OVERVIEW OF EMPLOYEE BENEFITS CONSIDERATIONS IN MERGERS AND ACQUISITIONS

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I. Overall Goals of Due Diligence and Negotiations.

A. Understanding Seller's ERISA Plans and Obligations.

B. Determining Hidden or Contingent Liabilities.

1. Effectively negotiate reps and warranties.

2. Develop appropriate indemnification provisions and coordinate with overall indemnification basket used in transaction.

3. Negotiate any appropriate adjustment to purchase price; escrow portion of purchase price pending resolution of issues/audits; or offset installment payments of purchase price.

C. Designing Benefits Structure Post-Closing.

1. Effectively negotiate covenants about future benefit plans.

2. Terminate Seller's plans at or before closing?

3. Have Buyer assume, adopt and continue Seller's plans as separate benefit structures, with or without modifications?

4. Spin-off, merge or integrate Seller's plans into Buyer's plans (or vice versa), and timing of doing so.

II. Effect of Transactional Structure on Liabilities and Future Actions.

A. Stock or Merger Transactions.

1. Seller's legal identity and status as an "employer" for plan purposes does not change.

2. Higher stakes: Buyer assumes liability for Seller's plans as a matter of law; therefore, both parties must identify and consider potential liabilities in the negotiation of the purchase price.

3. Because Buyer assumes liability for Seller's plans, Buyer has negotiating power in determining how Seller's plans will be handled after the closing.

B. Asset Sale Transactions.

1. Buyer does not normally assume Seller's plans or liabilities unless it is specifically provided or scheduled. (*Exception*: COBRA, where regulations directly address the liability of Buyer for certain "M&A qualified beneficiaries".)

2. Because of "successor employer" concept that many courts apply in the employment/benefits arena (despite the formal structure of the transaction), Buyer needs to negotiate protection through indemnification provisions, escrow arrangements, or purchase-price setoffs.

3. Because Buyer does not automatically assume Seller's plans, there is more give and take in the negotiations about the future of Seller's plans.

III. Overview of Retirement Plan Liabilities.

A. Generally.

1. Higher risk for "hidden" liabilities if Seller sponsors a qualified ***defined benefit*** plan, rather than a qualified ***defined contribution*** plan.

2. In qualified defined benefit plans, contributions are actuarially determined and the question of whether the plan has sufficient funds to pay accrued benefits out to participants depends upon the plan's investment return and the accuracy of its actuarial assumptions. This is especially true given new pension funding rules that will begin to apply in 2008 to defined benefit plans, under the Pension Protection Act of 2006.

3. In qualified defined contribution plans (401(k) and profit-sharing plans), liabilities are based on actual account balances and, therefore, are easier to evaluate and quantify.

B. Tax Issues for Qualified Plans.

1. *Complex Rules.* Intricate set of rules require compliance with both the "form" of the document and the "operations" of the plan.

a. Plan document and form. Plan document must continually be updated to reflect changes in law and regulations.

(i) Interim plan amendments since the last determination letter may have been required, without formal IRS application.

(ii) *Caution*: With volume of changes in law in recent years, remedial plan amendments are often not required immediately, but plan operations have had to conform to change in law more immediately.

b. Plan operations. Plan must comply operationally with:

(i) Minimum coverage and participation rules.

(ii) Top heavy rules.

(iii) Nondiscrimination testing—especially important for 401(k) plans that have employee pre-tax contributions and/or employer matching contributions.

(iv) Limits on annual contributions or benefits for each participant (including limits on amount of compensation that can be taken into account and the amount that a participant can accumulate under the plan in any given 12-month period).

(v) Other limits—on includible compensation; on amounts that can be deferred every year under a 401(k) plan; on amounts of "catch up" contributions permitted for participants over age 50, etc.

(vi) Complex distribution rules.

(vii) Complex funding rules for defined benefit plans.

2. *Sanctions and penalties.* Potential sanctions are harsh; can create significant financial liabilities for Seller (or Buyer, if these liabilities are assumed) or serve as justification for Buyer to refuse a transfer of assets or otherwise merge/integrate Buyer's plans into Seller's plans:

a. Tax deductions taken in prior years may be disallowed retroactively.

b. Earnings on trust, which have continued to accumulate on a tax-exempt basis, may be taxed retroactively.

c. Employees may be taxed on contributions made during the period of disqualification.

d. Excise taxes may be assessed depending on what qualification rule has been violated (i.e., funding obligations; return of excess 401(k) contributions, etc.)

Some of these problems can be cured through the IRS's voluntary correction program, called Employee Plans Compliance Resolution System, or "EPCRS".

C. ERISA Issues for Qualified Plans.

1. *Delayed 401(k) contributions*. Failure to comply with timing requirements of the plan asset regulations. Exposure: Additional contributions to make up lost earnings; participant claims; excise taxes.

2. *Fiduciary breaches*. Focus on plan investments (prudence; diversification; presence of employer stock; current investment policy statements; open brokerage windows) and on whether plan has been administered according to its written terms. Exposure: claims and civil penalties.

3. *Prohibited transactions*. Focus on contractual obligations or relationships between the sponsor and its principal shareholders, relatives, etc. Exposure: Claims and excise taxes.

4. *Reporting or disclosure problems*. Focus on timely and complete filing and disclosure of 5500s with completed audits (if necessary); SPDs; SARs; and PBGC filing. Exposure: Claims and civil penalties.

5. *Funding issues for defined benefit plans*. Focus on whether plan is underfunded or overfunded; whether there is any liability for defined benefit plans maintained by other members of Seller's controlled group; and whether there is any funding or withdrawal liability under a multi-employer plan sponsored by a union, to which different unrelated employers contribute based on the terms of their collective bargaining agreements. Exposure: Significant contributions, potential penalties and excise taxes, and potential liens.

D. Financial Exposure for Qualified Plans.

1. Accrued but unpaid contributions; PBGC premiums.

2. Liability for contributions and funding of plans sponsored by other members of the Seller's controlled group of corporations.

3. Withdrawal liability if Seller participates in a multi-employer plan.

IV. **Overview of Liabilities with Nonqualified Deferred Compensation Plans.**

A. Generally.

1. Nonqualified deferred compensation plans can be individualized employment or deferred compensation agreements, or plans that benefit a select group of highly compensated employees.

2. Greater scrutiny since enactment of 409A and anticipated audit activity beginning in 2007.

B. Plan Documentation Compliance.

1. All documentation must be updated to comply with new requirements of 409A, which applies to compensation deferred on or after January 1, 2005.

2. Plan amendment deadline extended through 2008; other forms and communications had to comply beginning in 2004, for compensation being deferred in 2005 or later years.

C. Operational Compliance.

1. *Tax issues.*

a. Historic principles of constructive receipt have not changed.

b. Focus is on whether plan, in operation, has satisfied 409A, including application of any grandfathering or transitional rules.

c. Exposure: Possibility that Seller has agreed that in the event of any failure, Seller will "gross up" affected executives for the 20% excise tax that is payable.

d. Reporting obligations (on W-2s and 1099s) of amounts deferred under a deferred compensation plan, and amounts includible in income if 409A rules are not satisfied.

2. *ERISA issues.*

a. Focus is on whether plan meets the standards for classification as a "top hat" plan.

b. If so, exempt from ERISA fiduciary, vesting and funding requirements; reduces exposure to potential claims.

c. If so, ERISA reporting and disclosure obligations are met with one-time filing; reduces exposure to claims and civil penalties.

D. Financial Exposure for Nonqualified Plans.

1. Accrued liability should be reflected on Seller's financial statements.

2. Liability is mitigated to extent it has been funded (in whole or in part) with a rabbi trust, life insurance or other arrangement that may need to be assigned or transferred from Seller to Buyer as part of the transaction.

V. **Welfare Plan and Payroll Practice Liabilities.**

A. Medical Plans.

1. *Compliance Issues*.

a. Plan documentation, participant communications, and required notices are complex and must satisfy a myriad of different laws, including:

(i) State insurance laws (if applicable).

(ii) Mental Health Parity Act.

(iii) COBRA.

(iv) Newborns' and Mothers' Health Protection Act.

(v) Women's Health and Cancer Rights Act.

(vi) Health Insurance Portability and Accountability Act (including portability; special enrollment; privacy and security rules).

(vii) Medicare Modernization Act.

Exposure is potential claims; excise taxes; and civil penalties.

b. Tax nondiscrimination rules for self-funded health plans and flexible spending account plans. Exposure: Claims; taxability of reimbursements made from discriminatory health plans to highly compensated employees (who may ask Seller to "gross them up").

c. <u>ERISA compliance</u> with fiduciary, plan administration and reporting and disclosure rules. Exposure: Claims and civil penalties.

2. *<u>Financial issues</u>*.

a. <u>Retiree health commitments</u>.

(i) Should be disclosed on Seller's financial statements.

(ii) Determine duration and extent of commitments, and whether "vested"—<u>i.e.</u>, has Seller reserved the unqualified right to change or terminate these benefits, in order to manage financial exposure.

(iii) Analysis required of:

(A) Plan documents and SPDs.

(B) Any individualized agreements or promises of lifetime benefits—especially for founders and key employees.

(C) All employee communications.

(D) Past practices.

(iv) Analysis of whether retiree or lifetime benefit commitments are insured or funded, in whole or in part, to limit or manage Seller's financial exposure.

b. <u>Accrued but unpaid premiums or benefits, including runoff liabilities:</u> For self-funded medical plans, estimating the amount of accrued but unfunded termination liability if Seller's plans are terminated.

c. <u>Excise taxes and penalties:</u> For COBRA violations; reporting and disclosure obligations under ERISA; and notification and disclosure obligations under health laws listed above, such as HIPAA, WHCRA, NMHPA, and MMA.

B. Other Welfare Plans and Payroll Practices.

1. *Compliance issues*.

a. Plan documentation for flexible spending account plans, dependent care assistance programs, adoption assistance programs, and educational assistance programs that comply with applicable requirements of Internal Revenue Code and ERISA.

b. Nondiscrimination rules for group term life insurance plans, dependent care assistance programs, and certain educational assistance programs.

c. ERISA compliance, including plan administration, claims processes, and reporting and disclosure obligations—especially for plans that are subject to ERISA (such as EAPs and severance plans) but may not have been treated as such by Seller.

2. *Financial issues*.

a. Welfare insurance plans: Accrued but unpaid premiums or contributions.

b. Severance plans: Accrued but unfunded severance pay obligations.

(i) A severance plan will be considered a “welfare plan,” not a “pension plan,” as long as they do not exceed the employee’s annual compensation and payments are made over a period of less than 24 months after termination.

(ii) Seller’s severance pay plans should be reviewed to determine if amounts are payable upon transaction (even if employee is rehired by Buyer); whether amounts are payable if an employee continues to be employed but has a material reduction in duties or compensation in the new organizational structure post-transaction; and which party—Seller or Buyer—has that liability.

c. Vacation/sick/personal leave payroll practices.

(i) These liabilities are almost always accrued but unfunded, and can be significant depending on the generosity of the Seller in permitting employees to accrue and carry over unused benefits.

(ii) Many states (and policies of Seller) require accrued vacation or paid leave to be paid upon termination.

(iii) Issues include whether the transaction will trigger payment; whether Seller or Buyer will pay; and to what extent will accrued leave balances and service credit be transferred to Buyer.

VI. Action Steps to Take for Future of Benefit Plans, Post-Closing.

A. General Considerations.

1. *Legal restrictions*.

a. Driven by structure of transaction (stock vs. asset).

(i) Merger/stock transactions: Seller's employees automatically become employees of Buyer (or Buyer's acquisition subsidiary). All service credit transfers.

(ii) Asset transactions: Seller's employees do not automatically transfer to Buyer, and Buyer can determine if it wants to hire Seller's employees. Service credit does not automatically transfer by operation of law, but must be specifically negotiated.

b. Tax qualification rules.

(i) Minimum participation and coverage rules (subject to transition rule where the plans of both the Seller and the Buyer continue to satisfy these rules through the last day of the plan year following the plan year in which the acquisition occurred, provided that the plans satisfied the minimum participation and coverage rules immediately prior to the acquisition and no significant changes are made to the plan's eligibility or coverage during the transition period.)

(ii) Nondiscrimination tests, including identification of HCE's and determination of top heavy status.

(iii) Anti-cutback rules.

2. *Costs*. Of maintaining separate plans; of integrating plans; of terminating plan, especially if mid-year or off-cycle.

3. *Compatibility of plans and company cultures.* Examples include different philosophies about company stock; amount of matching contributions; vesting schedules; subsidy of health insurance coverage; paid leave accruals and forfeitures, etc.

4. *Impact on employee morale.*

B. Future Steps for Retirement Plans.

1. *Termination of Seller's plans.*

a. General structure.

(i) Seller amends plan and/or takes corporate action to terminate plan.

(ii) *Note*: "Partial terminations" of plans can happen automatically, by operation of law, if Seller's workforce is sufficiently reduced due to layoff, reorganization, etc. as part of the acquisition and there is a reduction of 20% or more in the number of participating employees. Only "affected" participants (i.e., those who have been laid off) are required to be fully vested.

b. Distributions may be affected.

(i) Timing of termination of Seller's plans may affect the right of Seller's employees to receive a distribution of their benefits.

(ii) *Example*: If a Seller's 401(k) plan is terminated after closing but Buyer maintains a qualified retirement plan, then benefits cannot be distributed because of certain successor employer limitations. This limitation can be avoided if Seller's plan is terminated prior to closing, either by plan amendment and/or by board action.

c. 100% vesting. Termination requires 100% vesting of benefits. This can have a cash-flow impact if the plan sponsor relies on the amount of forfeitures to offset commitments to future costs, or if the plan is a defined benefit plan.

d. Notice requirements. Advance notice may be required—at least 45 days' advance notice is required for certain pension plans. No advance notice is technically required for profit sharing or 401(k) plans, but is recommended for employee relations purposes.

e. Withdrawal liability. For multi-employer defined benefit plans, the termination of an employer's participation in the plan will trigger the calculation and assessment of withdrawal liability, which can be a significant expense.

f. IRS filing. Filing with IRS (and with PBGC if a defined benefit plan) is recommended to receive a determination that the termination does not adversely affect the qualified status of the plan.

g. Amendments. May require amendment to plan to change plan sponsor and memorialize termination.

2. *Freezing of plans*.

a. Pension plans require advance notice of at least 45 days.

b. Full vesting required.

c. Avoids distribution limitations that apply to 401(k) plans.

d. Effective technique if the Seller's plans have operational issues, and if the Buyer is concerned about the plans' tax-qualified status and does not want to continue to operate them.

e. Requires additional administrative costs, since frozen plans must continually be updated to reflect changes in the law, plus satisfy annual reporting and audit requirements.

f. May require amendment to plan to change plan sponsor and memorialize freezing of plans.

3. *Merger of Seller's plans into Buyer's plans*.

a. Requires analysis of protected benefits, rights and features, so that these benefits are preserved and separately accounted for (even if not applicable to "new" benefits after the date of plan merger or even if they are eventually amended out of the plan). Optional forms include any feature relating to a distribution form, such as payment schedules (lump sum vs. installment vs. annuities), timing of payments, the medium of distribution, and all election features.

b. Requires an agreement of plan merger/transfer of assets, or a plan amendment, plus coordination with recordkeepers for transfer and reconciliation of data and implementation of “black out periods” (with advance notice to participants) when assets are transferred.

(i) Requires that participants have opening account balances in the surviving plan that are equal to the closing account balances under separate plans.

(ii) Before merger, unallocated forfeitures under separate plans must be allocated to plan participants.

c. Avoids full vesting, administrative costs and complexities of maintaining two plans.

d. Increases risks to Buyer, since latent defects that may jeopardize the tax-qualified status of Seller’s plans may taint Buyer’s plans.

e. Cost-effective technique if a defined benefit plan of one party is overfunded and a defined benefit plan of another party is underfunded.

f. May require plan amendment to reflect new plan sponsor; avoid dual eligibility; and provide for appropriate service credit.

4. *Continued maintenance of Seller’s plans without change.*

a. Feasible as long as minimum coverage, minimum participation requirements, and nondiscrimination tests can be met.

b. Provides continuity for employees of Seller.

c. More exposure for Buyer if there are latent disqualifying defects or if the indemnification has questionable value.

d. May require plan amendment to reflect new plan sponsor; avoid dual eligibility and provide for appropriate service credit.

e. In an asset-based transaction, the transaction agreement should provide that all liabilities associated with the maintenance of the Seller’s plan prior to the transaction remain the liabilities of the Seller, and that Seller indemnifies Buyer to extent Buyer has any abilities for per-closing benefit plans.

f. Buyer needs to make sure that Seller will be responsible for prior 5500 reporting and that it gets all sufficient information to maintain the plan.

5. *Continued maintenance of Seller's plans with amendments to improve or reduce future benefits, or spin-off of a portion of Seller's plan assets.*

   a. Feasible as long as minimum coverage, minimum participation requirements and nondiscrimination tests can be met.

   b. Provides continuity for employees of Seller.

   c. More exposure for Buyer if there are latent disqualifying defects or if the indemnification has questionable value.

   d. Advance notice required for certain pension plans.

   e. Spin-offs of plan assets from defined benefit plans can be very complex because of required actuarial calculations, so that the portion of the spun-off plan has at least as much funding of their benefits after the spin-off as before the spin-off.

   f. May require plan amendment to reflect new plan sponsor; avoid dual eligibility; and provide for appropriate service credit.

C. Future Steps for Nonqualified Deferred Compensation Plans.

1. *Terminate plans.*

   a. The final 409A regulations describe the circumstances under which nonqualified deferred compensation plans can be terminated in connection with a transaction.

   b. As a general matter, plans can be terminated, and all amounts can be paid out, within 30 days before or 12 months after a change in control transaction.12 months of a transaction, without running afoul of the 409A's limitations on acceleration payments, but only if all similar arrangements are terminated.

2. *Continue separate plans.*

   a. Provides continuity for employees of Seller.

   b. Limits risks for Buyer if there is concern about compliance of Seller's plans with 409A or ERISA obligations.

   c. May require plan amendment to reflect new plan sponsor; avoid dual eligibility; and provide for appropriate service credit.

d. Note: The final 409A regulations provide that in asset purchase transactions, the Buyer and Seller can negotiate and agree whether or not individuals who perform services for the Seller immediately before the transaction, and who perform services for the Buyer immediately after the transaction, have experienced a "separation from service" that may trigger the right to certain nonqualified payments. All similarly situated individuals must be treated alike, and the negotiated decision must be memorialized in writing before the closing of the asset purchase transaction.

3. *Merge and integrate plans.*

a. Provides more consistency and integration among employees.

b. Requires coordination with recordkeepers for transfer and reconciliation of data and possible implementation of “black out period” for investment of notional accounts when assets are transferred.

c. Plan amendments may be required to grandfather or reflect separate accounts for transferred assets; reflect new plan sponsor; avoid dual eligibility; and provide for appropriate service credit.

D. Future Steps for Welfare Benefit Plans.

1. *Continue separate plans.*

a. All plans and insurance contracts need to be reviewed to determine need for amendments for sponsoring employer, eligibility, etc.

b. For self-insured medical plans, minimum coverage rules may not be met after transaction. Exposure: Reimbursements made to highly compensated employees from a discriminatory self-insured plan is includable in income (and executives may seek tax “gross up”).

c. May require plan amendment to reflect new plan sponsor; avoid dual eligibility; and provide for appropriate service credit.

2. *Termination of Seller’s plans and integration of Seller’s employees to Buyer’s plans.*

a. Provides more consistency and integration among employees; enables Buyer to have more leverage for negotiations with vendors.

b. Right to change or terminate any benefits—especially retiree medical benefits—will turn on language in the medical benefits program.

c. If done mid-year, exposure could include:

(i) Mid-year termination penalties.

(ii) Runoff termination liabilities with self-funded plans.

(iii) Appropriate crediting of charges against annual deductibles and out of pocket limits (or flex account elections and balances).

(iv) Waiver or crediting of pre-existing condition limitations.

d. COBRA coverage for "M&A qualified beneficiaries"—those who have a qualifying event in connection with the transaction.

e. Plan amendments may be required to reflect new plan sponsor; avoid dual eligibility; and provide for appropriate service credit.

E. Future Steps for Payroll Practices.

1. Cash out of some or all of benefits before transaction.

2. Carryover of some or all of benefits.

3. Amendments to policies may be required to avoid dual eligibility and provide for appropriate service credit.

<u>EMPLOYEE BENEFITS DUE DILIGENCE CHECKLIST</u>

	<u>Employee Census Information</u>
	Name and address
	SSN
	Date of Birth
	Gender
	Date of Hire (including all credited service)
	Job Title
	Base Salary
	Target Bonus/Commission
	Retirement Plan Coverage
	Medical Plan Coverage
	Dental Plan Coverage
	Vision Plan Coverage
	<u>Contact Information</u> ***(for each broker; insurance carrier; actuary; consultant; claims payor or third-party administrator)***
	Name and address
	Phone number
	Email address and website
	Plan number
	<u>Qualified Retirement Plan</u> ***(defined benefit pension plans; money purchase pension plans; profit-sharing plans; 401(k) plans)***
	Plan documents and amendments *(Note: for prototype plans, this includes and adoption agreement and underlying prototype plan document)*
	Trust documents
	Summary plan descriptions ("SPDs")
	Insurance or group annuity contracts
	Most recent IRS determination letter *(Note: for prototype plans, this includes an approval letter for the prototype and may also include an individualized determination letter if plan is a nonstandardized prototype)*
	Service agreements
	3 most recent 5500s with all schedules, audits, and actuarial reports
	Nondiscrimination testing and top-heavy testing for 3 past years
	Funding information, valuation reports, and calculation of withdrawal liability (if any) for defined benefit pension plans.
	Financial information showing the amount of any accrued but unpaid contributions or benefits, and when due

EMPLOYEE BENEFITS DUE DILIGENCE CHECKLIST

	Nonqualified Deferred Compensation Plans ***(voluntary deferred compensation plans, supplemental executive retirement plans-SERPs, excess benefit plans, executive agreements)***
	Plan documents, agreements, including any documentation about 409A analysis and compliance
	Documents for rabbi trust or other funding vehicles
	Descriptions of any informal arrangements
	Trust statements for last 3 years
	Service agreements
	If a public company, documentation regarding identification of "specified employees" subject to 6-month delay on payments
	Financial information with amount of accrued but unpaid benefits
	Insurance/Welfare Plan Benefits ***(health insurance plans [including HMOs, PPOs, wrap plans, retiree plans, Medigap plans], prescription drug plans, dental plans, vision plans, employee assistance plans, flexible spending accounts and cafeteria plans, dependent care assistance programs, life insurance plans, short and long-term disability insurance plans, accidental death and dismemberment policies, business travel insurance plans, long-term care insurance plans, severance pay plans)***
	Plan documents
	Trust agreements
	Insurance policies, including stop-loss insurance
	Service agreements
	Summary descriptions, booklets or communications provided to employees
	Individualized agreements, contracts or summaries of oral agreements providing for welfare benefits
	3 most recent 5500s, plus all schedules and audits
	Nondiscrimination testing for past 3 years, as applicable
	Sample COBRA notification forms
	Sample HIPAA Certificates of Creditable Coverage and Medicare Part D Notices
	Schedule of current COBRA recipients and people eligible to elect COBRA, plus COBRA premiums and date when COBRA ends
	Financial information for past 3 years regarding medical claims experience; premium information; accrued but unpaid insurance premiums; penalties for mid-year termination of contracts; estimated run-off liability for self-insured plans
	HIPAA privacy notice and compliance manuals with policies and procedures for HIPAA privacy and security rules
	Copies of all HIPAA business associate agreements

<u>EMPLOYEE BENEFITS DUE DILIGENCE CHECKLIST</u>

	Payroll Practices ***(vacation leave, sick leave, paid time off, personal leave, paid holidays, severance policies)***
	Copy of employee manual or handbook and all policies regarding vacation leave, sick leave, personal leave and severance pay
	Summaries of individualized agreements and historical patterns or practices that might create expectations for severance or payment of accrued leave benefits
	Financial information showing amounts of accrued liabilities and when payable