EMPLOYEE BENEFIT PLAN CONSIDERATIONS IN MERGERS & ACQUISITIONS

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Topics for Discussion

- Overview of M&A Transactions
- 401(k) Plans, Defined Benefit Plans and Welfare Plans
- Collective Bargaining Agreements and Multiemployer Plan Withdrawal Liability Issues
- Selected Plan Assumption Issues
- Plan Defect Issues and Selected Litigation Issues Related to M&A Transactions
- Other employee-related issues beyond the scope of this presentation:
  - Executive employment agreements and non-qualified deferred compensation plans and SERPs
  - Equity awards
  - Change in control agreements and 280G excise parachute payments
  - ESOP-specific issues and foreign benefit and ex-pat plans
  - Employment law issues, including employee misclassifications

M&A Transactions – Where to Start

- What type of transaction is it?
  - Asset
  - Equity/Merger
  - Spin-Off
  - Joint venture
- What employees and employee benefit plans are involved in the transaction?
  - Is there a collective bargaining agreement/union?
- What does Buyer want to happen with respect to Seller employees and their benefits?
- What does Seller want to happen with its employees and their benefits?
- Is HR "in the tent"?
- Other considerations particular to the transaction?
  - Which party is driving the transaction? Is it is bid situation?

M&A Transactions – Transactions Generally

- Asset Transaction - Generally:
  - Buyer is acquiring assets from Seller
    - Seller continues to exist after closing
  - Buyer may offer employment to some or all of Seller's employees who are connected to the assets being purchased
  - Seller benefit plans stay with Seller and Seller employees hired by Buyer are covered by Seller benefit plans
    - However, Buyer may agree to assume Seller plans
  - If union employees, Buyer may be required to enter into a collective bargaining agreement ("CBA")
  - Representations and warranties are more limited than with an equity transaction
  - Restrictions in "conduct of business" provisions may apply to Seller's ability to hire, enter into CBAs, increase compensation and change benefits

M&A Transactions – Transactions Generally

- Equity Transaction - Generally:
  - Buyer is acquiring Seller or a subsidiary of Seller
    - Could be a “merger of equals”
  - Employees of Seller will become Buyer employees by operation of law
    - What if a subsidiary is acquired and the employees assigned to the subsidiary are employed by another Seller entity? Will the employees by transferred?
  - Buyer gets benefit plans maintained by Seller entity
    - What if a subsidiary is acquired and the benefit plans are maintained by another Seller entity? Will the there be a transfer?
  - If union employees, Buyer will assume the CBA
  - Representations and warranties are more expansive than with asset transaction
  - Restrictions in “conduct of business” provisions may apply to Seller’s ability to hire, enter into CBAs, increase compensation and change benefits
  - There can be additional issues if Seller is in bankruptcy

M&A Transactions – Transactions Generally

- Spin-Off Transaction - Generally:
  - Parent spins-off a subsidiary ("Spinco") into a new stand alone company
    - Both Parent and Spinco exist after the transaction
  - Parent and Spinco create new, mirror benefit plans effective as of the spin
    - If employer stock in Parent 401(k) plan prior to spin, generally there will be both Parent stock and Spinco stock in both Parent and Spinco 401(k) plans
      - Ongoing "stock drop" litigation related to Parent or Spinco 401(k) plan holding stock of other entity after spin
    - Can Spinco get a determination letter for the "new" plan?
    - Will there be plan offsets?
  - If union employees, Spinco will assume or enter into a CBA
  - Can be employee transfer issues to address (service credit & transition services)
  - Restrictions in "conduct of business" provisions may apply to Seller's ability to hire, enter into CBAs, increase compensation and change benefits

M&A Transactions – Transactions Generally

- Joint Venture - Generally:
  - Typically, neither partner has 80% ownership of the joint venture ("JV")
    - JV is not a member of either partner's controlled group
  - Where are the employee?
    - Will JV employees be employed by JV or continue to be employed by partners with a seconding or leasing arrangement?
    - If employees stay with partner employer, then employees continue in same benefits
      - Employee issue if different benefits for similar employees
  - If JV is employer and establishes JV benefit plans, partner will need to determine what benefits will be provided
    - What is the impact on the JV employees' benefits at partner?
  - Partners need to address issues a variety of employee issues – for example, partner equity awards, employment transaction issues, bonuses and welfare benefits/disability

M&A Transactions – Seller Warranties Regarding Employee Benefit Plans

- In equity or asset transaction and Buyer assumes one or more Seller employee benefit plans, Buyer may require Seller to represent and warrant, among other items, the following in the transaction agreement:
  - Seller employee benefit plans, programs and arrangements currently maintained or contributed to by Seller are listed on a disclosure schedule
    - Should it be only "material" plans?
  - Seller has made available copies of its most current plan documents and trusts
  - Pension plans are adequately funded
  - All plans are in compliance with applicable requirements under the Employee Retirement Income Security Act ("ERISA") and the Internal Revenue Code ("Code")
    - Is "material" compliance sufficient?
    - Should there be an express Obamacare compliance representation?
  - Tax qualified plans are so qualified, trusts and VEBA-funded plans are tax exempt
  - Seller has received a favorable IRS determination letter or has a pre-approved plan IRS opinion letter regarding the tax qualified status of each 401(k), profit sharing and pension plan intended to be qualified under Code Section 401(a)

M&A Transactions – Covenants Regarding Employees and Benefits

- Seller may require Buyer to make covenants with respect to its future treatment of Seller employees and post-closing compensation and benefits
  - Buyer covenants can be in both asset and equity transactions and can vary substantially depending on which party is driving the transaction
  - Who can enforce a breach?
- Items that may be addressed:
  - Treatment of employees, including offers of employment if an asset transaction
  - Maintaining a certain level of benefits for a defined period of time (generally 1 to 2 years)
    - What severance is due if terminated during that period
    - Who is responsible for COBRA
  - Service credit for Buyer benefit plans
  - Issues related to disposition/assumption of benefit plans

M&A Transactions – Covenants Regarding Employees and Benefits

- Examples:
  - Buyer will continue to employ all of Seller's employees on the same terms as substantially similar Buyer employees for a defined period
  - Buyer shall provide compensation and benefits no less favorable in the aggregate than those provided by Seller prior to closing for a defined period
  - Buyer shall provide Seller employees with service credit for eligibility, vesting and benefits (other than as will result in duplication of benefits or in a pension plan)
  - Buyer will provide a defined level of severance for Seller employees terminated by Buyer during a defined period (without cause)
  - Buyer shall indemnify Seller and its agents, officers, and directors against any claims asserted by any Seller employee arising from Buyer's acts or omissions after the closing
- Does the covenant result in an "amendment" to the plan or otherwise limit Buyer's ability to make changes to the plan post-transaction?

M&A Transactions – Benefits Due Diligence

- If Buyer will assume Seller's benefits plans, Buyer will want to review the plan documents and related materials in an effort to determine what potential exposure Buyer may be assuming with Seller plans
  - Seller will schedule or list its employee benefit plans, programs and arrangements and employee contracts and make them available to Buyer
- Buyer will also want to review any employment agreements and change in control arrangements, in addition to any severance arrangements
  - Seller will make representations concerning its benefits plans and other employee arrangements and disclosure any exceptions to the representations in schedules
  - Buyer will be particularly interested in any potential liability associated with pension and multiemployer plans, retiree medical and change in control/severance arrangements
- Many times there will be a due diligence document on which Seller will respond to Buyer questions arising from its due diligence review

M&A Transactions – Benefits Due Diligence

- Examples of due diligence items typically requested:
  - Plan documents, including amendments, trust agreement, SPDs and SMMs
  - Most recent Forms 5500
  - Employee benefits handbook and policies and employee communications related to benefits
  - Insurance contracts and third party vendor contracts
  - Employment agreements
  - Determination letters or opinion letters
  - Change in control agreements
  - Severance arrangements
  - CBAs
  - Funding reports for pension plans
  - Information concerning any IRS audits or DOL examinations
  - Information concerning any corrections under IRS or DOL programs

M&A Transactions – Benefits Due Diligence

- Things to look for:
  - Has 401(k) or pension plans been timely amended for law and design changes?
  - Have qualified plans and welfare plans passed non-discrimination testing?
  - Can the benefit plans be amended and/or terminated at any time?
  - Obamacare compliance, including backup documentation to support that it is not subject to a penalty under Code Section 4980H?
  - Is there any retiree medical obligation that cannot be terminated?
  - Will the transaction trigger accelerated vesting or payments under any plans or agreements? What about for equity awards?
  - Is there a Code Section 280G excise parachute tax triggered and or there tax gross-ups under Code Section 280G or Code Section 409A?
  - Employment law issues, including employee misclassifications?
  - Are there any Code Section 409A compliance issues?
  - Is there a CBA and if so what does it require for employee compensation and benefits? What about potential withdrawal liability?

M&A Transactions – Benefits Due Diligence

- Any qualified plan operational issues?
  - For example, plan loans and hardship distributions
- What happens if there is problem discovered after closing?
- Is there is representation and warranty insurance?
  - If so, what does it cover and what amounts?
- Access to benefit records?

Plan Options - Generally

- Generally, there are 4 options with respect to the treatment of a Seller employee benefit plan:
  - Assumption of the plan
    - Buyer to retain Seller's plans in present form
    - Unless Buyer takes other action, this is the outcome in an equity transaction, where the employer remains the same
    - In an asset transaction, by contrast, Buyer must take steps to formalize its adoption of the employee benefit plan
  - Termination of the plan
    - The parties can decide to terminate the plan in connection with the transaction
    - Buyer may thereafter create a new plan that will cover any of Seller's employees hired by Buyer or allow these employees to participate in Buyer's existing plans for its workforce
    - May seek IRS determination letter related to the termination; with respect to defined benefit plans, filings with the PBGC may be required

Plan Options - Generally

- Generally, there are 4 options with respect to the treatment of a Seller employee benefit plan (con't):
  - Merger of the plans
    - Seller's plan is merged into Buyer's existing plan
    - Buyer must make sure that all of the assets of the combined plan are available to pay benefits to participants and beneficiaries of both pre-merger plans
    - Rules regarding plan mergers vary depending upon whether the plans merged are defined benefit plans, 401(k)/defined contribution plans, or both
    - Surviving plan must protect all benefits, rights and features associated with benefits accrued to the date of the merger (for example, distribution options)
    - Merged plan does not have to retain the same provisions with respect to future benefit accruals
    - Merged plan will retain the liabilities of both plans
    - A qualification defect in one plan "taints" the other plan
    - There can be timing issues if one of the plans to be merged is a safe harbor 401(k) plan

Plan Options - Generally

- Generally, there are 4 options with respect to the treatment of a Seller employee benefit plan (con't):
  - Spinoff or Transfer
    - When a transaction involves the sale of only a portion of Seller's business and Seller continues to maintain its plan for its remaining employees, Seller may spinoff or transfer the portion of the plan that covers Seller employees who will become Buyer employees
    - A spin-off results in a new separate plan and thereafter one plan will cover employees remaining with Seller, while the second plan will cover all employees of the division or business that is sold
    - Alternatively, Seller may transfer all assets and liabilities related to Seller employees who will become Buyer employees from its plan to a Buyer plan

401(k) Plans in M&A Transactions

- 401(k) plans are subject to special distribution rules
- Elective deferrals and Roth 401(k) contributions can only be distributed upon the following events:
  - Severance from employment, death and disability (as defined in the Code),
  - Age 59½ in-service withdrawals and hardship withdrawals, or
  - Plan termination
- Severance from employment means participant is no longer employed by employer that maintains the 401(k) plan
  - Employer means on a controlled group basis
  - In an asset transaction, generally, Seller employee has a severance from employment for Seller 401(k) plan if he or she becomes a Buyer employee, unless Buyer assumes and continues Seller 401(k) plan
  - In an equity transaction where a Seller subsidiary is acquired, Seller employee should have a severance from employment for Seller 401(k) plan, assuming no spin-off or transaction of employee's benefit to Buyer 401(k) plan

401(k) Plans in M&A Transactions

- 401(k) plans are subject to special successor plan rules that limit the ability to terminate a 401(k) plan
- Distributions are not available upon termination of a 401(k) plan if there is another 401(k) plan in the controlled group during the 12-month period beginning after termination and distribution of all plan assets
  - As a result, in an equity transaction, if Buyer does not want Seller 401(k) plan, Buyer will want to require Seller to terminate the plan no later than the day before the closing and thus the plan is never maintained by a member of Buyer's controlled group and distributions can be made to former Seller employees
  - If the plan is not terminated before the closing, then Buyer is not able to terminate it if Buyer or a member of Buyer's controlled group maintains another 401(k) plan with the 12-month period noted above
  - The successor plan rules do not apply in an asset transaction, unless Buyer assumes and continues Seller 401(k) plan
  - "Termination" occurs when Seller's board or other governing body takes formal action to terminate the plan (even though the plan assets will not be distributed until after the closing)

401(k) Plans in M&A Transactions

- Other issues to consider with 401(k) Plans:
  - If Buyer assumes Seller 401(k) plan and Seller 401(k) plan and/or Buyer 401(k) plan is a "safe harbor" 401(k) plan, a mid-year plan merger is generally not available
  - If Buyer will merge Seller 401(k) plan into Buyer 401(k) plan, confirm that all Seller 401(k) plan "protected benefits" are preserved in Buyer 401(k) plan
  - Confirm whether an ERISA "blackout" will occur in connection with the transaction and if so a blackout notice will be required
  - If Buyer does not assume Seller 401(k) plan and Seller 401(k) plan permitted loans, to avoid a loan default and related early distribution 10% penalty, Seller will want to require Buyer to cause Buyer 401(k) plan to accept rollover of participant loans or, in the alternative, Seller could cause Seller 401(k) Plan to continue to accept loan repayments from former Seller employees
  - End of year true-ups of match and profit sharing/non-elective contributions

Defined Benefit Plan in M&A Transactions

- Defined benefit or pension plans have funding requirements and are subject to Title IV of ERISA
  - Title IV provides defined benefit plan termination procedures and guarantees a certain level of plan benefits should a plan sponsor default on its pension obligations
  - Title IV establishes the Pension Benefit Guaranty Corporation (“PBGC”), which administers the termination procedures and benefit guarantees under Title IV
  - The PBGC is not funded by general tax revenues but instead collects insurance premiums from employers that sponsor the insured pension plans, earns money from investments and receives funds from pension plans it happens to take over
- The PBGC can, and many times will, get involved when a transaction involves a defined benefit plan
  - There are certain “reportable events” that either Seller or Buyer or both must notify the PBGC of in a timely manner (sometimes prior to the event)
  - Moreover, there is controlled group liability with respect to a defined benefit plans

Defined Benefit Plan in M&A Transactions

- In an equity transaction, generally, Buyer gets Seller defined benefit plan
  - If a Seller subsidiary is the subject of the transaction and Seller is the plan sponsor of Seller defined benefit plan, generally, Buyer will not get Seller defined benefit plan
  - An exception is when Buyer agrees to assume the plan or there is a spin-off or transfer of a portion of Seller defined benefit plan to Buyer
- If an asset transaction, generally, Buyer does not get Seller defined benefit plan
  - However, there may be business reasons for Buyer to agree to assume Seller defined benefit plan or accept a portion of the plan through a spin-off or transfer
  - Whether Buyer assumes Seller plan will have an impact on Buyer's due diligence review
- Assumption of Seller defined benefit plan (and any other plan) will result in additional representations by Seller than would be required if Buyer was not assuming Seller's plans

Defined Benefit Plan in M&A Transactions

- Seller may be a party to a defined benefit plan that is a multiemployer plan, which is a plan maintained pursuant to a CBA between an employee organization and an employer
  - If employer stops participating in the multiemployer plan, it may be subject to partial or complete withdrawal liability
  - ERISA provides that "all trades or businesses (whether or not incorporated) which are under common control within the meaning of ERISA section 4001(b)(1) are considered a single employer" and thus there is controlled group responsibility for the withdrawal liability
  - There could be successor liability (discussed later)
  - If a CBA provides for a defined benefit plan for Seller union members, Buyer could be required to provide a defined benefit plan for such members it employs
  - If Buyer has its own defined benefit plan and assumes Seller's defined benefit plan, whether an asset or equity transaction, Buyer needs to consider how Seller's plan will integrate with its overall benefit structure
  - Covenants may limit what Buyer can do with Seller's plans for a certain period of time; CBAs can have the same limiting impact on Buyer

Defined Benefit Plan in M&A Transactions

- Funding issues for defined benefit plans
  - To protect against the risk that a plan will not be sufficiently funded to pay participant benefits at retirement, the Code imposes minimum funding requirements
  - The requirements do not require that the plan be fully funded and in fact many plans are underfunded
  - If Buyer assumes Seller’s defined benefit plan and it is not fully funded, Buyer will be responsible for the funding deficiency
  - Moreover, the funding liability reported on Seller’s financial statements may not accurately indicate the plan’s true liability

Defined Benefit Plan in M&A Transactions

- Funding status of a defined benefit plan will vary depending upon whether it is viewed from a "projected benefit obligation" ("PBO") or "ongoing" basis or a "accumulated benefit obligation" ("ABO") or "termination" basis
  - As opposed to PBO, ABO does not consider any future salary increases
  - A fully funded plan on a PBO basis that assumes the plan will continue into the future may be underfunded on an ABO basis. As a result, due diligence with respect to a plan's funded status is critical
- In addition to reviewing the plan documents, actuarial reports and Forms 5500 with respect to a defined benefit plan that Buyer will be acquiring or assuming, Buyer will want to engage an actuary to determine the plan's true liability and future projected cost.

Defined Benefit Plan in M&A Transactions

- Buyer may seek a purchase price adjustment for the plan liabilities it inherits or assumes based on the funded status of the plan
- While Seller may agree to a purchase price adjustment, the parties may differ on the assumptions that should be used to determine the plan's funding status
  - Since the calculation is based on actuarial assumptions, including assumptions with respect to the applicable interest rates and mortality tables, the parties must agree on what assumptions will be applied. This will include an agreement as to whether the plan valuation is to be based on a PBO/on-going basis or more costly ABO/termination basis
  - An alternative to a price adjustment is to require Seller to make a contribution to the plan so that it is fully funded as of the closing date

Controlled Group Liability

- ERISA and the Code contain “controlled group” rules that treat multiple corporations or related trades or businesses as a single employer
  - Parent-subsidiary, brother-sister or affiliated service group
- Members of the controlled group are jointly and severally liability for a number of purposes, including for
  - Multiemployer plan withdrawal liability
  - Plan termination liability
  - Minimum funding obligations
  - Excise taxes for failure to make minimum required contributions
  - PBGC liens for unpaid contributions greater than $1,000,000
  - PBGC premiums
- Buyer will want representations specific to Seller’s controlled group (generally referred to as Seller’s “ERISA Affiliates”) to understand whether there is any potential controlled group liability that Buyer may be acquiring

Controlled Group Liability

- An issue of particular concern today:
  - If a private equity fund invests in a portfolio company that maintains a defined benefit plan, and thus has funding liabilities under the Code and ERISA, can the fund be aggregated with the portfolio company as a single employer under the controlled group rules?
  - If so, the fund - Buyer - would be jointly and severally liable for the portfolio company's defined benefit plan's liabilities
  - In the past, the answer was no - the fund is not considered part of Seller's controlled group because fund is not a "trade or business" but a "passive investment"
    - A "trade or business" for tax purposes is actively engaged in an activity for the primary purpose of income and profit, with continuity and regularity (trade or business is not defined in the Treasury regulations)

Controlled Group Liability

- In 2007, a PBGC internal appeals board ruled that a private equity fund could be considered a "trade or business" for controlled group purposes under ERISA
  - Case involved a bankrupt portfolio company's underfunded pension plan that ended up with PBGC
  - PBGC based its holding on agency theory: PBGC attributes to fund all of activities of the fund's general partner, which PBGC found had "full control" over the investment fund's business and affairs, including the management of the fund's portfolio companies
- In 2013 case *Sun Capital Partners III, LP v. New England Teamsters & Trucking Industry Pension Fund*, 724 F.3d 129 (1st Cir. 2013), the U.S. Court of Appeals for the First Circuit held that a private equity fund was not merely a passive investor, but was in fact a "trade or business"
- The Supreme Court refused to review the case and thus the decision stands
- The case involved two private equity funds that invested (30% and 70%, respectively) in a portfolio company, Scott Brass, Inc. ("SBI"), that subsequently went into bankruptcy

Controlled Group Liability

- The general partner of the funds had a contract to provide management services to SBI
- SBI was a party to a multiemployer pension plan and consequently defaulted on its withdrawal obligations to the pension fund
- The pension fund claimed the equity funds were jointly and severally liable for the withdrawal liability because the funds were engaged in a "trade or business" and were under "common control" with SBI
  - The facts indicated that the management company was very involved in the management of SBI
- First Circuit held that one of the two equity funds was a "trade or business" under an "investment plus" theory and remanded to the district court to determine if the other fund was also a trade or business
  - The First Circuit did not rule on whether the funds were under common control but remanded that issue to the district court for review
- The bottom line is that a private equity fund should consider the possibility that it could be held responsible for Seller portfolio company's controlled group liabilities associated with its defined benefit plan

Defined Benefit Plan & ERISA Section 4062(e)

- ERISA Section 4062(e) applies to a single-employer defined benefit plan
  - Provides that if an employer ceases operations at a facility in any location and, as a result of such cessation of operations, more than 20% of the total number of the employer's employees who are participants under a plan established and maintained by the employer are separated from employment, the employer shall effectively be subject to the withdrawal and termination liabilities described under ERISA Sections 4063, 4064, and 4065
- What does this mean? If applicable, the plan's funding liability is determined on a plan termination basis as if it was terminated immediately before the cessation date
  - Example: Employer X sponsors a defined benefit plan with 10,000 active participants that is underfunded on a termination basis in the amount of $10,000,000
  - If Employer X ceases operations at facility Y and 2,500 employees, who all participate in the plan, are terminated, and this is an ERISA Section 4062(e) event, Employer X will have liability determined under ERISA Section 4063(b) in the amount of $2.5 million ($10 million x 2,500/10,000)

Defined Benefit Plan & ERISA Section 4062(e)

- Liability amount is held in escrow by the PBGC, or the employer may post a bond
  - If the plan is not terminated within 5 years, the liability is abated and any payment held in escrow is refunded without interest or the bond cancelled
- ERISA Section 4062(e) doesn't take into account an M&A transaction
- On July 8, 2014, PBGC announced a moratorium on the enforcement of ERISA Section 4062(e) cases until the end of 2014
  - PBGC explained that the moratorium would enable PBGC to ensure that its efforts are targeted to cases where pensions are genuinely at risk and to allow PBGC to work with the business community, labor, and other stakeholders
  - During the moratorium period ending on December 31, 2014, PBGC did not take any enforce action on open or new cases
  - However, the PBGC required companies to continue to report new ERISA Section 4062(e) events that occurred during the moratorium period even though the PBGC would not take any action on those events during the moratorium period

Defined Benefit Plan & ERISA Section 4062(e)

- Congress amended Section 4062(e), on December 16, 2014, to make 3 significant changes to the statute:
  - First, a cessation of operations will trigger Section 4062(e) only if it results in a reduction of 15% or more of the employees eligible to participate in any defined benefit or defined contribution plan in the controlled group
    - Prior to amendment, whether Section 4062(e) applied was based only on the employees covered by the pension plan at issue; this change should prevent a transaction impacting a small number of employees from triggering Section 4062(e)
    - Requires a permanent, rather than temporary, cessation of operations
    - Excludes certain employees in situations where there is a transfer of operations from one facility to another or where a business is sold or otherwise disposed of but operations continue with the successor employer
  - Second, plans that are 90% funded on a variable-rate-premium basis and small plans (fewer than 100 participants) are excluded
    - Congress encourages PBGC to continue its current practice of not enforcing Section 4062(e) when the plan sponsor is financially sound

Defined Benefit Plan & ERISA Section 4062(e)

- Third, under a alternative approach, plan sponsors may satisfy Section 4062(e) liability by making additional, fixed annual contributions to the plan for 7 years
  - The cost of the additional contributions should be lower than the standard approach as:
    - the unfunded liability on which the 7-year payment is based is determined on variable-rate-premiums rather than on a plan termination basis;
    - the annual required additional contribution is capped; and
    - once the plan is 90% funded on a variable-rate-premium basis, no further contributions are required
  - Certain notice and other requirements must be met by a plan sponsor to use this alternative approach

- Generally, amended Section 4062(e) applies to events occurring on or after December 16, 2014
  - For events occurring prior to December 16, 2014, if no PBGC in place, the plan sponsor may elect to use the new 7-year option and December 16, 2014, is deemed to be the date of the Section 4062(e) event.
- Congress directed PBGC not to enforce Section 4062(e) in a manner inconsistent with the amended statute, including with pre-December 16, 2014 events (unless a settlement agreement is already in place)

Welfare Plans in M&A Transactions

- ERISA defines a "welfare plan" to mean a plan, fund, or program maintained by an employer (or employee organization) that provides medical, surgical, or hospital care or benefits, or benefits in the event of sickness, accident, disability, death or unemployment, or vacation benefits, apprenticeship or other training programs, or day care centers, scholarship funds, or prepaid legal services and is not a retirement plan
  - Welfare plans include medical, dental, vision, accidental death and dismemberment insurance, group life insurance, long term disability, HRAs, HSAs, flexible spending accounts, tuition assistance and long-term care
  - Related plans that are not ERISA welfare plans – 125 cafeteria plan and dependent care
  - May or may not be an ERISA welfare plan – severance and short term disability
- Unlike retirement plans, welfare plans are not funded
  - Exception is a voluntary employees' beneficiary association ("VEBA"), which is a funded tax exempt trust that pays for eligible medical expenses

Welfare Plans in M&A Transactions

- In an equity transaction, as with the retirement plans, Buyer will get Seller welfare plans
  - Exception where a Seller subsidiary is acquired by Buyer and Seller welfare plans are not sponsored by the subsidiary (and parties do not agree for assumption of the plans)
- In an asset transaction, as with the retirement plans, Seller retains its welfare plans unless the parties agree otherwise
- Many of the plans will be insured arrangements
  - Buyer will want to review and understand the insurance contracts as part of due diligence
- Medical
  - Self-funded or insured and if self-funded, is there a stop-loss policy
  - How are medical claims for pre-closing events, but that are unpaid, to be handled?
  - Be mindful of potential MEWA issues

Welfare Plans in M&A Transactions

- Retiree Medical
  - Does Seller have unfunded retiree medical benefits
  - If asset transaction and Buyer is assuming medical, Buyer will want to confirm whether there are retiree medical benefits and if so the projected cost
    - However, is there a risk of successor liability?
  - If equity transaction, Buyer will get the retiree medical and thus should understand cost
  - Can Buyer terminate retiree medical?
- COBRA
  - COBRA regulations prescribe default coverage rules for “M&A Qualified Beneficiaries”
    - An “M&A Qualified Beneficiary” is an employee, spouse or dependent child that has a COBRA qualifying event occur prior to or in connection the transaction and
      - If an asset transaction, the last day of employment is associated with the sale of the assets
      - If an equity transaction, the last day of employment is with acquired entity

Welfare Plans in M&A Transactions

- COBRA (con't)
  - Buyer and Seller may agree which is responsible for COBRA for M&A Qualified Beneficiaries
  - COBRA regulations provide for a default if no contractual agreement or if one party fails to comply with the agreement:
    - Seller must provide COBRA if Seller or a member of Seller's controlled group continues to maintain a group health plan post-closing – regardless if asset or equity transaction
    - If Seller does not maintain a group health plan post-closing, then Buyer plan must provided COBRA in an equity transaction and, if Buyer is a "successor employer" in an asset transaction
      - "Successor employer" means Buyer continues the business operation associated with the assets acquired without significant change
- Affordable Healthcare Act ("ACA")
  - Buyer will want to confirm whether Seller was subject to ACA and if so whether Seller complied with the employer mandate and filing requirements
    - Has Seller received a 226J Letter?
    - Does Seller has documents to support such compliance?

Successor Liability

- Generally in an asset transaction Buyer can elect not to assume Seller's defined benefit plan and not take on the plan liabilities
  - But remember the controlled group liability issue
- An exception to the general rule is successor liability where there is a *de facto* merger, such as:
  - A continuity of ownership or of enterprise, a dissolution of Seller or an assumption necessary for uninterrupted continuation of Seller's operations
  - Buyer is really Seller as in the case of a reorganization or restructuring
  - A fraudulent transfer design for the avoidance of liability
- This was the result in the *Upholsterer's International Union Pension Fund v. Artistic Furniture*, 920 F.2d 1323 (7th Cir. 1990)
  - Buyer had successor liability with respect to a multiemployer defined benefit plan where there was (i) a continuity of operations and (ii) knowledge of the liability
  - The court basically looked to unfair labor practice situations and considered employee protection in its holding

Successor Liability

- The *Artistic Furniture* holding has been agreed with by the First, Second, Third, Sixth and Ninth Circuits and by district courts in the Fifth Circuit
- Most recently, in *PBGC v. Findley Industries, Inc.*, 2018 WL 4201636 (6th Cir. Sept. 4, 2018), the Sixth Circuit continued the expansion of successor liability with respect to ERISA pension plans, holding
  - A “trust” created by a pension plan sponsor’s founder was a “trade or business” under ERISA, and
  - The federal common law doctrine of successor liability applied in determining liability for unfunded pension liability under ERISA

CBAs and Multiemployer Plans

- If Seller is a party to a CBA, Buyer will want to review what benefits are required under the CBA, including whether it requires a defined benefit plan for the covered employees
- In an equity transaction, the CBA will generally come over with the acquired entity
- In an asset transaction, depending on the asset being acquired, Buyer may be subject to a "successor" clause in the CBA. If there is not such a clause, Buyer may be required to bargain in good faith with the union
- CBAs can govern not only current pension benefits at the time of closing, but may also provide for pension increases for future years that are subject to the CBA

CBAs and Multiemployer Plans

- Future benefit increases may not be reflected in the plan document or the actuarial reports prepared for the plan
  - Buyer will want its actuary to review and determine the current funding status of the plan and also the impact on funding of future benefit increases required under the CBA
- The CBA may require covering the union members in a single-employer plan or a multiemployer plan
  - If Seller is party to a multiemployer plan, Buyer will need to review the funding status of that plan, which may be substantially underfunded
  - If the plan is substantially unfunded, Buyer may be able to avoid the multiemployer plan with an asset transaction
- If an equity transaction, since Seller will continue to make contributions to the multiemployer plan, generally, there is no withdrawal and thus no accompanying withdrawal liability, as a result of the transaction
  - Buyer succeeds to Seller's contribution history, which may result in a larger withdrawal liability should Buyer in the future experience a partial or complete withdrawal from the plan

CBAs and Multiemployer Plans

- If an asset transaction and Seller ceases to make contributions to the multiemployer defined benefit plan, a complete plan withdrawal results
  - Seller will have complete withdrawal liability
  - If Seller continues to make contributions to the plan for union members employed at one or more of Seller's other businesses, but the contributions total less than 30% of the total Seller contributions prior to the transaction, Seller will have a partial plan withdrawal, and thus partial withdrawal liability
- Seller may avoid complete or partial withdrawal liability if it and Buyer rely on the "sale of assets rule" under ERISA Section 4204
  - Buyer agrees (i) to continue to make contributions to the plan the same as Seller and (ii) posts a bond or deposits funds in an escrow for a five-year period
  - If Buyer doesn't stop making contributions to, or withdraw from, the plan during that five-year period, Seller will avoid withdrawal liability
  - Seller remains secondarily liable for withdrawal liability it would have had if Buyer stops making contributions or withdraws during the five-year period (and doesn't make its withdrawal liability payment)

CBAs and Multiemployer Plans

- Opting to use Section 4204 changes the impact of withdrawal liability on the parties
  - Seller: Only secondary liability triggered in a narrow circumstance and thus can avoid a withdrawal liability
  - Buyer: Liability for the last five years of Seller’s contribution history (rather than all of Seller’s contribution history as in the equity transaction case)
  - It is possible that the last five years contribution history will actually result in no potential withdrawal liability for Buyer
  - The multiemployer plan may grant Buyer a variance from the bond or escrow requirement
- If the Section 4204 sale of asset rule is not used, Buyer doesn't take on any Seller liability or Seller’s contribution history; Buyer treated as a new employer joining the multiemployer plan

Selected Issues Related to Assumption of Plan

- Tax Deduction for Defined Benefit Plan Contribution
  - If Buyer and Seller agree that Buyer will assume Seller's defined benefit plan and Seller agrees to a price adjustment to reflect the underfunded status of the plan, is the contribution by Buyer deductible as a plan contribution or is it capitalized expense related to the transaction?
    - Issue is contributions related to services provided by Seller employees prior to becoming Buyer employees
  - In a pre-ERISA case, *David R. Webb Co., Inc.*, 77 T. C. 1134 (1981), the court ruled no deduction
  - In Private Letter Ruling 8411106, IRS considers post-ERISA situation where Buyer assumed Seller's ERISA plan that is a tax-qualified plan
    - IRS states that after ERISA there is an obligation to satisfy the Code's minimum funding requirements
    - In the case before IRS, there was no accumulated funding deficiency - that is, the plan sponsor had met the minimum funding requirements
    - IRS concluded that since Buyer did not assume any "real liability" from Seller when it took on the plan, future contributions are considered deductible

Selected Issues Related to Assumption of Plan

- Mirror/Offset Plan
  - In asset transaction where Buyer does not assume Seller's defined benefit plan, but agrees to establish a mirror plan with the same benefit formulas as Seller's plan and recognize service and pay credits with Seller for vesting and benefit accruals but then offsets such benefit against the vested benefit the participant will receive under Seller's defined benefit plan ("Mirror/Offset Plan")
    - Result is that employee does not have to "start over" to earn his or her pension benefit with Buyer
    - Example: With a final average pay formula, the employee's compensation with Seller and Buyer, along with years of service with Seller and Buyer for vesting and early retirement subsidies, will be used by Buyer's Mirror/Offset Plan to calculate the employee's benefit, offset by the benefit the employee is entitled to receive under Seller's plan
  - To keep employee's benefit as close to "the same" under both plans, Buyer will want Seller's plan to recognize employee's service with Buyer for purposes of early retirement subsidiaries (and favorable reduction factors if employee commences his or her benefit prior to normal retirement date) and vesting

Selected Issues Related to Assumption of Plan

- Mirror/Offset Plan Example:
  - Assume Seller's plan and Buyer's Mirror/Offset Plan have a "30 and out" provision - employee with 30 years of service may retire and commence benefits prior to normal retirement date with early retirement subsidies
  - If employee has 29 years of service with Seller and two years of service with Buyer, the employees will be eligible for the 30 and out benefit under Buyer's plan but not Seller's plan unless Seller's plan will recognize the employees two years of service with Buyer
  - If Seller's plan does not recognize Buyer service, Buyer may have to "make-up" the "lost benefit" from Seller's plan, in particularly if union employees under a CBA
- Another Mirror/Offset Plan issue to consider is post-closing date increases in pension benefits
  - Assume that the pension pay factor is increased under a new, post-closing CBA
  - Such increase will generally not be recognized by Seller's plan
  - Does Buyer's plan calculate the off-set based on the contribution rate in effect at the time of the employee's retirement or does Buyer's plan use the contribution rate in effect at the time of closing?

Selected Issues Related to Assumption of Plan

- Assumption of Seller's pension plan generally will trigger a "reportable event" that must be timely reported to the PBGC
- In addition, parties may need to timely file with IRS Form 5310-A, Notice of Plan Merger or Consolidation, Spinoff, or Transfer of Plan Assets or Liabilities; Notice of Qualified Separate Lines of Business
  - IRS has indicated that when there is a change in plan sponsors, notice of that change is required with Form 8822-B, Change of Address or Responsible Party — Business, within 60 days after the change. Currently, there is no penalty for failure to file Form 8822-B

Plan Defects

- Seller’s representations should provide that its qualified plans are intended to comply with Code Section 401(a) and generally that Seller is not aware of any reason why such plans should no longer be qualified
  - If a qualification issue is uncovered during due diligence prior to closing, Seller and Buyer will need to agree on how to deal with the issue
  - If a qualification issues is uncovered after closing, Buyer will need to address
- Depending on the severity of the defect, the plan may need to be corrected pursuant to IRS’s correction program, the Employee Plans Compliance Resolutions System (“EPCRS”)
  - It may be possible to self-correct some operational defects, depending on the when the defect occurred and whether it is “significant” or “insignificant”
  - Plan document failures and other significant operational and demographic errors (that cannot be self-corrected) require submission to the IRS under the “Voluntary Correction Program (“VCP”) under EPCRS
    - VCP requires the payment of a “compliance fee” and requires time for the IRS to review and issue a compliance statement

Plan Defects

- ERISA issues can also be uncovered during the due diligence process, such as delinquent Forms 5500 and certain fiduciary breaches/prohibited transactions
  - For example, late 401(k) deferral contributions to the trust
- May need to use one of the Department of Labor two voluntary self-correction programs
  - Delinquent Filer Voluntary Compliance Program
  - Voluntary Fiduciary Correction Program.
- In asset transaction, Buyer may add a provision in the transaction document requiring Seller to contribute all or a part to the cost to correct a defect that may be found with respect to Seller's plan post-closing

Selected Litigation Issues

- *Halliburton Co. Benefits Committee v. Graves*, 463 F.3d 360 (5th Cir. 2006)
  - A 1998 merger agreement between Halliburton and Dresser Industries required Halliburton to maintain Dresser's retiree plans, except to the extent that any modifications were consistent with changes in Halliburton's medical plans for its own similarly situated active employees
  - The merger agreement also provided that its provisions were solely for the benefit of Halliburton and Dresser and did not confer any right, benefit, or remedy to any other person except for members of Halliburton's board of directors, who were permitted to enforce the provisions for three years
  - The Halliburton and Dresser boards approved the merger agreement and Halliburton entered into a separate agreement to assume the sponsorship of, adopt, and continue the Dresser retiree plans
  - Five years later in 2003, Halliburton modified the Dresser retiree plans to be more closely aligned with Halliburton retirees' benefits by freezing Halliburton's contribution costs and making Dresser retirees responsible for future premium increases; Halliburton did not make similar modifications for its own similarly situated active employees

Selected Litigation Issues

Halliburton Co. Benefits Committee v. Graves, 463 F.3d 360 (5th Cir. 2006)

On appeal Halliburton argued that

- Retiree benefits provision in the merger agreement did not "effect a plan amendment" because it did not properly follow plan amendment procedures
- Retirees could not enforce the provision because only Halliburton directors were permitted to enforce the terms of the merger agreement; and
- Requiring Halliburton to maintain the Dresser retiree plans amounted to an impermissible vesting of benefits

– The court disagreed and held that the merger agreement amended the plan

- "Enforcement of a plan's provision, including any amendments thereto, falls exclusively in ERISA's remedial scheme" and so while retirees could not sue for breach of contract, they could seek clarification of their rights under the terms of the Dresser retiree plans
- "Employers generally are free under ERISA to modify or terminate plans, but if the plan sponsor cedes its right to do so, it will be bound by that contract"
- "Halliburton [could not] unilaterally take away the 'bargained-for rights' that Dresser and Halliburton negotiated and made on the retiree program as part of their merger agreement. The parties were free to impose contractual obligations on the right to amend or terminate the Dresser [plans], and they did. Because of these limitations, Halliburton cannot alter the retiree program, except as consistent with the plan as amended by [the merger agreement]"

Selected Litigation Issues

- *Evans v. Sterling Chemicals, Inc.*, 660 F.3d 862 862 (5th Cir. 2011)
  - In Evans, which involved an asset transaction in 1996 and then a 2001 bankruptcy, the Fifth Circuit, citing its decision in Halliburton, held that agreeing to provide retiree medical benefits to Cytec “acquired employees” at the same levels provided under Seller’s pre-APA retiree medical plan constituted an amendment to the retiree medical plan, even though the merger agreement was rejected as part of the bankruptcy proceeding
  - APA required Cytec's written consent to reduce benefits or increase premiums or Cytec had to increase premiums in its plan
  - Sterling included Plaintiffs in the Sterling retiree medical plan, but did not write any new provisions into the plan's formal documents
  - The plan contained reservation-of-rights provisions permitting amendment or modification of the Sterling Plan “at any time and from time to time” by action of Sterling's Employee Benefits Plans Committee (the Committee)
  - In 2001 - 4 years after the acquisition - Sterling filed for Chapter 11 bankruptcy, but during the bankruptcy, Plaintiffs' benefits and premiums remained unchanged

Selected Litigation Issues

- *Evans v. Sterling Chemicals, Inc.*, 660 F.3d 862 862 (5th Cir. 2011)
  - In 2003, after emerging from bankruptcy, Sterling raised Plaintiffs' premiums to levels consistent with the premiums paid by other plan participants and then again premiums were raised twice later
  - As part of the bankruptcy, Sterling rejected the APA
  - No indication that either Cytec made similar increases to its retiree benefit plan premiums, and Sterling did not receive Cytec's prior written consent for the increase
  - Plaintiff's sued
  - District court ruled in favor of Sterling finding the APA didn't amend the plan and Halliburton was distinguishable; alternatively upon rejecting the APA, the restriction in the APA was no longer in effect
  - Fifth Circuit disagreed finding Halliburton controlled and APA amended the plan
    - Fifth Circuit says that as long as the agreement is in writing, it contains a provision directed to an ERISA plan, and the plan amendment formalities are satisfied, the agreement will be considered a valid plan amendment to the plans addressed in the agreement

Selected Litigation Issues

- *Evans v. Sterling Chemicals, Inc.*, 660 F.3d 862 862 (5th Cir. 2011)
  - Turning to the bankruptcy, while the APA was rejected the bankruptcy court's Confirmation Order provided that all retiree benefits were "treated as executory contracts and assumed as part of the reorganization and nothing in the order modified the plan
  - Since the "amendment" occurred prior to the bankruptcy and was a part of the plan, rejection of the APA didn't matter
  - The fact that the parties did not intend for the APA to be a plan amendment did not matter. But the court reserved on the issue whether that would have mattered
  - Finally, the court noted that a provision of a corporate agreement - the APA - could be both a contractual obligation and a plan amendment at the same time
- In light of Halliburton and Evans, in addition to no 3rd party rights, Buyer will want specific language in the transaction agreement that provides that nothing in the agreement is intended to amend any plan or affect Buyer's or any of Buyer's affiliate's right to amend or terminate any plan
  - Will that work?

Plan Considerations in M&A Transactions

- Questions?

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