DON'T LET THE ERISA TRAIN DERAILED THE DEAL:
7 Simple Steps to Help Minimize ERISA Liabilities in an
M&A Transaction

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Employee benefit plans involve complex and overlapping regulatory structures. Total retirement plan assets in the United States exceeded 17 trillion dollars as of September 30, 2011. That figure does not include any of the dollars devoted to health or welfare plans, amounts that might be provided through foreign plans or any of the variety of other types of employee benefit plans such as severance plans, stock plans, etc. So, whether representing the seller or the buyer, whether the transaction is a stock sale or a sale of assets, and whether the client is large or small, in all mergers and acquisitions transactions involving employees, counsel will have to deal with employee benefits issues. This article examines practical steps that a business lawyer can take to help their client minimize potential employee benefits liabilities.

Step #1: Start early and assemble a competent team.

One of the first steps should be to assemble a competent team of professionals to assist. In addition to the top executives who are working on the transaction, qualified human resources personnel should be brought into the process as early as possible. If discovered soon enough, many benefits issues can be resolved at a reduced cost through Internal Revenue Service (“IRS”) or U.S. Department of Labor (“DOL”) voluntary compliance programs. If the competence of the Human Resources (“HR”) staff in the benefits area is an issue or if the client prefers not to notify HR of an impending sale or merger of the company, then outside HR consultants can be used. Other members of the team could involve employee benefits counsel, accountants experienced with benefits issues, plan consultants, plan actuaries and third party plan administrators.

Step #2: Compile a comprehensive list of the “benefits” and “plans” and then look for red flags.

Once a team is in place, the buyer should request and the seller should provide a comprehensive list of employee “benefits” and employee benefit “plans.” Note the distinction, an employer may provide an employee benefit that is not a part of an employee benefit “plan.” Representations and warranties in a purchase and sale or merger agreement often vary based on whether a benefit is a “plan” and if it is a plan, whether it is subject to ERISA. For example, most stock option plans are plans, but are not welfare benefit plans or deferred compensation plans and therefore, are not subject to ERISA at all. To constitute an employee benefit “plan” the employer must have established an administrative scheme. In contrast, if an executive’s employment agreement provides a one-time severance payment, that payment is an employee benefit, but is not likely to be an employee benefit “plan.” However, severance payments that extend over several years may rise to the level of an employee benefit “plan.” Even if both of the companies involved in the transaction profess not to maintain any “employee benefit plans,” someone must make the legal determination that there are not any benefit “plans,” which is not always simple or easy to do.

It is important to keep in mind that for many employee benefit plan issues, the normal standards of substantial compliance do not apply. Failure to exactly follow the terms of a qualified retirement plan can potentially disqualify the plan, resulting in the loss of favorable tax treatment for the entire plan even if the failure affects only one employee, is immaterial or is in the employees’ favor. For example, if the plan sponsor fails to timely adopt a required interim amendment to a qualified plan, that failure can disqualify the plan, even though the amendment itself has no application to that particular plan. An improper COBRA notice can result in significant liability, even if the failure was only with respect to one employee for a short period of time and even where the employee has other coverage. If employees’ retirement plan funds are being transferred to the buyers’ plan, a “black-out” notice is required and stiff penalties can apply if it is not provided in a timely manner; this is true also where the notice is provided but no one kept a copy of it and there is no proof of delivery. Thus, for many employee benefits problems, the term “no harm, no foul” does not apply.

It is also important to distinguish between the types of benefit plans and issues involved. Some benefits issues are common, but are easily remedied and rarely result in large penalties, litigation or significant enforcement action. For example, a late or missing
The scope and degree of due diligence in benefits matters will depend on the size of the transaction, the number of employees, the type of transaction (asset sale or stock sale) and the types of benefits plans involved. In an asset sale, employee benefit plans are generally the responsibility of the seller, even after the transaction closes, but there are exceptions and counsel involved in asset sales will need to keep in mind that some liabilities, such as certain liabilities under COBRA, will transfer even in an asset sale. However in a stock sale or merger, the buyer or successor becomes responsible, not only for the ongoing administration of the plans, but also for certain liabilities of the seller with respect to the prior administration of those plans. For example, if a qualified retirement plan has a disqualifying defect, the plan remains disqualified for tax purposes until the qualification error is actually corrected, even if the disqualifying event occurred many years ago and prior to the closing. If that plan is merged into the buyer’s plan, the buyer’s plan will also be disqualified. Or if the buyer assumes sponsorship or administration of the disqualified plan, the buyer may be left with only two choices, allow the plan to become disqualified or pay to fix the defect.

Once the type of transaction and benefit plans have been identified for the buyer by the seller, and any red flags noted, a customized “due diligence checklist” can be created. For example, sellers commonly request that buyer provide a list of all employee benefits and employee benefit plans along with a representation that these constitute all of the benefits offered by buyer to its employees and that all such plans comply with ERISA. Again, the earlier in the process this is done, the better. If a seller is actively seeking a buyer, it is best if the seller can start its own due diligence process as soon as it starts contemplating a sale. This allows the time needed for the seller’s HR department to compile a complete list of benefits and plans and related plan documents (e.g., the plan’s “adoption agreement,” accompanying “basic plan document,” summary plan description, copies of recently filed Form 5500s, independent financial auditor’s reports, documents (e.g., the plan’s “adoption agreement,” accompanying “basic plan document,” summary plan description, copies of recently filed Form 5500s, independent financial auditor’s reports, recent government agency determinations), and other relevant information.

Step #3: Use a proactive approach to due diligence.

The employer provides an inadequate response to due diligence requests. It will be impossible to evaluate and minimize risks without complete and accurate information.

The employer is or has been the subject of government (or private) enforcement actions or litigation involving benefits or benefit plans.

1. The employer maintains an employee stock ownership plan (“ESOP”) or other plan that invests in securities of the employer. When an ESOP owned business struggles, employees may lose both their jobs and their retirement savings at the same time. Claims that plan fiduciaries should have sold the plan’s company stock sooner rather than later are not uncommon.

2. The employer maintains or contributes to a defined benefit plan (particularly if the plan is subject to Title IV of ERISA). Employers who sponsor defined benefit plans must meet minimum funding requirements and are liable for any underfunding of the plan. That liability can be passed to a buyer, even in an asset sale.

3. The employer contributes to a multi-employer plan. These employers and their successors may be subject to “withdrawal liability” if the plan is underfunded and the employer’s obligation to make contributions ceases.

4. Executives have rights to benefits upon a change in control. The buyer will want to understand what rights and benefits might be triggered by a change in control and whether such benefits are subject to restrictions on corporate income tax deductions for compensation paid in connection with a change in control.

5. Employees are provided with deferred compensation through non-qualified plans. All non-qualified deferred compensation benefits should be reviewed to confirm that they are either exempt from, or compliant with, Internal Revenue Code Section 409A as the penalties for non-compliance can be significant, especially in California which layers an additional 20% state tax penalty on top of the 20% federal penalty.

6. The employer is a member of a controlled/affiliated group. Liability for underfunded defined benefit plans can extend to all members of a controlled group, regardless of whether or not the controlled group members have employees participating in the plan.

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reports, adopting resolutions and plan amendments) and start the process of reviewing those documents for compliance. Often, the buyer must make multiple requests for the documents called for in the checklist. Buyers who promptly receive complete and well organized responses to benefits due diligence requests can take some comfort in that – it may or may not mean that the benefits plans have been administered with the same attention to detail, but it is at least a sign that they have been. Buyers who receive limited or incorrect responsive documents to a due diligence request may likewise view that as an indication that in an area that demands meticulous recordkeeping, seller’s HR department has been found lacking.

Once the due diligence documents have been produced and reviewed, the buyer will be in a better position to negotiate appropriate protections in the acquisition agreement itself and to review the need for fiduciary or other insurance as discussed below.

Step 4: Review and/or purchase appropriate liability insurance.

Both sellers and buyers can provide some additional protection for themselves by each purchasing appropriate errors and omissions and fiduciary liability insurance, in addition to any fidelity bonds required under ERISA. As with all insurance policies, the policy must be purchased prior to the date it is needed; new policies do not typically cover prior acts. Employee benefit plan sponsors often act in more than one capacity with respect to the same plan (e.g., a decision to amend a plan is typically a “plan sponsor” decision that is not subject to fiduciary responsibility or liability, but a decision to hire an investment manager for plan funds is a fiduciary decision that is subject to fiduciary liability.)

Because of this, plan sponsors and fiduciaries often need multiple policies such as: (1) a general liability policy (which for example, generally covers liability from slip and fall or auto accidents but often excludes any ERISA liability); (2) an officer and director errors and omissions policy (which covers acts of the officers and directors in their capacity as plan sponsor, but usually does not cover acts as an ERISA fiduciary); (3) the ERISA required fidelity bond (which benefits the plan itself, but does not provide coverage to plan fiduciaries or corporate officers and directors themselves); and (4) a fiduciary liability policy (which should cover fiduciary liabilities to the extent described in the policy). Further, the policies need to be reviewed carefully to eliminate gaps in coverage. For example, in a recent federal case, IBM found itself on the wrong side of a fiduciary liability coverage dispute, when it was sued by plan participants for a decision that was made in its capacity as plan sponsor, and no fiduciary breach was alleged. In that case, although the class action suit against IBM involved a decision made with respect to its qualified retirement plan, the state court ruled that the fiduciary insurance policy did not provide coverage for the $300 million dollar settlement or the $88 million dollars in legal defense fees that IBM incurred in defending the lawsuit.

Step #5: For Buyers - Negotiate to obtain strong protection from the seller.

Buyers should seek broad representations and warranties with respect to all benefit plans, even those that were maintained in prior years and have since been terminated or that are anticipated to be terminated. The statute of limitations may not provide protection in the event that claims for benefits are made or a plan disqualification error is found. For this reason, if seller is providing contractual indemnities, the length of time for such indemnity should be reviewed in connection with the expected period of liability for unknown, but commonly found benefit plan issues and any caps on the indemnity should also be considered in light of the size of the potential liabilities related to the benefit plans. If compliance issues are discovered during due diligence, those can be corrected pre-closing or covenants to correct can be drafted. Care should be taken in drafting covenants, especially covenants that require that benefits be continued post-closing. In an unusual holding, a covenant in a merger agreement that required that the successor maintain a retiree medical plan post-closing except if the same changes were made to the retiree medical plan of the successor was deemed to be an amendment to the plan itself. Therefore, the buyer was held to have breached the merger agreement by attempting to subsequently amend the plan to reduce ongoing retiree medical benefits of the acquired employer’s plan without also amending the plan for its own employees.

Step #6: For Sellers – Negotiate for representations and warranties that you can actually give.

Although buyers typically seek broad representations and warranties, a seller may not be able to give those representations in good faith. Despite the seller’s best efforts, the difficulty of knowing whether the myriad of statutes and regulations that do apply to benefits plans have actually been complied with can be daunting and the more obscure ones easily missed. As discussed, both the Internal Revenue Service and the United States Department of Labor, Employee Benefits Security Administration offer voluntary compliance programs to employers who find and
desire to correct their own compliance mistakes. These programs grew out of recognition, both by the government agencies that regulate employee benefits plans as well as by Congress, that it is virtually impossible to fully comply with these rules 100% of the time and that honest mistakes may occur.33 Sellers will want to negotiate for a limited representation that limits liability to known issues and takes into account only the actual plans being offered (for example, if the seller does not and has never maintained any defined benefit plan, representations regarding compliance with funding rules, Pension Benefit Guarantee Corporation (“PBGC”) filing requirements, etc. can be stricken in favor of a representation that no such plans are or ever have been maintained by seller, nor is seller obligated under any such plan).

Step #7: For Buyers and Sellers – Work together for a smooth transition.

Once a company is sold or a transaction has closed, the real work may begin with respect to the employees and employee benefits that are affected by the transaction. It is wise to plan for this from the beginning, so that arrangements can be made by the buyer to either retain key personnel directly as employees (or independent contractors) or files can be transferred to new personnel with some opportunity to reach prior employees with questions. In approximately 25% of the penalty appeals for late filings of Form 5500,34 the reason cited is that there was a prior M&A transaction and plan records were either lost or HR personnel left and the responsibility to get the Form 5500 filed was never properly transferred to a successor employee.35

Tasks often move slowly in the employee benefits world—final information returns are not due until seven months after the end of the following plan year, companies often have a twelve month or more grace period to meld their plans and employees, and it is not unusual for the Internal Revenue Service to take a year or more to respond to a voluntary correction filing, if any. Further, U.S. Department of Labor investigations can drag on for years, and employees may not make claims for benefits until they retire, long after the deal has closed. In the meantime, employee benefit compliance can easily fall through the cracks, e.g., even though no new contributions are being made to the plan, Form 5500s must be filed until such time as a plan no longer has any remaining assets, and by that time most of the participants are gone. Likewise, if a voluntary correction filing is made just prior to closing, it may take a year or longer for the IRS to review and act on the filing and by the time the IRS asks for more information or signed plan amendments, a responsible person with authority to act may still be needed to complete the voluntary correction of a plan defect.

In addition, a number of benefits issues do not arise until the transaction closes. For example, a substantial layoff can lead to what is known as a “partial termination” in a qualified plan requiring immediate full vesting of affected employees,36 notices to the PBGC37 may be required upon the sale of a controlled group or in other circumstances,38 plan documents may need to be amended to either include or exclude newly acquired employees or new controlled group members (ideally this has already been done or is done concurrently with closing), plans may need to be terminated or merged, and new employees may need to be enrolled in buyer’s plans. While it is of course helpful to anticipate and plan for these events as much as possible prior to closing, many of them will not actually be implemented until after closing and cooperation between personnel of seller and buyer will help that situation.

In the case of a 401(k) plan, if the plan is being terminated as a part of the M&A transaction and it is intended that employees be given the option of taking a distribution from the plan even though they will continue employment after the closing, the plan termination should be initiated through board action prior to the closing. Otherwise, distributions to employees who have not severed from employment may be prohibited and the only practical options will be to either merge the seller’s 401(k) plan into the buyer’s plan or leave it as a frozen plan and pay benefits as employees actually do sever employment.39

Conclusion

Potential liabilities with respect to employee benefit plans in an M&A transaction can be significant and can attach to successor employers in sometimes surprising ways. However, counsel can proactively assist their clients in taking steps to minimize employee benefits liabilities in an M&A transaction by taking a few simple steps. Of these, the most important are to: (1) start early and (2) assemble a competent team. If these two steps are followed, the expert team can then engage in the required due diligence, review for red flags, assist with drafting covenants and representations in agreements and will have time to make any necessary compliance corrections, including filings under governmental voluntary correction programs if needed. Finally, buyer and seller can work together to help assure a smooth transition for employees and their benefits.
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Endnotes

1 Most private retirement and welfare benefit plans are subject to the federal statute known as “ERISA” which is an acronym for “Employee Retirement Income Security Act of 1974” (Pub. L. No. 93-406, 88 Stat. 829 (“ERISA”)). While ERISA preempts most state laws, it does not preempt all state laws. See ERISA § 514. ERISA itself is found in both the United States Tax Code (Title 26 U.S.C.) as well as the United States Labor Code (Title 29 U.S.C.) and employee benefit plans that are subject to ERISA are regulated by both the Department of the Treasury and the Employee Benefits Security Division of the United States Department of Labor. “Defined Benefit Pension Plans” may also be subject to regulation by the Pension Benefit Guarantee Corporation (“PBGC”) under Title IV of ERISA. Some employee benefit plans are themselves “securities” and are also regulated by the Securities and Exchange Commission. See, e.g., Section (a)(1) of the Securities Act of 1933 (15 U.S.C. §77b(a)(1) et. seq.) and Section 3(a)(10) of the Securities Exchange Act (15 U.S.C. §78c(a)(10)). Plans that are funded through insurance policies are subject to state regulation ERISA § 514(b)(2)(A) and non-ERISA plans are subject to applicable state laws.


3 See Rev. Proc. 2008-50, 2008-35 I.R.B. 464 which established the IRS voluntary correction program known as “EPCRS” or the Employee Plans Compliance Resolution System;” 71 Fed. Reg. 75, 20261 (April 19, 2006), which established the Department of Labor’s voluntary fiduciary compliance program. See also, 67 Fed. Reg. 60, 15051 (March 28, 2002) which establishes a program for voluntary correction of late filings to the Department of Labor (“DOL”) for plans covered by ERISA of the required annual informational return for plans on Form 5500 (the Delinquent Filer Voluntary Compliance Program, “DFVCP”). Correction under DFVCP is also accepted by the IRS and the PBGC (see section 5 of DFVCP).

4 See ERISA § 3(3); Department of Labor (“DOL”) Reg., 29 C.F.R. §§2510.3-1-2510.3-2; Fort Halifax Packing Co. v. Coyne, 482 U.S. 1 (1987)(statute requiring severance payment did not result in the creation of an “employee benefit plan” within the meaning of ERISA).


6 Fort Halifax, 482 U.S. at 1737.

7 29 C.F.R. § 2510.3-2(b).


9 Basch Engineering Inc. v. Comm’r., T.C.M. 212 (1990) (plan disqualified for failure to timely amend to reduce minimum age to 21, even though no employees were actually under the age of 21 at the time); Christy & Swan Profit Sharing Plan v. Comm’r., T.C.M. 62 (2011) (plan disqualified for failure to timely amend, even though no participant affected).

10 COBRA is an acronym for the “Consolidated Omnibus Budget Reconciliation Act of 1985.” See I.R.C. § 4980B; ERISA § 601 et seq.


12 ERISA § 101(i); 29 C.F.R. § 2570.130 et seq.

13 For example, many 401(k) plans are occasionally a few dates late in transmitting employee elective deferrals to the plan trustee. Although this error is a relatively common violation, the dollar amount of liability to correct it is generally small, as it is based on lost earnings during the relatively short period that the contributions are not in the plan and an excise tax on those amounts. See supra note 3 in regard to the DFVCP.

14 See supra note 3.

15 Moriarty v. Svec, 164 F.3d 323, 327 (7th Cir. 1998).


18 I.R.C. § 412; ERISA Section 4062.

19 ERISA § 4068.

20 ERISA § 4201, et seq.

21 I.R.C. § 280G.


24 ERISA §§ 4062, 4064.

25 Subject to contractual modification of statutory obligations, if a seller in the sale of substantially all of its assets stops providing health benefits within 18 months of closing, the buyer could be required to provide COBRA coverage where the buyer has continued the seller’s business. Treas. Reg. § 54.4980B-9, 66 Fed. Reg. 1855 (Jan. 10, 2001).

26 See, e.g., Rev. Proc. 2008-50 § 14.03 which provides for a sanction in the form of a non-deductible payment to be paid by a buyer in a corporate transaction, even if there are no new failures after the transaction closed and the buyer took over the plan.

27 ERISA § 412.
30 Martin Fireproofing Profit Sharing Plan v. Comm’r., 92 T.C. 1173 (1989) (plan disqualified for all years following error in applying annual dollar limits on contributions; disqualification not limited to year of error and failure to file proper form with return resulted in no statute of limitation for that year), citing Boggs v. Comm’r., 83 T.C. 132, 144 (1984)(plan’s violation of nondiscrimination rule resulted in disqualification for subsequent years), rev’d. on another issue, 784 F.2d 1166 (4th Cir. 1986).
31 Halliburton v. Graves, 463 F.3d 360 (5th Cir. 2006).
32 Id. at 368.
34 If a required report on Form 5500 is not timely filed, either the IRS (in the case of a non-ERISA plan) or both the IRS and the DOL (in the case of a plan subject to ERISA), may assess penalties. I.R.C. § 6058 (The IRS may assess penalties of $25/day up to $15,000/year); ERISA § 502(c)(2) (DOL may assess penalties of up to $1,100/day with no annual limit).
36 I.R.C. § 411 (d)(3).
37 See supra note 1.
38 For example, notice to the PBGC is required within 30 days of closing if a transaction results in a change in the membership of a controlled group of corporations of a plan sponsor. ERISA § 4043. Advance notice may be required for certain large defined benefit plans of non-publicly traded companies. See ERISA § 4043(b).
39 See I.R.C. § 401(k)(10(A)(401(k) plan may not distribute benefits if member of controlled group maintains or established another defined contribution plan).

CORRECTION

With approval of the respective authors, the following section of the Legislative Update – Financial Institutions and Consumer Financial Services article that appeared on page 21 of the Annual Review (2012) of Business Law News is amended to read as follows:


(Enacted Chapter 82)

Effective July 11, 2011, SB 458 modified Code of Civil Procedure §580e to prohibit a deficiency judgment on one-to-four unit residential properties where the loan has been modified or refinanced, up to the amount of the original loan(s). It also extends short sale anti-deficiency protections to junior liens and broaden the overall prohibition to provide that, "[n]o deficiency shall be owed or collected, and no deficiency judgment shall be requested or rendered" if the short sale is agreed to in writing by the lien holder. It also clarifies that, in cases where the loan is secured by multiple collateral, only a deficiency judgment is prohibited. A consumer may not voluntarily waive this protection, and a lienholder may not require any additional compensation beyond the sale proceeds in exchange for giving written consent to the sale. These provisions do not apply if the trustor or mortgagor is a corporation, limited liability company, limited partnership, or a political subdivision of the state.

Amends Code of Civil Procedure §580e.