

EMPLOYEE BENEFITS IN MERGERS AND ACQUISITIONS

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EMPLOYEE BENEFITS IN MERGERS AND ACQUISITIONS

1. WHY SHOULD WE WORRY ABOUT EMPLOYEE BENEFITS IN CONNECTION WITH MERGERS AND ACQUISITIONS?

Two reasons: To avoid unexpected or unwanted liabilities for either the buyer or the seller and to ensure that the acquisition creates a smooth transition for affected employees.

a. *Employee benefits can be a major source of liabilities that an unwitting buyer could assume or an unwitting seller could retain without the proper information and disclosure typically obtained in the due diligence phase of the transaction.*

b. *Parties to the transaction should be concerned about combining or integrating the benefit plans and cultures of the buyer and the seller and ensuring that the seller's employees understand what benefits will apply after the transaction. Additionally, the seller may require, or the buyer may desire, to keep certain of the seller's employee benefit plans after the acquisition.*

NOTE: Much of the law about combining the various types of benefit plans or arrangements in the context of mergers and acquisitions is not very well developed and is subject to interpretation by the parties and their counsel. In the area of nondiscrimination for qualified retirement plans, for example, the IRS has conceded that the law is ambiguous at best. In the preamble to the final 401(a)(4) regulations published in 1991, the IRS stated that “[p]ending issuance of further guidance, in limited situations, in the context of a merger or other acquisitions, a reasonable good faith effort to satisfy the nondiscrimination requirements consistent with the statutory and regulatory requirements will be acceptable. Whether compliance is reasonable and in good faith in this context requires that employers make every reasonable effort to satisfy all relevant portions of the section 401(a)(4) regulations.” 55 C.F.R. 49906.

2. WHAT BENEFIT PLANS SHOULD WE BE CONCERNED ABOUT IN A TRANSACTION?

a. Qualified Retirement Plans.

i. **Defined contribution plan.** This type of plan includes profit sharing, thrift, 401(k), stock bonus, money purchase pension plans and ESOPS. All of these plans require that each participant or beneficiary in the plan have an individual account in the plan to account for each participant's interest in the plan. As contributions are made to the plan, they are allocated to participants' accounts according to the allocation formula under the plan. Benefits under this type of plan can be paid in a lump sum, installments or annuities in accordance with the plan document. Because these plans are designed to be “tax-qualified”, employers are permitted to take a tax deduction for contributions to the plan as made and participants are not taxed on these contributions (and the earnings on these contributions) until distributed from the plan.

Because participants are entitled to only what is allocated to their accounts under the plan, the buyer does not have to be concerned about unfunded liabilities.¹ Typically, the only liability about which the buyer need be concerned is the contributions that need to be made for the current year. From the seller's perspective, if the sale occurs during mid year and the seller's plan will be terminated, the seller should notify the buyer whether it intends to make a contribution for the short plan year (either a profit sharing contribution or a matching contribution or both). Unless the buyer is notified that the seller intends to make an employer contribution for the short year, the seller may be prohibited from otherwise making such a contribution.

ii. **Defined benefit plans.** The retirement benefits under this type of plan are based on the benefit formula set forth in the plan document rather than what amounts are credited to a participant's account. The formula is typically based on a participant's age, salary and years of service. Benefits under this type of plan are typically paid in the form of a joint and survivor annuity to a married participant or a single life annuity in the case of a single participant.

As opposed to defined contribution plans, defined benefit plans do not have individual accounts and contributions are based on the assumptions made by actuaries, which may include among other things, age, compensation, and length of service. These plans are subject to minimum funding requirements in the Internal Revenue Code. However, meeting these funding standards does not automatically mean that the assets in the plan will be sufficient to pay all of the plan's liabilities if they became due all at once, as they would if the plan terminated. Generally, an actuary's funding assumptions take into account the fact that the plan will be funded over a relatively long period of time. Additionally, if the employer has granted past service credit for some participants an actuary might typically assume that past service will be funded over a long period of time. If a plan is terminated and was required to pay all benefits immediately, many of the actuary's assumptions often become invalid and the plan may be significantly under funded on a termination basis.

iii. **Multiemployer plans.** Union sponsored plans covering union members employed by two or more unrelated employers are almost all defined benefit plans, but an increasing number of defined contribution plans have been established as well. Generally, an employer is required to make a contribution to these plans as specified in the collective bargaining agreement and is typically based on a cents per hour contribution rate. If an employer withdraws from a multiemployer plan, such as by selling the business that employs the union employees, the employer will be liable for its share of the unfunded liabilities of the multiemployer plan even if the employer made all contributions required under the collective bargaining agreement.

NOTE: This could represent a significant liability for the unwitting buyer and if the seller participates in a multiemployer plan, careful consideration should be given to withdrawal liability under Title IV of ERISA.

¹ The exception to this rule exists for "money purchase" pension plans, which require the employer to make a certain percentage of compensation contribution each year to the plan. Although these plans are defined contribution plans, they are subject to the minimum funding standards of Section 412 of the Code.

iv. **Welfare benefit plans.** Welfare benefits cover a broad range of plans including health, life, short and long term disability, certain severance plans, medical reimbursement, dependent care plans, and cafeteria plans. Welfare benefit plans are funded either through insurance contracts or funded by the employer out of its general assets. Some welfare benefits can be funded through tax exempt trusts such as a VEBA under Section 501(c)(9) or a trust under Section 501(c)(17).

An important issue for the buyer to review is whether the seller offers post-retirement medical benefits, which can represent a large unfunded liability of the seller. In some cases, a seller will maintain that retiree medical liabilities are not true liabilities because the seller may claim that they can terminate the coverage at any time. This may or may not be true. It generally depends on whether the seller has reserved to itself the right to amend or terminate these benefits in the plan document itself, the summary plan description and any applicable collective bargaining agreement.

However, the right of an employer to terminate retiree medical benefits may not be all that relevant. Unless both seller and buyer want to terminate the benefits, it may be better to structure the transaction on the assumption that the retiree benefits will continue and that the liabilities will be incurred. This is similar to the position taken by the Financial Accounting Standards Board when it adopted FAS 106, which requires financial reporting of liabilities for retiree benefits regardless of whether they are legal liabilities as long as it is reasonable to expect that the benefits will continue to be provided to retirees.

Of course, the most difficult problem is determining the liabilities for retiree medical benefits. In the negotiations between seller and buyer relating to retiree benefits, the problems of determining present value of the liability is critical. Where the sale is a sale of assets and the seller is a continuing entity, the most common resolution is for the seller to retain much of the liability with some assurance to the buyer that the seller will not reduce or terminate the benefits to the employees of the acquired business to any greater extent than other employees and retirees of the seller. Even still, it will be necessary to negotiate the benefits to which the seller will remain liable. Clearly, if an employee has retired prior to the sale, the seller would normally be liable for his retiree benefits. Frequently, seller will also remain liable for the retiree benefits of persons who are eligible to retire on the date of the sale of the business. This approach may actually be a windfall to the buyer since most of the employees may continue in the active employ of the buyer. The fairest arrangement may be for the buyer to be responsible for the medical benefits of the employees until they retire from the buyer's employment at which time the seller would pick up the retiree medical benefits under the seller's plan.

Additionally a buyer should review whether a seller offers severance benefits. Under ERISA, if a severance plan pays more than two times compensation or pays benefits over more than a two-year period, the arrangement will be considered an ERISA pension plan and is subject to all of ERISA's requirements unless offered only to a select group of management or highly compensated employees. ERISA § 2510.3-2(b) If the severance plan does not qualify as a pension plan, chances are it is a welfare benefit plan subject to ERISA. The buyer must be aware of the terms of the severance plan and whether severance benefits will be paid as a result of the transaction (even for employees who are hired by the buyer). In that case, the severance plan could be amended prior to the transaction to clarify that it will or will not pay benefits under the facts of the transaction.

v. **Executive compensation plans.** This plan is generally any plan that is designed to provide benefits only for a company's executives. Executive plans include various types of deferred compensation plans, executive only medical and life benefits, split dollar life insurance benefits and other stock or equity based compensation programs. Because of the tax concerns, an employer may not "fund" an executive's nonqualified deferred compensation benefits. Instead, these benefits are paid out of the employer's general assets or out of a "rabbi" trust established by the employer.

Executive plans generally state explicitly what occurs if the employer is sold. Specifically, these benefits may be enhanced as a result of a merger or other transaction. These enhancements may include acceleration of stock options, immediate funding and payout of deferred compensation benefits or other "golden parachute" benefits payable to executives. Certainly, an employer must evaluate the type of executive benefits and quantify the liability to executives that may become due as a result of the transaction.

3. **WHAT CAN A BUYER OR SELLER DO TO PROTECT THEMSELVES IN A CORPORATE TRANSACTION?**

The buyer and seller should focus on two steps in the transaction: (1) negotiation of the representations and warranties in the sale and purchase transaction agreement and (2) due diligence. Certainly, the process of due diligence cannot be overestimated. Indeed due diligence will impact the representations and warranties demanded and provided by each party.

Due diligence involves identifying all of the employee benefit plans of the seller, determining whether such plans have complied in form and in operation with applicable requirements, their level of funding, whether any benefits are paid solely as a result of the transaction and the impact of any risk on the overall transaction. So long as this process is conducted at an early stage, the buyer and seller have adequate time to deal with problem issues and possibly make adjustments to the purchase price if necessary.

In an asset sale, the buyer may but is not required to take over the seller's plans and in such a case should seriously consider not taking over any of the seller's plans to avoid liability. In a stock transaction, the buyer is typically required to assume the seller's plans and the buyer might require the seller to terminate some or all of such plans before the transaction to mitigate any liability.

In an asset sale, even though the buyer does not assume any of the seller's plans, the buyer still needs to be concerned about successor liability under COBRA and under Title IV of ERISA. Even in an asset sale, the buyer should undertake due diligence to determine whether COBRA or Title IV of ERISA represents potential liability and should ensure that these issues are properly covered in the representations and warranties.

The buyer should do more in the due diligence process than merely identify the seller's plans. The buyer should review all plan documents, determination letters, employee communications, financial and other reports to make sure that they are internally consistent and whether there exists any unidentified potential liability. If any of the benefits are provided pursuant to a collective bargaining agreement, that agreement should be reviewed to determine whether any automatic increases are required.

Here are the major due diligence issues to be reviewed:

- COBRA - will the transaction trigger a COBRA notice event and if so under whose plan are the qualified beneficiaries covered?
- Defined benefit plans - What is the funded status of the plan on an ongoing and on a termination basis? What will be the PBGC's interest in the transaction?
- Defined contribution plans - Does the plan have a current IRS determination letter and are there operational defects?
- Executive compensation arrangement - Will the payout of benefits be accelerated as a result of the transaction?
- Collective bargaining agreements - Do they require automatic benefit increases?
- Multiemployer plan withdrawal liability - Will it be triggered?
- Retiree medical benefits - Who keeps or assumes the liability?
- Severance benefits - Will these benefits be owed as a result of the transaction?
- Plan loans - How will they be handled?

4. **DEALING WITH PLANS.**

a. **Adopt the Plan.** If the plan covers only the employees of the business that is being purchased, it is possible for the buyer to adopt the plan, as is. The buyer should require that the seller represent and warrant to the funding status of the plan and might require a purchase price adjustment for any unfunded liabilities.

NOTE: Such a purchase price adjustment should not be specified in the acquisition documents. If it is, the IRS could argue that a prohibited transaction has occurred.

In an asset purchase, the buyer should be precise with respect to what liabilities and responsibilities are being assumed. Generally, the buyer should merely agree to perform the future duties and obligations of the employer-sponsor of the plan. To the extent that there have been prior violations of the law with respect to the plan, they remain the responsibility of the seller. Prior violations could include violations of the minimum funding standards, the reporting and disclosure rules, the fiduciary rules of ERISA, the qualification and other requirements in the Code or the COBRA rules. Any prior violation should remain the responsibility of the seller.

The purchase agreement should deal with the division of responsibilities between the buyer and seller with respect to contributions, reporting and administrative duties relating to the current plan year and the preceding plan year. For example, it is appropriate that the seller

retain the responsibility for filing the Form 5500 for the prior year and for the audit of the plan if one is necessary. The seller should also retain the responsibility for making contributions to the plan for periods up through the date of acquisition. The buyer should normally file the Form 5500 for the plan year in which the acquisition occurs and should be responsible for making contributions to the plan for periods after the date of the acquisition.

In a stock acquisition, the buyer does not have the ability to avoid responsibility for the prior operation of the plan. Consequently, the buyer will need to be more careful in identifying any possible liabilities for errors in the administration of the plans of the acquired company. While the purchase agreement should contain specific representations and warranties that the operations of the plans have complied with applicable laws, these representations and warranties are only as good as the seller's ability to pay for any defect later discovered. One other alternative is to require the seller to terminate some or all of its plans prior to the close of the acquisition.

b. **Plan Spin-off or Split-up.** Often the employees of the business being acquired are covered by a plan that covers employees of other divisions or subsidiaries of the selling company. If the parties agree, the plan can be divided into two plans with the plan for the acquired company being adopted by the buyer while the plan for the rest of the seller's operation remains the seller's plan.

Spin-offs of defined contribution plans (individual account plans) is a relatively simple process. The accounts of the participants are merely transferred to the spun-off plan. See Code § 414(l). Spin-offs of defined benefit plans are somewhat more complicated. If the plan is a defined benefit pension plan, the participants in the spun-off plan must have at least as much funding of their benefits immediately after the spin-off as they had prior to the spin-off. See Treas. Reg. § 1.414(l)-1(n). Rev. Rul. 86-48. Depending on the size of the spun-off plan and the category of participants that are spun-off or retained, the actuarial calculations necessary to accomplish a spin-off may be extremely burdensome and may not be economically doable. See ERISA § 4044, which sets forth priority allocations for classes of participants where the assets in the plan are not sufficient to cover the benefit obligations.

In spinning-off a portion of a defined benefit plan that has surplus assets, the parties will usually negotiate the actuarial assumptions and methods upon which the spin-off will be based. Through such negotiations, it may be determined that the buyer will receive some of the surplus. Frequently, these calculations are based upon the actuarial methods and assumptions being used for financial reporting purposes under FAS 87. However, in all situations, the assets of both component plans, immediately after the spin-off, should be sufficient, using PBGC plan termination assumptions, to provide the participants in each plan with the same benefit, if the plans terminate immediately after the spin-off, that they would have received if the plan had terminated immediately prior to the spin-off.

The parties should also be aware that the PBGC is increasing its audit of defined benefit plans that are spun-off to protect the PBGC's interest. In certain cases where the plan is being spun-off into a corporation or controlled group of corporations that have a weaker financial position than the corporation or controlled group of corporations from which the plan came, the PBGC may either challenge the parties actuarial assumptions for the spin-off and/or require both

the buyer and seller to provide the PBGC with financial assurances (either in the form of increased disclosure or, in certain cases, guarantees of some sort).

In contrast to qualified retirement plans, if the plan is a welfare plan, there are no rules applicable to the spin-off. It, therefore, falls on the parties to the transaction to negotiate an appropriate transfer of plan assets to the spun-off plan.

c. **Plan Mergers.** Where a buyer is an ongoing business, it will have employee benefit plans of its own and will often want to incorporate the employees of the seller into its employee benefit plans. One strategy to integrating the existing employee benefit plans of the seller and the buyer is a plan merger. In a plan merger, the two plan become one so that the assets of the two former plans become commingled and can be used to pay benefits to any of the participants in the two former plans.

To the extent the merger involves two defined contribution plans, the rules simply require that the account balances of each participant in the new plan be the same as their account balance under the old plan. See Code § 414(l). Under Section 411(d)(6), all accrued and optional forms of benefits, however, from both of the plans must be preserved. Therefore, if one of the old defined contribution plans contains annuity provisions, the new plan must preserve that right (at least for the applicable participants). The IRS recently issued regulations relaxing some of these optional form of benefit rules in the context of defined contribution plans and these rules must be reviewed prior to eliminating any optional form of benefit.

If two defined benefit plans are merged, the participants must be protected from getting less, should the new plan terminate within the next 5 years, than they would have received if the two prior plans had terminated immediately prior to the merger. This requires that the plan's actuary certify that sufficient records are being kept in order to allow such a calculation to be made.

When two defined benefit plans are merged, it is very rare to find that the benefit structures of the two plans are the same. The buyer must decide whether to continue both benefit structures for the respective groups of covered employees or to develop a single benefit structure for all the employees covered by the plan. In practice most buyers will try to integrate two benefit structures into one structure with certain non-continuing features grandfathered for those employees who were previously covered by them. This approach must be carefully analyzed under the 401(a)(4) regulations, which require certain grandfathered benefits to meet nondiscrimination tests throughout the period that the grandfathered benefit remains in the plan. Because grandfathered benefits apply to an increasingly smaller population by mere attrition alone which becomes more weighted toward highly compensate employees, the regulations may be violated at some time in the future. The 401(a)(4) regulations do, however, allow certain benefits, rights and features, such as the right to receive a lump sum to continue for a grandfathered group of employees provided that the benefit, right or feature is not modified after the date of acquisition and provided that the grandfathered group of employees is a nondiscriminatory group at the time eligibility for the benefit, right or feature is frozen determined by reference to the buyer's total workforce. See Treas. Reg. § 1.401(a)(4)-4(d)(1).

d. **Clone-Offset Plan.** If a plan is not transferred to the buyer, the buyer may want to adopt a similar plan for the employees in order that the employees continue to be covered by

the same benefit formula. This will assure the employees that the acquisition will not cause them to lose potential retirement or other benefits. Under this approach, buyer's new plan generally is identical in its benefit formula to the seller's plan and gives credit for service with the seller for purposes of benefits and vesting. In order to avoid duplication of benefits, however, the buyer's plan offsets its benefit by any vested benefits payable under the seller's plan. The "clone-offset" plan will prevent the employees from losing potential benefits to the extent the benefit formula in the plans is based upon the final average compensation of the employees immediately prior to their retirement.

Clone-offset plans are eligible for a safe harbor design under the 401(a)(4) regulations. These regulations allow a clone-offset plan to qualify for a safe harbor on the basis of the total benefit being provided to the employee. This is true regardless of whether the seller's plan freezes the accrued benefits of the employees transferred to the buyer's plan or allows the accrued benefits to increase by reason of compensation increases. Thus, it is possible to count post-sale service for vesting and eligibility for benefits and to recognize increases in the compensation of the employees with the buyer under the seller's plan. It is not possible to qualify for the safe harbor if seller's plan counts service with the buyer for purposes of computing the employee's benefit under the seller's plan. Treas. Reg. § 1.401(a)(4)-3(f)(9).

e. **Plan Termination.** Terminations of either qualified retirement plans or welfare benefit plans can occur as a result of the negotiations between the buyer and the seller or can occur afterwards. In the former case, the plan termination is usually the result of the parties determining that the buyer will not adopt the seller's plan for one of several possible reasons. The buyer may not want to adopt a defined benefit plan or a retiree medical benefit plan because of large unfunded liabilities. The buyer may also not want to adopt a plan simply because it does not fit into the buyer's benefit structure.

If the seller terminates a qualified retirement plan, the employees will become fully vested in their accrued retirement benefits to the extent they are funded. They may receive annuities or lump sum distributions that can be rolled over into another qualified retirement plan or an Individual Retirement Account.

Termination of a qualified retirement plan after the acquisition may be unanticipated and may defeat the expectations of either the employees or one of the parties to the transaction. For example, if the seller has transferred an overfunded plan to the buyer with the expectation that the plan will be continued, the termination of the plan would result in a windfall to the buyer. In that situation, the acquisition agreement could provide either that the buyer agrees not to terminate the plan within a certain period of time after the sale, or that if the buyer does terminate the plan a portion of the recovered surplus assets will be paid to the seller (unless the purchase price has been increased to account for the transfer of the surplus).

f. **Partial Termination.** In the event of the partial termination of a qualified retirement plan, all accrued benefits of employees affected by the partial termination must become fully vested to the extent that the benefits are then funded. Code 411(d)(3). A partial termination can be either of two types of events: an event that causes a significant group of employees to cease to participate in a plan ("vertical partial termination") or an amendment to a plan that reduces the benefits provided by the plan and increases the likelihood that an employer

will receive a reversion of surplus plan assets (“horizontal partial termination”). See Treas. Reg. § 1.411(d)-2(b).

The sale of a subsidiary or division may be a vertical partial termination if the plan is not going to be transferred to the buyer and the employees of the affected employees will cease to be participants in the plan. Such a sale may have the same effect for the affected employees that a total plan termination would have for all the employees covered by the plan. That is, an event can cause the cessation of the coverage of the group of employees and defeat the possibility of their coming vested under the plan.

Whether a partial termination occurs because of the sale of a division or subsidiary will depend on the facts and circumstances of each case. Not all events that defeat an employees possibility of vesting in his plan benefits constitute a partial termination of the plan. Obviously, the mere layoff or discharge of a single employee or a small number of employees should not cause a partial termination. Otherwise, the vesting provisions of a plan would be virtually meaningless. While the case law in this area is not entirely consistent, factors that have been considered significant include: whether there was any unilateral act by the employer that resulted in the cessation of the participation of a group of employees, and if so, the nature of the employer’s act; whether the group of employees affected by the event or act was an identifiable, separate group of employees such as all the employees of a division or subsidiary; and whether the group of employees is a significant group in terms of numbers or as a percentage of the plan’s participants. Treas. Reg. 1.411(d)-2(b); In re: Gulf Pension Litigation, 763.F. Supp. 1149 (S.D. Tex. 1991); Tipton and Kalmbach, Inc. v. Comm’r, 83 T.C. 154 (1984); Ehm v. Phillips Petroleum Co., 583 F. Supp. 1113 (D. Kan. 1984).

There is no question that the sale of a division or subsidiary is an event that can cause a partial termination. The only question is whether the division or subsidiary represents a significant number or percentage of the covered employees. While no set percentage is specified by statute or regulations or has been developed under case law, 20% has emerged as a threshold percentage necessary for a partial termination to occur. Since the sale of a subsidiary or division is a voluntary act by the employer, any reduction at or above the 20% level, while not conclusive, has a high likelihood of being considered a partial plan termination

In calculating the 20% reduction, it is important to understand that the relevant percentage reduction will not necessarily be limited to the reduction caused by the sale as an isolated transaction. The sale may be combined with other sales or with plant closing to reach the 20% threshold depending on the facts and circumstances. For example, if a company sells four different manufacturing units to four different buyers in a series of transactions and at the end of the series of transactions the company has ceased being in the manufacturing business, the four sales could be combined to determine the percentage reduction in the number of plan participants. Arguably, in such case, the event causing the partial termination was not the sale of any single factory but was rather the company’s decision to get out of the manufacturing business.

5. **PROBLEM ISSUES IN MERGERS AND ACQUISITIONS.**

a. **COBRA.**

i. **Final Regulations.** The IRS issued final COBRA regulations effective January 1, 2001. However, the rules for “business reorganizations” don’t apply until January 1, 2002. However, from a practical perspective, employers should consider the rules in effect before 2002. The new rules that deal with COBRA in the context of business reorganizations are not simple. The liability between the buyer and seller, however, can be analyzed by asking four questions

(1) **Is the form of the transaction either a stock sale or an asset sale?**

A stock sale is any sale that causes the corporation to become a different employer or a member of a different employer. For example, if, as a result of a transaction, a corporation ceases to be a member of a controlled group of corporations (80% stock ownership typically) regardless of whether the corporation is a member of a new controlled group of corporations, a stock sale has occurred.

An asset sale occurs if there is a transfer of substantial assets, such as a plant or division, or a transfer of substantially all of the assets of a trade or business.

(2) **Who are the buying and the selling groups?**

The final regulations define buying and selling group to represent buyer and seller because COBRA liability in business reorganizations may impact any entity in the controlled group of corporations or businesses under common control.

The selling group is the controlled group of corporations or businesses under common control of which a corporation ceases to be a member as a result of the stock sale.

The buying group is the controlled group of corporations or businesses under common control of which the acquired organization becomes a member as a result of the stock sale.

The acquired organization in a stock sale is the corporation that ceases to be a member of the selling group as a result of the stock sale.

(3) **Who are the qualified beneficiaries affected by the transaction?**

It is important to focus on who are characterized under the regulations as “M&A qualified beneficiaries.” An M&A qualified beneficiary is a qualified beneficiary whose qualifying event occurred prior to, or in connection with, the sale (can be an employee, spouse or dependent so long as the covered employee’s last employment before the qualifying event was with the acquired organization in the case of a stock sale or was associated with the assets being sold in the case of an asset sale).

Understanding who is a qualified beneficiary whose qualifying event occurred prior to the sale is not usually a difficult task.

Understanding who is a qualified beneficiary whose qualifying event occurred in connection with the sale is not so easy.

However, here is an easy rule. If employees continue to be employed by the acquired organization after a stock sale, they are never M&A qualified beneficiaries. Even if they are no longer covered under a group health plan after the sale they are not M&A qualified beneficiaries. This rule also applies to the employee's spouse and dependents. The employees must lose their job as a result of the sale to obtain M&A qualified beneficiary status.

Here is another easy rule. In general (and except as provided in the following paragraph), an asset sale is a qualifying event with respect to the employees who were associated with the purchased assets whether or not they are employed by the buying group after the sale. This rule is conditioned on the employee losing group health coverage under the selling group's plan.

In an asset sale, if the buyer is considered a "successor employer" after the sale, the above rule does not apply and there is no qualifying event from the resulting asset sale. A buyer is a successor employer when (i) the selling group ceases to provide any group health plan in connection with the sale, and (ii) the buying group continues the business operations associated with the purchased assets without interruption or substantial change.

(4) **What plan must cover the M&A qualified beneficiary?**

If the selling group maintains any plan after the transaction, the selling group must cover the M&A qualified beneficiaries.

In a stock sale, a plan of the buying group is liable if the selling group ceases all plans in connection with the sale.

In an asset sale, a plan of the buying group is liable if the buying group is a successor employer and the seller ceases to maintain any group health plan.

The parties to a transaction are free to allocate the responsibility for providing COBRA coverage by contract, even if the contract imposes responsibility on a different party than would the regulations. **IMPORTANT:** So long as the party to whom the contract allocates responsibility for COBRA actually performs its obligations, the other party will not have any COBRA responsibility. **THE COROLLARY:** If the party to whom the contract allocates COBRA responsibility defaults on its duty, and if under the regulations, the other party has the responsibility for COBRA coverage, the other party remains responsible for providing COBRA coverage.

ii. **COBRA Planning.** In the context of mergers and acquisitions, prudent parties will address not only whether a qualifying event has occurred as a result of the transaction but also the content of the COBRA coverage. The COBRA coverage should be negotiated by

the parties to the deal and the COBRA liability should be specifically allocated in the purchase and sale documents.

NOTE: The party assuming the COBRA liability should ensure that its insurance carrier (in the context of an insured plan or the stop loss carrier) is willing to provide COBRA coverage to the qualified beneficiaries. The party not assuming the liability should obtain an indemnification from the party assuming the liability and the buyer should obtain a representation from the seller that the seller has complied with COBRA.

b. **Plan Loans.** In many acquisitions, the buyer is purchasing a division or subsidiary of a company that has a 401(k) plan with outstanding loans. The sale of the business will result in the termination of employment of the employees of the business and will frequently cause the plan loans to become immediately payable — a result which neither the buyer, the seller, nor the employees want. In that situation, the buyer and the seller will usually work out an arrangement whereby the buyer will cover the employees of the business in either the buyer's 401(k) plan. The plan loans will then be transferred from the seller's plan to the buyer's plan so that the loans do not have to become immediately due.

The transfer of the loans from seller's plan to buyer's plan has sometimes run into opposition from one of the parties. For example, the buyer may not want to have a direct transfer of assets from the seller's plan because the seller's plan contains a method of distribution or optional form of benefit which the buyer does not want to preserve in its plan. See Treas. Reg. § 1.411(d)-4 Q&A-3(a). In those cases, the parties might arrange for a bridge loan to the participants which can be used to repay the loan from the seller's plan. The seller's plan might also allow the employee the election to receive a distribution of all amounts in the employee's account (including the loan) and the buyer could allow the employee to roll such amounts (including the loan) into the buyer's plan. Care should be taken to ensure that the terms of the loan, once in the buyer's plan, comply with the loan requirements in the buyer's plan.

c. **Distributions from 401(k) Plans.**

i. **Distributions Generally.** Code Section 401(k)(2)(B) provides that distributions from a 401(k) plan may not be distributable to participants or other beneficiaries earlier than --

- (1) Separation from service, death, or disability,
- (2) An event described in section 401(k)(10),
- (3) In the case of a profit sharing plan the attainment of age 59½, or
- (4) Hardship.

ii. **Section 401(k)(10).** Section 401(k) (10) provides that lump sum distributions may be made from a 401(k) Plan in the following events:

- (1) The termination of the plan without establishment or maintenance of another defined contribution plan (other than an ESOP).

(2) The disposition by a corporation of substantially all (at least 85%) of the assets used by such corporation in a trade or business of such corporation, but only with respect to an employee who continues employment with the buyer corporation. It is unclear whether both the buyer and the seller must be corporations. The buyer may not assume the plan or receive a transfer of assets from the seller's plan.

(3) The disposition by a corporation of such corporation's interest in a subsidiary, but only with respect to an employee who continues employment with such subsidiary. The seller must continue the plan after the sale, and no part of the assets or the seller's plan may be transferred to the buyer's plan.

The above amounts must be distributed in a lump sum and, in the event of a disposition of assets or of a subsidiary, the transferor (seller) corporation must maintain the plan after the disposition.

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