

**John C. Hughes** is a Shareholder in The ERISA Law Group, P.A. in Boise, Idaho. His practice is focused in the area of employee benefits/ERISA. He primarily counsels and assists employers with compliance issues relative to all types of benefit plans. John is the Coeditor-In-Chief of the *401(k) Advisor*, a nationally circulated monthly newsletter on issues relating to 401(k) plans.



## Martelle Bratton & Associates, p.a.

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950 W. Bannock St. Ste 950 | Boise, ID 83702  
Phone: (208)319-2600 | Fax: (208)319-2601

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