ERISA Benefit Plans in M&A: Transitioning Pension, Retiree Welfare and Defined Contribution Plans

Best Practices to Avoid Liability for Termination, Withdrawal and Nondiscrimination Testing

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AGENDA

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V. International Plans
I. Pension Plan Obligations
I. PENSION PLAN OBLIGATIONS

A. Treatment of Pension Plans
B. Single Employer Plan Underfunding Liability
C. Multiemployer Plan Withdrawal Liability
D. Joint and Several Controlled Group Liability (Sun Capital)
E. Minimizing Potential Liability in M&A Deal
A. Treatment of Pension Plans
I. PENSION PLAN OBLIGATIONS

A. Treatment of Pension Plans – In Transaction

**Stock Sale & Merger:**

- Treatment of a plan depends on whether it is maintained at the target entity (or any of its subsidiaries) versus a parent or other affiliate.

- Any plan maintained by the target entity or any of its subsidiaries will continue to be maintained by that entity, unless the parties provide otherwise.

- If a plan is maintained at the target’s parent or other affiliate, parties may agree to provide for the transfer of plan sponsorship or a division of the plan.

- Employees of target who continue to be employed by target after closing will not be terminating employment.
I. PENSION PLAN OBLIGATIONS

A. Treatment of Pension Plans - In Transaction

Asset Sales:

- Assets of an entity, but not the entity, itself, are acquired
- Absent agreement to provide otherwise, plans will remain with the Seller and will not be transferred to buyer
- Employees who transfer to Buyer will be terminating employment with Seller (but if plan or spun-off plan is assumed by Buyer, no termination may occur)
I. PENSION PLAN OBLIGATIONS

A. Treatment of Pension Plans - In Transaction

Possibilities

- Plan is automatically assumed/continued
- Plan is contractually assumed by Buyer
- Portion of assets and liabilities of Plan are “spun-off” as a new plan and contractually assumed
- Portion of assets and liabilities of Plan are transferred by trust-to-trust transfer to Buyer’s plan (e.g., a spin-off and merger)
I. PENSION PLAN OBLIGATIONS

A. Treatment of Pension Plans - In Transaction

- Transaction agreements should specifically address:
  - How plan will be assumed by Buyer
  - How trust-to-trust transfer/spin-off will be effected:
    - Timing
    - Activities
    - Actuarial assumptions
    - Dispute mechanism (“battle of the actuaries”)
I. PENSION PLAN OBLIGATIONS

A. Treatment of Pension Plans - In Transaction

Transfer of Plan Assets: Trust-to-Trust Transfer /“Spin-off”

IRC 414(l) (Treas. Reg. §1.414(l)-1)

- DC Plans
  - Transfer of vested and unvested accounts
    - Active participants
    - Parties may agree to transfer accounts of inactive participants who were employed by business or subsidiary

- DB Plans
  - Assets and liabilities must be transferred to provide each participant in the spun-off plan with a benefit that is at least equal to the value of the benefit the participant would have been entitled to receive before the merger
I. PENSION PLAN OBLIGATIONS

A. Treatment of Pension Plans – Post-Transaction

Treatment of Plan by Buyer

- Merge plan into Buyer’s existing plan
- Freeze plan
- Terminate plan
I. PENSION PLAN OBLIGATIONS

A. Treatment of Pension Plans – Post-Transaction

Merging Plans

- Plans may be merged into similar plans of Buyer
- When plans are merged, it is necessary that the surviving plan include all of the "protected benefits" of the merged plans
  - Protected benefits include early retirement benefits, certain retirement subsidies, and optional distribution forms
  - Vesting schedules may need to be preserved
Merging Plans

- Before merging plans, determine which benefits must be sustained as protected benefits.
  - The maintenance of certain protected benefits may make a plan merger infeasible or administratively burdensome.
I. PENSION PLAN OBLIGATIONS

A. Treatment of Pension Plans – Post-Transaction

Issues to Consider When Assuming Qualified Plans

- **Prior Service Credit**. (IRC 401(a)(4))
  - If employees of target are hired, Buyer may be required to, or may voluntarily decide to, amend its plans to grant prior service credit to transferred employees
    - Granting prior service credit to an employee of an acquired entity recognizes the employee's service to the acquired entity as service to the buyer for plan purposes
  - In an asset sale, prior service credit can be granted to transferred employees of an acquired entity for either eligibility or vesting purposes, or both, and can be limited to a maximum number of years
  - Such grant would be tested under IRC 401(a)(4) to determine whether such an amendment is not discriminatory in favor of highly compensated employees
  - In a stock sale, the grant of prior service to the transferred employees of an acquired entity is generally required for both eligibility and vesting purposes
Transfer of Plan Assets: Trust-to-trust Transfer Spin-off:

- If Buyer acquires only a division or subsidiary of seller and such division or subsidiary participates in the seller's tax-qualified plan, Buyer will not be able to assume the plan in which the acquired entity participates.

- Rather than assuming the plan, buyer may agree to take a trust-to-trust transfer from such plan.
  
  - Typically called a “spin-off”
I. PENSION PLAN OBLIGATIONS

A. Treatment of Pension Plans – Post-Transaction

Transfer of Plan Assets: Direct Rollover Distributions

- Sale of assets may be a distributable event for most plans unless Buyer assumes plan (or spin-off of plan)

- Where stock of subsidiary is sold Buyer and subsidiary’s employees participate in Seller’s tax-qualified pension plan, employees may be treated as having a termination of employment under the plan.

- If there is a distribution event under the seller’s plan, transferred employees may be permitted to roll over their benefits to one of Buyer’s plan
Transfer of Plan Assets: Trust-to-trust Transfer/Spin-off

- In a trust-to-trust transfer, an employee's account balance is paid by the trustee of one plan to the trustee of another.

- IRC 411(d)(6) requires that accrued benefits or optional forms of benefits not be reduced or eliminated.

- After a trustee-to-trustee transfer, a participant’s accrued benefits and optional forms of benefits that existed under the transferor's plan must exist to the same extent under the Buyer's plan.

- More flexibility to eliminate optional forms of benefit under DC Plans

- If Buyer agrees to allow a trust-to-trust transfer to its plan, it should carefully review the prior plan to ensure that such protected benefits will continue to be offered to transferred participants.
I. PENSION PLAN OBLIGATIONS

A. Treatment of Pension Plans – Post-Transaction

Terminating Plans

- Corporate action to terminate
- Full vesting of participants required (may include certain terminated participants)
- DC Plans, including 401(k) plans, may be terminated at any time
  - In the case of a stock deal or merger, if a 401(k) is terminated after closing, participants in the terminated plan may not participate in a new 401(k) plan for 12 months.
  - To avoid 12-month ineligibility period, 401(k) plan should be terminated immediately prior to closing (actual distributions may be made after closing)
- To terminate a single employer pension plan, plan will need to be fully funded, which may be very costly
Freezing Plans

- An assumed plan may be “frozen”
  - eligibility
  - accruals

- If a plan is frozen:
  - all active participants must continue to accrue vesting service in their plan benefits
  - plan must continue to be maintained in compliance with applicable law (e.g., Form 5500 should be filed, the plan document must be updated for legally required changes, etc.)
I. PENSION PLAN OBLIGATIONS

A. Treatment of Pension Plans – Post-Transaction

Freezing Plans
DB Plans

- Plan sponsor of a closed DB plan typically provides a DC plan for its new hires
- In the early years after the DB plan has been closed to new entrants, the plan may be able to satisfy the coverage requirement of IRC 410(b) without being aggregated with the DC plan
- IRC 410(b) minimum coverage test typically becomes more difficult for a closed DB plan to satisfy over time, as the proportion of plan participants who are highly compensated employees increases
I. PENSION PLAN OBLIGATIONS

A. Treatment of Pension Plans – Post-Transaction

Freezing Plans

DB Plans

- IRC 401(a)(26) requires that each qualified pension plan to benefit at least 50 employees or 40% of all employees in the controlled group
- Plans may not be aggregated to satisfy this requirement
- This requirement may restrict Buyer from maintaining a frozen pension plan permanently
- IRC 401(a)(26) provides a transition period to comply
- Transition period being on the closing date and ends of the last day of the first plan year beginning after the plan year in which the closing date occurs
I. PENSION PLAN OBLIGATIONS

A. Treatment of Pension Plans – Post-Transaction

Issues to Consider When Assuming Qualified Plans

- Nondiscrimination in Participation
  - To be tax-qualified, a plan must not discriminate in favor of "highly compensated employees"
  - If a plan is assumed in connection with a transaction, difficulties may arise in complying with IRC 410(b) depending on concentration of highly compensated employees in the acquired company and the overall concentration of highly compensated employees in Buyer’s controlled group
  - IRC 410(b) provides a transition period to comply with the coverage requirements following a transaction
  - Transition period begins on the closing date and ends on the last day of the first plan year beginning after the plan year in which the closing date occurs
I. PENSION PLAN OBLIGATIONS

A. Treatment of Pension Plans – Post-Transaction

Issues to Consider When Assuming Qualified Plans

- **Nondiscriminatory Contributions or Benefits**: (IRC 401(a)(4))
  - A plan must not discriminate with respect to contributions or benefits provided under the plan discriminate in favor of highly compensated employees
  - IRC 401(a)(4) contains three basic requirements:
    - Either the contributions or the benefits provided under a plan must be nondiscriminatory in amount (401(k) plans must satisfy a different nondiscrimination amount requirement)
    - Plan's benefits, rights, and features must be made available to participants in a nondiscriminatory manner; and
    - Effect of plan amendments (including grants of past service credit) and plan terminations must be nondiscriminatory
  - It may be difficult to satisfy this nondiscrimination requirement following a merger or acquisition because of the change in the workforce and the plans in which various groups of employees participate
I. PENSION PLAN OBLIGATIONS

A. Treatment of Pension Plans – Post-Transaction

Issues to Consider When Assuming Qualified Plans

- **Non-Discrimination of Optional Benefit Forms.** (Treasury Regulation §1.401(a)(4)-4(d))
  - Optional forms of benefit can continue to be available to participant in plan if:
    - Benefit satisfied the requirements under IRC 401(a)(4) immediately before the transaction and
    - Benefit is available under the plan of Buyer after the transaction on the same terms as it was available under prior plan before the transaction.
I. PENSION PLAN OBLIGATIONS

A. Treatment of Pension Plans – Post-Transaction

Freezing Plans – DB Plans

- Notice 2014-5
  - Limited relief from nondiscrimination requirements if DB plan was frozen before December 13, 2013
I. PENSION PLAN OBLIGATIONS

A. Treatment of Pension Plans – Post-Transaction

Issues to Consider When Assuming Qualified Plans

- **401(k) Plans**
  - IRC 401(k) and 401(m) provide that the amount of participant elective deferrals and matching contributions made on behalf of highly compensated employees cannot exceed the amount of deferrals and matching contributions to a plan on behalf of non-highly compensated employees by a certain amount.
  - These tests, known as ADP and ACP tests, are not performed on a controlled group basis – each 401(k) plan must satisfy these tests.
B. Single Employer Plan Underfunding Liabilities
Underfunded Defined Benefit Pension Plans

- One of the most significant Buyer liability issues in corporate transactions
  - Funded based on actuarial assumptions on several factors, such as—
    - Long-term interest rates
    - Mortality
    - Turnover
    - Retirement age
    - Investment returns
  - Assumptions used may vary depending on purpose for which liability is determined—
    - Financial accounting
    - Termination liability
    - PPA funding target/minimum contribution requirements
I. PENSION PLAN OBLIGATIONS

B. Single Employer Plan Underfunding Liabilities

- In the past several years, underfunding of defined benefit pension plans has become common, due to factors such as—
  - Economic Downturn – Impacts investment returns
  - Depressed Interest Rates – Increases present value of accrued benefits and funding targets
  - PPA Funding Requirements – Limits use of credit balances to fund benefits and requires higher funding levels than prior law
I. PENSION PLAN OBLIGATIONS

B. Single Employer Plan Underfunding Liabilities

- Primary issues Buyer needs to consider regarding target’s underfunded single-employer defined benefit pension plans include—
  - **Unfunded Termination Liabilities** – Adversely impacts Buyer’s balance sheet
  - **Requirement Minimum Contributions** – Effect on cash flow
  - **IRC § 436** – Will benefit restrictions be triggered?
I. PENSION PLAN OBLIGATION

B. Underfunding Liabilities: Termination Liability

- Underfunded DB Plan may be terminated through a “distress” termination initiated by the plan sponsor or through an “involuntary” termination initiated by the PBGC
  - PBGC may initiate an involuntary termination if it determines, among other things, that—
    - Plan has not met the minimum funding standard (e.g., a funding deficiency arises)
    - Plan will be unable to pay benefits when due
    - PBGC’s long-run loss with respect to the plan may increase unreasonably if the plan is not terminated
      - Liability risk to PBGC of plan termination before a corporate transaction is compared to liability risk of terminating plan after transaction.
      - *For example*, if transaction would substantially increase plan liabilities or reduce PBGC’s ability to collect termination liability, PBGC may decide its potential long-run loss warrants termination of plan
I. PENSION PLAN OBLIGATION

B. Underfunding Liabilities: Termination Liability

- When an underfunded DB Plan terminates, the PBGC may assert three types of termination liability claims—
  - **Unfunded Liabilities**: Difference, as of the date of plan termination, between the value of all accrued benefits under plan over value of plan assets, using conservative actuarial assumption set out in PBGC regulations for this purpose
    - Liabilities determined under these assumptions can be substantially higher than plan liabilities determined on an on-going basis
  - **Unpaid Contributions**: Unpaid contributions to the plan, prorated to the date of plan termination
  - **PBGC Premiums**: Unpaid annual PBGC premiums, prorated to date of plan termination, plus PBGC termination premiums
I. PENSION PLAN OBLIGATIONS

B. Underfunding Liabilities: Termination Liability

- Termination liability is joint and several obligation of contributing sponsor and each member of its controlled group
  - PBGC may seek payment of 100% of joint and several termination liability from any member of the controlled group
  - No provision in ERISA for allocating joint and several liability among controlled group members
I. PENSION PLAN OBLIGATIONS

B. Underfunding Liabilities: Termination Liability

- **Imposition of Lien**
  - If the Unfunded Liabilities are not paid upon demand, a lien in favor of the PBGC will be placed on all property of the plan sponsor and its controlled group members
    - Amount of lien is lesser of the Unfunded Liabilities and 30% of the combined net worth of the plan sponsor and its controlled group members
I. PENSION PLAN OBLIGATIONS

B. Underfunding Liabilities: Termination Liability

- PBGC Intervention in Transaction (PBGC Early Warning Program)
  - PBGC monitors companies with underfunded pension plans and looks for transactions that pose an increased risk of long-run loss to the PBGC
    - Focus is on transactions that may substantially undermine sponsor’s ability to fund plan or PBGC’s ability to collect termination liability if plan is terminated. *Examples*—
      - Break-up of controlled group, including spin-off of subsidiary
      - Major divestiture by employer who retains significant underfunded pension liabilities
      - Transfer of significantly underfunded pension liabilities in connection with sale of business
    - PBGC might request additional information regarding transaction and then go away, or may threaten involuntary termination of plan prior to the transaction if there are major issues
      - Threat of involuntary termination provides PBGC leverage to negotiate additional protections for plan, such as additional contributions, security for future contributions or a guarantee from a financially sound company that is leaving the controlled group
I. PENSION PLAN OBLIGATIONS

B. Underfunding Liabilities: Termination Liability

- **Evasive Transactions: 5-Year Lookback Rule**
  - If the principal purpose of entering into a transaction is to evade termination liability and the pension plan terminates within 5 years after transaction, the transaction is ignored for purposes of assessing termination liability against prior contributing sponsor
    - Benefit increases that are effective after the transaction date are not taken into account
  - If prior sponsor ceases to exist due to a reorganization, merger or consolidate, the successor entity (and the members of its controlled group) will be responsible for the termination liability
I. PENSION PLAN OBLIGATIONS

B. Underfunding Liabilities: Unpaid Contributions

- **Minimum Required Contributions**
  - **Funding Target**: Plan sponsors must make minimum required contributions to plans when value of plan assets is less than present value of all benefits accrued as of the beginning of the plan year (the “funding target”)
    - Minimum required contribution for year equals plan’s target normal cost plus amortization of the funding shortfall
      - Target normal cost is the present value of all benefits accrued during the plan year
      - Funding shortfall is the difference between the plan’s funding target and the plan’s assets
    - Additional contribution requirements and a higher funding target apply to “at risk” plans, i.e. funding target attainment percentage is less than 80%
  - **Timing**: Minimum required contribution for a plan year generally must be paid 8½ months after the end of the plan year
    - Quarterly contributions are required if the plan had a funding shortfall for the prior year
  - **J&S Liability**: Like termination liability, liability for unpaid minimum required contributions is joint and several obligation of plan sponsor and controlled group members
I. PENSION PLAN OBLIGATIONS

B. Underfunding Liabilities: Unpaid Contributions

- **Excise Tax on Unpaid Minimum Contributions**
  - If minimum required contribution isn't timely paid, sponsor will be charged an excise tax
    - For single-employer plans, the tax is 10% of the unpaid contribution
      - Can increase to 100% if contributions remain unpaid
    - Tax is in addition to interest charged on late payment.

- **Lien for Unpaid Contributions**
  - If a minimum required contribution is not made when due and the balance of unpaid contributions is more than $1 million, a lien may be imposed on the property of the liable controlled group members in the amount of the unpaid contributions
    - PBGC can perfect lien, which will give PBGC a security interest in the property of the plan sponsor and controlled group members
    - Treated as federal tax lien
I. PENSION PLAN OBLIGATIONS

B. Underfunding Liabilities: Benefit Restrictions

- IRC § 436 – Restricts benefit payments, benefit increases and benefit accruals under single-employer defined benefit pension plans based on plan underfunding
  - If adjusted funding target attainment percentage (AFTAP) is less than 80%, but greater than or equal to 60%—
    - 50% restriction on accelerated benefit distributions (e.g., lump sums)
    - No amendments increasing benefits
  - If AFTAP is less than 60%—
    - 100% restriction on accelerated benefit distributions
    - No amendments increasing benefits
    - No unpredictable contingent event benefits
    - Cessation of future benefit accruals
  - Buyer needs to be aware of these restrictions when assuming all or a portion of target’s underfunded plan
    - For example, these restrictions can be particularly inconvenient where buyer assumes target’s underfunded cash balance plan or other defined benefit plan that pays benefits in form of lump sum
C. Multiemployer Plan Withdrawal Liability
I. PENSION PLAN OBLIGATIONS

C. Multiemployer Plan Withdrawal Liability

- Withdrawal liability arises when an employer participates in, and then completely or partially withdraws from, an underfunded multiemployer pension plan
  - An employer that withdraws from a multiemployer plan is liable for the employer’s share of the plan’s unfunded vested benefits
  - Amount of withdrawal liability is determined under statutory formula and calculated as of the last day of the plan year before the plan year in which the employer withdraws
  - Upon withdrawal, the plan determines the amount of withdrawal liability, notifies the employer of the amount and collects it from the employer

- Joint and several obligation of each member of employer’s controlled group of trades of businesses
I. PENSION PLAN OBLIGATIONS

C. Multiemployer Plan Withdrawal Liability

- Complete Withdrawal
  - A complete withdrawal occurs when an employer—
    - Permanently ceases to have an obligation to contribute to the multiemployer plan
      - *Examples:*
        - Employer sells the business that contributes to the plan
        - Employer ceases to be covered by a collective bargaining agreement
    - Permanently ceases all covered operations under the plan
      - *Examples:*
        - Employer permanently closes all plants and facilities that employ the workers covered by the plan
        - Employer goes out of business
I. PENSION PLAN OBLIGATIONS

C. Multiemployer Plan Withdrawal Liability

÷ Partial Withdrawal

÷ A partial withdrawal occurs when there is –

÷ Decline of 70% or more in the employer’s “contribution base units”
  ÷ Contribution base unit is the unit by which the employers contribution is measured (e.g., hours worked, individuals employed per month, etc.)
  ÷ Decline is measured over 3-year testing period, based on average number of contribution base units for the two plan years in which contribution base units were highest out of the 5 plan years immediately preceding the 3-year testing period

÷ Partial cessation of the employer’s obligation to contribute
  ÷ Employer permanently ceases to have obligation to contribute under one or more, but not all, of its collective bargaining agreements, but continues to perform work of the type for which contributions were previously required
  ÷ Employer permanently ceases to have obligation to contribute to plan with respect to work performed at one or more, but fewer than all, of its facilities, but continues to perform work at the facilities of the type for which the obligation to contribute ceased
I. PENSION PLAN OBLIGATIONS

C. Multiemployer Plan Withdrawal Liability

- **Amount of Withdrawal Liability**
  - Depends on several factors, including –
    - Contribution history of withdrawing employer
    - Amount of plan underfunding
    - Plan investment performance
    - Number and timing of other withdrawing employers
      - Last employer in might shoulder lion’s share of liability
  - Withdrawal liability can be extremely expensive
    - In 2007, United Parcel Service paid over $6 billion in withdrawal liability to Central State Teamsters Pension Plan
    - Even small employers can be assessed millions of dollars in withdrawal liability, depending on extent of plan’s unfunded vested benefits
I. PENSION PLAN OBLIGATIONS

C. Multiemployer Plan Withdrawal Liability

Withdrawal Liability in M&A Transactions

- Buyer in corporate transaction generally is not responsible for withdrawal liability resulting solely from the sale
  - But Buyer may expose itself to significant withdrawal liability if it sells or closes the relevant facilities in a subsequent transaction

- Where withdrawal liability exists at the time of corporate transaction—
  - **Stock Sale**: Buyer may assume potential withdrawal liability as a contingent liability
    - Buyer acquires contribution history of the acquired entity and will be responsible for withdrawal liability upon the occurrence of any of the triggering events
  - **Asset Sale**: May trigger withdrawal liability for the Seller, unless the “sale of assets” exception applies
I. PENSION PLAN OBLIGATIONS

C. Multiemployer Plan Withdrawal Liability

- **Sale of Assets Exception**
  - In an asset sale, Seller can avoid withdrawal liability if transaction is structured to comply with the “sale of assets” exception under ERISA § 4204
    - Buyer retains an obligation to contribute to plan in substantially the same number of contribution base units as Seller had prior to sale
      - Buyer picks up 5-year contribution history of Seller
    - Buyer posts bond to plan for period of 5 years after date of purchase equal to the greater of –
      - (i) the average required contributions of Seller for the 3 years prior to the sale, and
      - (ii) the amount of required contributions for the year immediately prior to the sale
    - The sales agreement includes a provision that the Seller will remain secondarily liable for a Buyer’s withdrawal for a period of 5 years after the sale
    - If all, or substantially all, of Seller’s remaining assets are distributed or Seller is liquidated prior to end of 5th plan year after transaction, Seller will be required to post bond or escrow amount equal to 100% of withdrawal liability Seller would have incurred without the exception
D. Joint and Several Controlled Group Liability
I. PENSION PLAN OBLIGATIONS

D. Joint and Several Controlled Group Liability

- Under ERISA, each member of the “controlled group” consisting of the employer and each trade or business under common control with employer is jointly and severally liable for employer’s share of the DB Plan obligations previously discussed, *i.e.—*
  - PBGC termination liability
  - Withdrawal liability
  - Required minimum contributions
  - PBGC premiums
  - ERISA liens

- Also, certain IRS tax-qualification requirements (*e.g.*, coverage and nondiscrimination testing, statutory plan limits, *etc.*) are applied on a controlled group basis
I. PENSION PLAN OBLIGATIONS

D. Joint and Several Controlled Group Liability

 Controlled Group Rules

 ERISA defines “controlled group” by reference to the rules under IRC §§ 414(b) and (c)

 IRC § 414(b): Controlled group of corporations (as determined, generally, under rules set out in IRC § 1563)

 IRC § 414(c): Controlled groups of trades or business (whether or not incorporated)

 Regulations under IRC § 414(c) based on similar principles as apply under IRC § 414(b)

 For purposes of joint and several withdrawal liability under Title IV of ERISA, “controlled group” is defined by reference to trades or businesses under common control, as determined under IRC § 414(c)
I. PENSION PLAN OBLIGATIONS

D. Joint and Several Controlled Group Liability

- Types of Controlled Groups (Under IRC § 414(c))
  - Parent-Subsidiary Controlled Group
    - Trade or business owns, directly or indirectly, a controlling interest (generally 80% or greater) in the contributing employer, or
    - Contributing employer owns, directly or indirectly, a controlling interest in the trade or business
  - Brother-Sister Controlled Group
    - Two or more organizations conducting trades or businesses are under common control if—
      - Same 5 or fewer persons who are individuals, estates or trusts own a controlling (80% or more) interest in each of the organizations, and
      - Taking into account the ownership of each such person only to the extent such ownership overlaps, such person are in effective control (50% or greater) of each organization
  - Combined Group
    - Any group of 3 or more organizations if—
      - Each organization is a member of either a parent-subsidiary or brother-sister group of trades of businesses under common control, and
      - At least one such organization is the common parent of both a parent-subsidiary and brother-sister group of trades or businesses under common control
I. PENSION PLAN OBLIGATIONS

D. Joint and Several Controlled Group Liability

“Trades or Businesses” under Common Control

To impose joint and several controlled group liability under ERISA, both the “trade or business” and “common control” elements must exist.

Trade or Business:

- Neither ERISA nor the IRC define what constitutes a “trade or business” for purposes of applying the controlled group rules.
- Under tax-law precedents, Investment activity alone is not a trade or business:
  - “Devoting one’s time and energies to the affairs of a corporation is not, of itself, and without more, a trade of business to the person so engaged. Though such activity may produce income, profit or gain in the form of dividends or enhancement in the value of an investment, this return is distinctive to the process of investing and is generated by the successful operation of the corporation’s business as distinguished from the trade or business of the taxpayer himself.” (*Whipple v. Comm’r.*, 373 U.S. 193, 202 (1963))

- *Groetzinger* test: A taxpayer is engaged in a trade or business if it is engaged in an activity with “the primary purpose of income or profit” and it is involved in such activity “with continuity and regularity.” (*Comm’r v. Groetzinger*, 480 U.S.D. 23 (1987))
I. PENSION PLAN OBLIGATIONS

D. Joint and Several Controlled Group Liability

- Impact of Controlled Group Rules on Private Equity Funds
  - If PE Fund is considered to be a trade or business under ERISA, the Fund’s ownership of a controlling interest in a portfolio company would cause the PE Fund and the portfolio company (and any other portfolio companies controlled by the Fund) to be treated as a controlled group
    - Membership in the controlled group would expand each time the PE Fund acquired a controlling interest in another portfolio company
  - The PE Fund and each portfolio company comprising the controlled group would have joint and several liability under ERISA for the pension plan liabilities of each controlled portfolio company
I. PENSION PLAN OBLIGATIONS

D. Joint and Several Controlled Group Liability

- Private Equity Funds as Trades or Businesses
  - **Historic Treatment**: Passive investment vehicles, such as PE Funds, that have no employees, no involvement in the day to day affairs of its investments and no income other than passive investment income, such as dividends, interest and capital gains were not considered to be conducting a trade of business for purposes of the controlled group rules.
  - **PGBC Position**: In a 2007 PBGC Appeal Board letter, applying the *Groetzinger* test, the PBGC took the position that a PE Fund was a trade or business because the primary purpose of the Fund was to make a profit and that through its general partner, as agent to the Fund, management of Fund’s investments was conducted with regularity.
    - The PBGC position has been referred to as an “investment plus” standard.
I. PENSION PLAN OBLIGATIONS

D. Joint and Several Controlled Group Liability


  - First Circuit held that a PE Fund qualified as a trade or business under ERISA and was potentially joint and severally liable for withdrawal liability owed to a multiemployer pension plan by a portfolio company in which Fund had invested

  - Court held that, at least where a passive investment in an entity might defeat the imposition of withdrawal liability, the court should apply an “investment plus” test to determine whether the entity is a trade or business under ERISA

  - **Investment Plus Test:** Making investments in portfolio companies for principal purpose of making profit is not enough to cause PE Fund to be treated as a trade or business

    - Additional factors would have to be present that would distinguish the PE Fund from a mere passive investor
I. PENSION PLAN OBLIGATIONS

D. Joint and Several Controlled Group Liability

- **Sun Capital (continued)**

  - **Factors**: Court did not provide guidelines for identifying which factors should be considered under “investment plus” test, but Court did hold that the following factors, in the aggregate, were sufficient to treat Fund as trade or business:

    - Partnership agreements and PPM contained statements to the effect that Fund would be actively involved in management and operation of portfolio companies
    - General partners were granted broad authority under partnership agreements to participate in management of portfolio companies, including authority to hire, terminate and compensate agents and employees of portfolio companies
    - Fund’s controlling stake in portfolio company enabled them and their affiliated entities to participate in management and operation of portfolio company to a degree well beyond that of a passive investor
    - Fund received a direct economic benefit an ordinary passive investor would not receive in the form of a management fee offset
I. PENSION PLAN OBLIGATIONS

D. Joint and Several Controlled Group Liability

- **Sun Capital (continued)**
  - **Common Control**: Court remanded case to district court to determine whether Fund was under common control with portfolio company
    - Although investment was structured so that none of the Sun Capital Funds individually held an 80% or greater interest in portfolio company, the plaintiff plan characterized investment agreement between Sun Capital Funds as a partnership or joint venture
      - If combined holdings of Funds were attributed to a single partnership or joint venture, resulting 100% ownership interest would constitute a controlling interest
    - Resolution of this issue will have a significant impact on how PE Funds structure their investments
E. Minimizing Potential Liability in M&A Deal
I. PENSION PLAN OBLIGATIONS

E. Minimizing Potential Liability in M&A Deal

- Pre-acquisition due diligence of underfunded pension obligations
  - Notes to Financial Statements
  - Form 5500
  - Actuarial reports
  - Funding notices

- Request estimate of withdrawal liability for multiemployer plans, if any
  - To extent possible, structure transaction so as to avoid triggering complete or partial withdrawal from multiemployer plan

- Effective representations covering pension obligations
  - All required contributions made, and PBGC premiums paid, when due
  - No requests for funding waivers
I. PENSION PLAN OBLIGATIONS

E. Minimizing Potential Liability in M&A Deal

- Develop appropriate indemnification provisions and coordinate with overall indemnification basket used in transaction
- If possible, avoid assuming sponsorship of underfunded DB Plans
  - Where assumption of underfunded DB Plan cannot be avoided, Buyer should negotiate appropriate adjustment to purchase price to account for unfunded liabilities, measured on a basis agreed upon by the parties
    - Escrow portion of purchase price pending resolution of issues/audits
    - Offset installment payments of purchase price
II. Retiree Welfare Benefit Obligations
II. RETIREE WELFARE BENEFIT OBLIGATIONS

A. Overview

B. Funding Alternatives
   (i) Pay-As-You-Go
   (ii) VEBA
   (iii) ERISA Considerations

C. Terminating Retiree Welfare Benefits

D. Retiree Welfare M&A Best Practices
A. Overview
II. RETIREE WELFARE BENEFIT OBLIGATIONS

A. Overview

- Many companies subsidize health and life insurance benefits for retirees and their dependents; liabilities for these benefits can be material.
- Structure of M&A transaction typically dictates whether Seller or Buyer will be responsible for Seller’s retiree welfare obligations.
  - **Asset Sale:** Buyer will rarely agree to a transfer of Seller’s retiree welfare obligations (at least with respect to current retirees).
  - **Stock Sale:** Buyer must assume such liabilities.
    - **Possible exception:** Buyer purchases stock of wholly-owned sub of Seller and negotiates carve-out of sub’s retiree health obligations, which are retained by Seller or other Seller-related entity.
- If liabilities for retiree health obligations will transfer to Buyer, Buyer should negotiate a purchase price adjustment to reflect unfunded current and projected liabilities.
B. Funding Alternatives
II. RETIREE WELFARE BENEFIT OBLIGATIONS

B. Funding Alternatives: Pay-As-You-Go

- Pay-As-You-Go
  - There is no requirement under ERISA to pre-fund welfare benefit obligations, including retiree welfare obligations
    - Participant contributions to welfare plans, although technically considered to be plan assets, are generally exempt from ERISA’s trust requirement (ERISA Tech. Rel. 92-01)
  - Unfunded retiree welfare obligations must be reflected as liabilities for “other postemployment benefits” on employer’s income statement and balance sheet
    - Fund, such as a trust, in which employer irrevocably deposits assets to pay retiree welfare obligations can be treated as an asset that at least partially offsets this liability
II. RETIREE WELFARE BENEFIT OBLIGATIONS

B. Funding Alternatives: VEBA

- Voluntary Employees’ Beneficiary Association (VEBA)
  IRC § 501(c)(9)
  - Most common type of funding entity for retiree welfare obligations
  - Tax-exempt organization that can accumulate tax-free income-producing reserves for the payment of life, sickness, accident or similar benefits to VEBA members and their dependents
    - Contributions are tax-deductible when made, subject to limitations
    - Benefits not taxable when received by member
  - IRS determination letter required
II. RETIREE WELFARE BENEFIT OBLIGATIONS

B. Funding Alternatives: VEBA

- **VEBA - General Requirements**
  - **Organization Requirement**: Separate legal entity independent of members or employer
    - Typically a trust, but can be a corporation or unincorporated association
  - **Activities**: Substantially all of VEBA’s operations must be in furtherance of providing permissible benefits
  - **Membership**: Generally restricted to employees (including dependents) with an “employee-related common bond,” such as—
    - Common employer
    - Labor union affiliation
    - Coverage under CBA
    - Employees of VEBA or union whose members are members of the VEBA
  - **Nondiscrimination**: Cannot discriminate in favor of highly compensated employees as to both eligibility and benefits (IRC § 505(b))
    - Does not apply to collectively bargained VEBAs
  - **Anti-inurement**: No part of the net earnings of a VEBA may inure to the benefit of any individual, other than through the payment of permissible benefits
    - Payment of disproportionate benefits to officers, shareholders or HCEs of a contributing employer would constitute inurement
    - On dissolution, assets may be distributed to members or used to pay benefits until depleted, but cannot revert back to the contributing employer
II. RETIREE WELFARE BENEFIT OBLIGATIONS

B. Funding Alternatives: VEBA

Funding a VEBA

- No required minimum contributions
- Maximum deductible contributions (IRC §§ 419 and 419A)
  - Referred to as “additional reserve for post-retirement medical and life insurance benefits” in IRC § 419A(c)(2). Does not apply to collectively bargained funds, funds sponsored by non-profits, employee pay all or 10-or-more employer plans.
- Funded over working lifetime of covered members
- Actuarially determined on a level basis using assumptions that are reasonable in the aggregate
II. RETIREE WELFARE BENEFIT OBLIGATIONS

B. Funding Alternatives: VEBA

- Funding a VEBA (continued)
  - Most fund over working lifetime of active employees and remaining lifetime of retirees
  - Separate accounts required for key employees
    - Key employee contributions count as annual additions under IRC § 415
  - Assets cannot revert to employer, but some flexibility to redirect funds
    - Amend to allow funds to be used for other permissible benefits (e.g., active medical, dental, life, disability, etc.)
    - Ensure that employer’s right to amend or terminate the VEBA at any time is reserved
II. RETIREE WELFARE BENEFIT OBLIGATIONS

B. Funding Alternatives: ERISA Considerations

- **ERISA Consideration for Funded Retiree Welfare Arrangements**
  
  - **Reporting and Disclosure**: Annual reports for funded welfare plan with 100 or more participants must include audited financial statements prepared by a qualified independent public accountant
    - Unfunded (pay-as-you-go) plans generally are exempt from this requirement (ERISA Tech. Rel. 92-01)
  
  - **Fiduciary Responsibilities**: ERISA fiduciary responsibility provisions apply to any funded ERISA plan, including a funded retiree welfare plan
    - Must be established and maintained in writing and designate “named fiduciaries” who have authority to control and manage plan operations and administration
    - Must be held in trust by one of more trustees with authority and discretion to manage the assets
    - Fiduciaries must act (i) solely in the interest of participants and beneficiaries, (ii) with prudence, (iii) by diversifying investments and (iv) in accordance with plan terms
    - Trust assets must be held for exclusive purpose of providing to participants and beneficiaries and cannot be used for, or diverted to, any other purpose
    - Can’t engage in certain ERISA “prohibited transactions” with trust assets
C. Terminating Retiree Welfare Benefits
II. RETIREE WELFARE BENEFIT OBLIGATIONS

C. Terminating Retiree Welfare Benefits

- **ERISA Standard**
  - ERISA § 201(1) expressly excludes employee welfare benefit plans from ERISA’s vesting provisions
  - Accordingly, the Supreme Court has held that—
    - “Employers or other plan sponsors are generally free under ERISA, for any reason and at any time, to adopt, modify or terminate welfare plans” *Curtiss-Wright Corp. v. Schoonejongen*, 514 U.S. 73, 78 (1995)
  - At the same time, the Court has recognized that employees may bargain for lifetime vesting of benefits and employers may waive their rights to terminate lifetime welfare benefits
II. RETIREE WELFARE BENEFIT OBLIGATIONS

C. Terminating Retiree Welfare Benefits

- **Contractual Vesting**
  - Most courts will enforce an express promise to provide lifetime welfare benefits
    - Where to look—
      - Plan documents
      - Summary plan descriptions (SPDs)
      - CBAs
    - If language in official plan documents is unclear as to employer’s intent to vest lifetime benefits, courts will consider extrinsic evidence
      - Benefit brochures
      - Employee handbooks
      - Enrollment materials
      - Informal communications
II. RETIREE WELFARE BENEFIT OBLIGATIONS

C. Terminating Retiree Welfare Benefits

- Contractual Vesting (continued)
  - Other places to look for lifetime benefit promises—
    - Employment/separation agreements
    - Change-in-control/severance plans
    - Voluntary retirement windows
  - Absent a “reservation-of-rights-to-amend-or-terminate” clause in plan documents, SPDs or CBAs, language stating that “coverage will continue after retirement,” or similar language, in employee communications can give rise to a claim that retiree benefits are vested and cannot be terminated
    - Retirees can be sympathetic plaintiffs in such cases
II. RETIREE WELFARE BENEFIT OBLIGATIONS

C. Terminating Retiree Welfare Benefits

- **Reservation-of-Rights Clause**
  - Courts have held that an unambiguous reservation-of-rights clause in plan documents or CBAs allowing employer to modify or terminate benefits is incompatible with promise to provide lifetime benefits.
  - Where official plan documents and SPDs include unambiguous reservation-of-rights clause, courts have held that plan or contractual language such as “medical benefits will continue beyond retirement,” or “continuous health insurance will be provided,’ does not conflict with the reservation-of-rights clause or otherwise create an ambiguity in plan language.
  - Likewise, promise of “lifetime” coverage generally will not trump an unambiguous reservation-of-rights clause.
    - But where an unambiguous reservation-of-rights clause is not included in documents, courts will generally interpret such “lifetime” language to require vesting of retiree welfare benefits.
    - Also, where reservation-of-rights clause is in plan document, but not iSPD, some courts have held that reservation-of-rights clause is not enforceable, and a promise of lifetime benefits in SPD creates a vested right to lifetime benefits.
D. Retiree Welfare M&A Best Practices
II. RETIREE WELFARE BENEFIT OBLIGATIONS

D. Retiree Welfare M&A Best Practices

- Due Diligence of Retiree Welfare Obligations
  - Assess FAS 106 liability for postretirement benefits
    - Notes to Financial Statements
    - Funded vs. unfunded liabilities
  - Review funding vehicles for legal compliance
    - Trust agreements
    - Form 5500, Schedule H
  - Confirm right to terminate benefits is reserved in plan documents, SPDs and CBAs
    - If not, check all relevant employee documents and employee communications for promises of lifetime benefits
  - Check employment agreements, separation agreements, CIC plans, etc. for additional promises of lifetime benefits
II. RETIREE WELFARE BENEFIT OBLIGATIONS

D. Retiree Welfare M&A Best Practices

- Allocation of Liabilities Among Parties
  - Purchase agreement should clearly delineate responsibility for retiree welfare obligations
    - **Asset deal**: Seller retains liability for current retirees; Buyer assumes for active employees
      - If benefits are vested and can’t be terminated by Buyer, Buyer should consider insisting that either Seller retain liability for all obligations or that purchase price be adjusted to take future liabilities into account
    - **Stock deal**: If Buyer is purchasing entire company, retiree welfare obligations will transfer with company to Buyer
      - Again, if benefits are vested and can’t be terminated by Buyer, Buyer should consider insisting that purchase price be adjusted to take future liabilities into account
      - If Buyer is purchasing subsidiary of parent, Buyer can treat deal similar to an asset deal and insist that Target’s parent retain responsibility for some or all of Target’s retiree health liabilities
III. Defined Contribution Plans
III. DEFINED CONTRIBUTION PLANS

A. Overview

B. Benefit Transition Alternatives
   (i) Stock Sale
      (a) Buyer Assumes Plan
      (b) Seller Terminates Plan
   (ii) Asset Sale
      (a) Buyer Assumes Plan
      (b) Asset Transfer to Buyer Plan
      (c) Rollover Account Balances

C. Plan Loan Issues in Asset Sales
III. DEFINED CONTRIBUTION PLANS

A. Overview

- DC Plans do not carry underfunding liability risks associated with DB Plans
- Primary M&A issues associated with tax-qualified DC Plans involve—
  - Legal and administrative compliance of plans
  - Post-transaction plan integration
- These issues are more easily managed if addressed early in the M&A process, NOT as an afterthought
III. DEFINED CONTRIBUTION PLANS

A. Overview

- As early as possible in deal process, parties should decide whether—
  - Buyer will assume Target’s plan and either—
    - Merge it with Buyer’s plan, or
    - Maintain it as a separate stand-alone plan for Target employees
  - Target will retain its plan and either—
    - Distribute accounts of Target employees who become Buyer employees in connection with transaction
      - Distributions can then be rolled over to Buyer’s plan or an IRA, or
      - Make a plan-to-plan asset transfer of Target employee accounts to Buyer’s plan
  - Target will terminate its plan prior to closing and distribute accounts to Target employees, which can be rolled over to Buyer’s plan or an IRA

- Benefit integration alternative that works best for the parties will depend on factors such as—
  - Structure of deal—asset vs. stock sale
  - Differences in benefit levels among plans
  - Legal compliance issues affecting plans
  - Benefit infrastructure in place at Buyer

- To avoid issues down the road, DC Plan integration strategy should be decided up front and be clearly reflected in transaction agreements
III. DEFINED CONTRIBUTION PLANS

B. Transition Alternative – Stock Sale

Stock Sale –

- Unless Target plan is terminated prior to closing, Buyer will assume sponsorship of Target plan by operation of law
  - **Exception:** If Target is wholly-owned sub of Parent, and Target participates in Parent plan, Buyer’s purchase of Target stock from Parent will be treated like an asset sale for purposes of Target plan

- **If Buyer assumes Target plan, Buyer can either—**
  - Maintain plan as a separate stand-alone plan for Target employees, or
  - Merge Target plan with Buyer plan
III. DEFINED CONTRIBUTION PLANS

B. Transition Alternative – Stock Sale

Buyer Maintains Separate Stand-Alone Plans

- **Legal and Administrative Compliance Issues** – Increased burdens and costs
  - **Compliance Testing**: Each plan must separately satisfy minimum coverage and nondiscrimination testing on controlled group-wide basis
    - Can be problematic if, for example, differences between Buyer’s and Target’s compensation structure results in one of the plans disproportionately covering a higher concentration of the combined entity’s HCEs
    - **IRC § 410(b)(6)(C) Transition Rule**: During transition period that begins on closing date and ends on last day of 1st plan year that begins after closing date, minimum coverage requirements of IRC § 410(b) will be deemed satisfied so long as the plans met requirements immediately prior to closing and plan coverage has not significantly changed during transition period
    - May need plan amendment to conform plan testing definitions and methods, if different
      - HCE definition—top-paid group election must be consistent across plans
      - Safe harbors
III. DEFINED CONTRIBUTION PLANS

B. Transition Alternative – Stock Sale

Buyer Maintains Separate Stand-Alone Plans

- Legal and Administrative Compliance Issues (continued)
  - **Document Maintenance**: Each plan document must continue to be kept current for tax law changes
  - **Eligibility**: Each plan’s eligibility provisions must be reviewed and coordinated to ensure that plans cover only those employees that are intended to be covered
    - *E.g.*, if either plan extends eligibility to “all employees” of company, plan amendment will be required
  - **Reporting and Disclosure**: ERISA reporting and disclosure requirements must be separately satisfied for each plan
    - Separate SPDs must be maintained
    - Separate Form 5500 and SAR required for each plan
  - **Investment Issues**:
    - Will each plan maintain its own slate of investment options, or will options be integrated?
    - Will separate trusts be maintained, or will Master Trust be used?
III. DEFINED CONTRIBUTION PLANS

B. Transition Alternative – Stock Sale

Buyer Merges Target Plan into Buyer Plan

- Eliminates duplicative burdens and costs associate with maintenance of separate plans, but raises other compliance issues
  - **Preservation of Protected Benefits (IRC § 411(d)(6))**: If Target plan permits in-service withdrawals, including hardship withdrawals, or in-kind distributions, Target employees must continue to be permitted to receive such distributions under combined plan; also vesting schedules must generally be preserved
    - In most cases, annuity distribution options do not need to be preserved if combined plan provides for lump sum distributions
  - **Discrimination Testing Challenges**: Variances, if any, in benefit levels and HCE concentration levels between Buyer and Target participant populations may make it difficult for the combined plan to pass discrimination testing
  - **Investment Option Integration**: May require complex option mapping analysis, participant notices and a blackout period to transition investments
  - **Allocation of Forfeitures**: IRC § 414(l) requires unallocated forfeitures under each of the merged plans be allocated before the merger, and cannot be allocated to participants in the other plan
  - **Tainted Assets**: If either plan has uncorrected or undiscovered qualification defects that can potentially disqualify the plan, merger of the tainted plan’s assets with the otherwise compliant plan will potentially result in the disqualification of the combined plan
III. DEFINED CONTRIBUTION PLANS

B. Transition Alternative – Stock Sale

Termination of Target Plan

- To avoid the legal and administrative compliance burdens and costs of maintaining separate plans and the tax-qualification risks associated with merging a potentially tainted Target plan with the Buyer’s plan, Buyer can insist that Target terminate its plan prior to closing and distribute accounts to Target participants, which can then be rolled over into Buyer’s plan (or an IRA)

- **Must Terminate Prior to Closing**: Unless the Target plan’s termination is effective as of a date before the deal closes, Buyer will be restricted from covering Target employees under one of its plans for a period of 12 months after distribution of Target plan assets is completed

  - Plan is considered terminated no earlier than the execution date of the board resolution or other similar legal action terminating the plan—*i.e., can’t retroactively terminate plan*
III. DEFINED CONTRIBUTION PLANS

B. Transition Alternative – Stock Sale

Termination of Target Plan

- **Plan Termination Requirements**
  - **Update Plan**: Plan must be updated before termination effective date for any legally required plan qualification amendments that have yet to be adopted
  - **Vesting**: Account balances of all participants must be fully vested as of termination date
    - Restore accounts of participants who have terminated employment within 5 years prior to plan termination date and have not received a distribution of their entire account balance
  - **Allocate Forfeitures**: Allocations must be in accordance with plan provisions for allocating forfeitures
  - **Distribute Account Balances**: Distributions must be made as soon as administratively feasible after termination date, but in no event later than 12 months
    - Distributions must be in form of lump sum
    - No participant consent required, but rollover notices must be given
    - Reasonable efforts must be made to locate missing participants
  - **Determination Letter Filing**: Not required, but recommended
    - If D-Letter application is filed, no distributions should be made until letter is received, and 12-month deadline for distributing account balances is measured from the date of the D-letter
  - **Final Form 5500**: Must be filed for plan within 7 months following completion of plan distributions
III. DEFINED CONTRIBUTION PLANS

B. Transition Alternative – Asset Sale

Asset Sale –

- Because Buyer will assume only those liabilities it agrees to assume, it is particularly important that the deal treatment of Target’s DC Plan be addressed early in the process and that such treatment be set out in the applicable transaction agreement

- Buyer may agree to either--
  - Assume sponsorship of Target plan
  - Accept an asset transfer of transferred employee accounts into Buyer’s plan, or
  - Not assume sponsorship or accept asset transfer, in which case transferred employees who come to work for Buyer will incur a severance from employment under Target plan, which may entitle them to an immediate distribution that can be rolled over into Buyer’s plan (or an IRA)
III. DEFINED CONTRIBUTION PLANS

B. Transition Alternative – Asset Sale

Buyer Assumes Target Plan

- Does not happen automatically; requires affirmation action to assume plan
  - Assignment and Assumption Agreement
  - Corporate Resolutions
    - By Target—to transfer sponsorship to Buyer
    - By Buyer—to assume sponsorship and adopt plan

- Otherwise, options and issues the same as for stock sale
  - Buyer can maintain Target plan as separate stand-plan, resulting in duplicative administrative compliance burdens and legal compliance costs, or
  - Buyer can merge Target plan into Buyer plan, subject to associated tax-qualification compliance risks
III. DEFINED CONTRIBUTION PLANS

B. Transition Alternative – Asset Sale

Asset Transfer from Target Plan to Buyer Plan

- If purchase agreement provides for transfer of Target employee accounts from Target plan to Buyer plan, transfer of Target employees to Buyer will not be a distributable event under Target plan (Same Desk Rule)

- Asset transfer treated under IRC § 414(l) as spin-off from transferor plan followed by a merger of the spun-off assets with the assets of the transferee plan
  - Accordingly, compliance issues are substantially identical to issues raised by plan mergers in context of a stock deal
    - Need to preserve protected benefits
    - Discrimination testing challenges
    - Tainted assets issue, etc.
      - Buyer should insist on appropriate indemnifications in the event acceptance of tainted assets disqualifies Buyer’s plan
III. DEFINED CONTRIBUTION PLANS

B. Transition Alternative – Asset Sale

Asset Transfer from Target Plan to Buyer Plan (continued)

- **Asset Transfer Agreement**: If not already included in purchase agreement, terms and conditions of the asset transfer should be set out in separate transfer agreement
  - Which accounts will be transferred
    - Just actives, or actives and vested terms
  - Which plan will accept the transfer (if Buyer maintains more than one plan)
  - Preservation of distribution rights and vesting schedules with respect to transferred accounts
  - Acceleration of unallocated matching contributions in Target plan, if applicable
  - Indemnities
III. DEFINED CONTRIBUTION PLANS

B. Transition Alternative – Asset Sale

Target Retains Target Plan - Distribution and Rollover

- Buyer in an asset deal may decide to avoid legal and administrative compliance issues associated with Target plan by refusing to agree to assumption of Target plan or acceptance of an asset transfer from plan

- **Severance from Employment**: If Target retains plan and does not transfer accounts to Buyer’s plan, Target employees will incur a “severance from employment” when they go to work for Buyer
  - If Target’s plan permits distributions on a “severance from employment” (as most plans do), then Target employees who are transferred to Buyer may request a distribution from Target plan and roll it over into Buyer’s plan (or an IRA)
  - **Consent Required**: Unlike a distribution made pursuant to plan termination, Target plan participants whose account balances exceed $5,000 must consent to a distribution made pursuant to a severance from employment
C. Plan Loan Issues in Asset Sales
III. DEFINED CONTRIBUTION PLANS

C. Plan Loan Issues in Asset Sales

- In an asset sale where Buyer is not assuming Target’s plan, treatment of Target plan loans should be addressed up-front
  - **Loan Acceleration**: Upon either the termination of Target’s plan or a participant’s severance of employment with Target (e.g., transfer employment to Buyer), any outstanding Target plan loan balance will become immediately due and payable

  **Exception**--

  - **Rollover of Loan Notes**: Purchase agreement can provide for the in-kind rollover of loan notes to Buyer’s plan
    - May require amendments to one or both of Target’s and Buyer’s plans to permit in-kind loan rollovers
    - Buyer’s plan will accept rollover of Target plan loans only if loans are not in default
      - To keep loans current, Target plan should continue to allow payments to be made on plan loans until amounts are either distributed or rolled over
      - Failure to continue loan repayments pending a rollover to Buyer’s plan may result in loan default and immediate taxation to participant
III. DEFINED CONTRIBUTION PLANS

C. Plan Loan Issues in Asset Sales

Loan Defaults

- Loan default results in either “deemed distribution” or “loan offset”
  - **Deemed Distribution**: Occurs when a participant is not otherwise entitled to a plan distribution (e.g., the participant remains actively employed after the loan default)
    - Because not actually distributed, loan balance remains an outstanding obligation of participant that must be repaid, even though loan is taxed as if it had already been distributed
      - If not repaid, continues to stay on plan books as an outstanding loan, restricting participant’s ability to take out new loans
    - Loan repayments after a deemed distribution increase tax basis of account (like after-tax contributions) and are not taxed again when ultimately distributed
    - Most deal-related defaults resulting “deemed distributions” are correctible under EPCRS
      - Only through VCP; SCP not available to correct loan defects after default
III. DEFINED CONTRIBUTION PLANS

C. Plan Loan Issues in Asset Sales

Loan Defaults (continued)

- **Loan Offset**: Occurs when the participant is otherwise entitled to a distribution under the plan (e.g., participant incurs severance from employment or plan is terminated)
  - Is an actual distribution of loan balance for all tax purposes
  - Because it is an actual distribution, it can be rolled over to an IRA within 60 days following offset to avoid immediate taxation
    - Rollover would require participant to come up with out-of-pocket cash in amount of the loan offset
    - Practical effect is that it gives an extra 60 days to pay off loan before it become taxable
    - If new employer’s plan offers loans, it may be possible to take out new loan to come up with cash to rollover loan offset amount
IV. NON-QUALIFIED DEFERRED COMPENSATION PLANS
IV. NQDC PLANS

Typical Plans

- Voluntary elective deferred compensation
- Employer-paid deferred compensation
- Excess benefit plans
- SERPs
IV. NQDC PLANS

IRC 409A

- Imposes strict rules regarding timing of distributions
  - Permitted distribution events
  - General prohibition on acceleration of distributions
- Imposes strict rules regarding timing of deferral and distribution elections
  - Initial elections
  - Subsequent elections
- Prohibits offshore rabbi trusts and financial health triggers
IV. NQDC PLANS

409A Distributions Restrictions

- Deferrals may be distributed/paid only upon specific triggers:
  - Separation from service (defined in IRC 409A regulations)
  - Death
  - Disability (defined in IRC 409A regulations)
  - A specified time or pursuant to fixed schedule specified at the deferral date
  - Change in Control (defined in IRC 409A regulations)
  - Unforeseeable Emergency (defined in IRC 409A regulations)
  - Other limited exceptions permit delay of distribution

- Rules apply to election to defer and the time and form of payment

- Any change in form and timing of payment must:
  - Not be effective until at least 12 months after date of election
  - Extend deferral for at least 5 years (except death, disability or unforeseeable emergency)
  - If payment date is tied to a specific time or pursuant to a fixed schedule, must be made at least 12 months prior to the date of the first schedule payment
IV. NQDC PLANS

Price of Non-Compliance

- Risk is on employees
  - All amounts deferred are included as taxable income
  - 20% additional tax on amount required to be included in income
  - Interest (underpayment rate plus 1%) imposed on underpayments that would have occurred had the deferred compensation been includible in year of first deferral, or if later, the first year the deferred compensation is not subject to a "substantial risk of forfeiture"

- All similar NQDC Plans of employer are aggregated for determining compliance and imposing taxes (if non-compliance):
  - Account Plans
  - Non-Account Plans
  - Separation Pay Plans
  - Other Plans (generally, equity-based compensation)
  - If 409A violation occurs, all plans of that type are deemed to have violated 409A
IV. NQDC PLANS

Funding

- Deferred compensation plans must be “unfunded”
- Payment of benefits must be subject to the credit of the employer
- “Rabbi” trust may have been established to hold assets of employer to pay benefits
- If stock deal (including merger), important to determine that all benefit liabilities under plan are reflected on financial statements of employer
IV. NQDC PLANS

Asset Transactions

- Unless otherwise agreed to, employees who transfer employment to buyer will have a “separation from service”

- If NQDC Plan provides for payment upon a separation from service, transfer of employment pursuant to transaction will require payment

- IRC 409A permits seller and buyer to uniformly treat all employees who transfer to buyer (or its affiliate) as not having incurred a separation from service
IV. NQDC PLANS

Stock Transaction

- Employees of acquired entity will not incur a separation from service for purposes of IRC 409A as a result of transaction
- A spin-off (or sale) of a subsidiary will not result in a separation from service if the employee continues employment with the spun-off entity (or its post-transaction affiliates)
- If employees participate in a parent-level NQDC Plan:
  - Buyer may need to establish a new NQDC Plan (typically a “mirror”) plan to implement any salary deferral elections made by affected employees for that year
  - Mechanism would need to be implemented to ensure that Seller has information to pay benefits upon participant’s future separation from service
IV. NQDC PLANS

Treatment of Plans in Transaction

- In a stock deal or merger, a NQDC Plan will continue as an obligation of employer (or its successor).

- In asset transaction, NQDC Plan will remain as obligation of employer unless parties agree to cause all or a portion of the plan to be assumed by buyer.

- If any portion of NQD Plan is assumed, parties will reflect liabilities in deal price (or other manner).
IV. NQDC PLANS

Structure of Transactions

- Alternatives are similar to tax-qualified pension plans
  - Assumption
  - Mirror Plan

- Unlike treatment of tax-qualified plans, assets and liabilities may be negotiated
  - Reflected in purchase price
  - Actual transfer of asset (or spin-off of rabbi trust) to Buyer
IV. NQDC PLANS

Payment Trigger: Change in Control

- If the terms of a plan require that plan pay all benefits on an accelerated basis upon CIC, benefits must be paid to comply with 409A
IV. NQDC PLANS

Plan Termination

- If NQDC Plan does not provide for accelerated payment of distributions on a CIC, NQDC Plan may be terminated if:
  - Irrevocable action taken by the employer within the 30 days preceding or the 12 months following a CIC (within 409A definition)
  - Payments under all plans treated as a single plan must also be terminated and liquidated
  - Payments must be made within 12 months
  - Where CIC involves an asset purchase transaction, the applicable employer with discretion to liquidate and terminate plans is the employer that is primarily liable immediately after the CIC for the payment of the deferred compensation
  - Termination must not need for participant consent
V. INTERNATIONAL PLANS
Non-U.S. Pension Plans

- Treatment of pension plan in transaction may require government approval
  - In the U.K., approval of Pension Regulator must be obtained
- Notification of Works Council may be necessary
- Applicable law of non-U.S. jurisdiction may not require pensions to be funded pursuant to a separate vehicle, such as a trust
- This heightens importance of the financial reporting of pension liabilities
- Note that financial reporting of non-U.S. pension plans will differ from U.S. (e.g., GAAP, IFRS)
- Even in an asset deal, a buyer may be subject to liabilities with respect to pension plans – even if buyer does not assume the plan
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