

insights

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Beware the tail of the dog: 5 tips in dealing with employee benefits in mergers and acquisitions

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In the context of the age-old M&A mantra “Don’t let the tail wag the dog,” employee benefits are usually relegated to the role of “tail of the dog.” However, employee benefit matters relating to a merger or acquisition can involve challenging legal issues that, on occasion, should be taken into account in determining whether or how a deal is done. Although this article is written from the standpoint of the buyer, the seller in a transaction must also deal with these issues, albeit from a different vantage point.

Tip 1: Beware a change in the structure of the transaction

The type of benefit issues and risks that arise in mergers and acquisitions depend in large part on the form of the transaction. Sometimes a deal begins as an asset transaction but morphs into a stock sale for reasons unrelated to employee benefits. Such a change can significantly increase a buyer’s employee benefit risks and liabilities after closing as noted below.

Stock sales

Stock sales involve the most employee benefit issues because, when a buyer acquires stock, it steps into the shoes of the seller. Any design problems or compliance issues that the seller has with respect to its employee benefit plans become the buyer’s problems and issues at closing.

In a stock sale, the due diligence performed with respect to the seller’s benefit plans is critical. Finding employee benefit issues prior to closing may allow the buyer to pressure the seller to address or minimize the issues prior to closing. Alternatively, the buyer can adjust the purchase price or obtain other concessions from the seller in response to the issues. The buyer can also attempt to protect itself from financial risk associated with benefits issues via indemnification provisions in the stock purchase agreement.

Representations made in the purchase agreement are also critical in stock sales. Since it is impossible for the buyer to detect all employee benefit issues via the due diligence process, the buyer relies on representations made by the seller in the purchase agreement and the disclosure schedule prepared by the seller to help uncover benefit issues.

Asset sales

In asset sales, a buyer has more control over the employee benefit issues that it assumes. The buyer can attempt to minimize benefit issues by refusing to adopt any of the seller’s benefit plans. Should the buyer choose this route, the scope of due diligence and the representations in the purchase agreement will be narrower. But note the discussion of successor liability below.

Given the above, it is critical to alert those responsible for negotiating a transaction to the importance of keeping the buyer’s human resources personnel and employee benefit legal counsel informed about any changes in the structure of a transaction. Late changes in the deal structure may warrant additional due diligence and revised employee benefit representations.

Tip 2: Beware multiemployer plans

One type of benefit plan that may cause a buyer to forego an acquisition opportunity is a multiemployer plan. A multiemployer plan is a collectively bargained qualified retirement plan to which more than one unrelated employer is required to contribute. Such plans are governed by a board of trustees comprised of union and employer representatives. The board and the collective bargaining agreement determine the plan terms.

Withdrawal liability is imposed if an employer ceases to have an obligation to contribute to a multiemployer plan or otherwise withdraws from the plan. Such liability is equal to a share of the plan's unfunded vested liability and is calculated based on the employer's contribution history. It is impossible to obtain current information on the amount of withdrawal liability that might be triggered by a sale transaction. Available information is typically at least a year old. Withdrawal liability is frequently much larger than anticipated. For example, such liability could increase due to the withdrawal of other participating employers since the last withdrawal liability calculation. If a multiemployer plan is determined to be in endangered or critical status, the board of trustees is permitted to impose minimum required contributions on participating employers.

Given the above, a buyer should think carefully before entering into a transaction in which it will assume obligations under a multiemployer plan or trigger withdrawal liability for such a plan as a result of the transaction.

Tip 3: Beware ESOPs

Another type of benefit plan that can be problematic in an acquisition is an employee stock ownership plan (ESOP). ESOPs are qualified retirement plans that are designed to invest primarily in employer stock. As such, a transaction involving an employer that maintains an ESOP will directly impact not only the buyer and seller, but also the retirement benefits of the seller's employees who are participants in the ESOP.

By way of background, the initial purchase of employer stock by an ESOP is typically made via a series of loans whereby the employer first borrows funds from a lender and then makes a loan to the ESOP for the purchase of employer stock. The employer makes annual cash contributions to the ESOP which the ESOP uses to pay down the loan from the employer. The employer uses loan payments from the ESOP to repay its loan from the lender. As the loan from the employer to the ESOP is repaid, the employer stock held by the ESOP is allocated to participant accounts.

The existence of an ESOP generally adds complexity and costs to a transaction. Although the ESOP trustee is the shareholder of stock held by the ESOP, Internal Revenue Code Section 409(e) requires the pass-through of voting rights to participants in certain situations. For example, if the transaction is a merger or sale of substantially all of the seller's assets, participants must be given opportunity to instruct the ESOP trustee how to vote the stock allocated to their accounts. The Section 409(e) pass-through requirement is not relevant to a stock sale because a shareholder vote is not required; it merely involves a decision whether or not to sell stock. However, the ESOP plan document itself may require pass-through of voting rights in a stock sale. This is because the voting of shares held by an ESOP is a fiduciary duty, and the employer and the ESOP trustee may prefer to pass-through voting rights to shift the fiduciary duty to the ESOP participants.

To further minimize fiduciary duties, some ESOP plan documents provide for "mirror voting" of unallocated shares, i.e., the ESOP trustee will vote the unallocated shares, i.e., the shares that are not yet allocated to participant accounts, in the same proportion as the participant voting of allocated shares.

If approval of the transaction by ESOP participants is required, the ESOP trustee is required to ensure that participants have sufficient information and that the voting process is fair. If an ESOP trustee is related to the employer, it may be advisable to engage an independent ESOP trustee for the transaction. Alternatively, such trustee may rely on the report of an independent appraiser with respect to the stock valuation and fairness opinion.

Given the above, buyers should carefully evaluate these costs and complexities before entering into an acquisition that involves an ESOP.

Tip 4: Beware defined benefit plans

Defined benefit plans are qualified retirement plans under which benefits are determined based on a formula set forth in the plan. The benefit formula is typically based on factors such as years of service, compensation and/or age.

A defined benefit plan is funded solely by employer contributions that are actuarially calculated to fund the plan on an ongoing basis. An employer is required to satisfy minimum funding standards. Pending changes in the actuarial assumptions used to determine minimum funding levels will likely adversely impact funding obligations.

While a defined benefit plan may satisfy the minimum funding standards on an annual basis, it will rarely be 100% funded on a termination basis. This means that, more often than not, a significant cash infusion by the employer will be required to terminate a defined benefit plan. As a result, terminating a defined benefit plan prior to closing a transaction is usually not an option. To further complicate the matter, it is impossible to precisely identify the financial liability connected with termination of a defined benefit plan because participants must be offered the opportunity to have benefits paid in the form of an annuity. The cost of annuities depends on the interest rates at the time the annuities are purchased and benefits distributed to participants (which can be months after the formal plan termination date).

A buyer must carefully assess the future funding liabilities it may be assuming if a defined benefit plan is one of the plans assumed as part of an acquisition.

Tip 5: Beware successor liability

Generally, a buyer of the assets of a business does not assume the seller's employee benefit liabilities unless expressly stated in the purchase agreement. However, there is a line of case law in which courts have imposed liability on a buyer of assets for the seller's employee benefit liabilities. This is commonly referred to as the

"successor liability" doctrine. While the facts of each case differ, the existence of continuity of the business after closing and the buyer's knowledge of the liability prior to closing will sometimes lead a court to hold the buyer liable for the seller's unpaid benefit liabilities.

Many successor liability cases involve withdrawal liability under a multiemployer plan or contributions that should have been made by the seller pursuant to a collectively bargaining agreement that is assumed by the buyer. However, other cases indicate that successor liability can also be imposed on a buyer with respect to retiree medical plans. See *Grimm v. Healthmont, Inc.*, 2002 WL 31459095 (D. Or., 2002) (court extended liability for union retiree medical benefits to the buyer of assets). In addition, courts have stated that buyers of assets could be responsible for liabilities under executive retirement plans. See *Brend v. Sames Corp.*, 2002 WL 1488877 (N.D. Ill. 2002). The concern of both employee benefit attorneys and buyers alike is whether the successor liability doctrine will be expanded in the future to other types of benefit plans based on the legal analysis in these cases.

Given the above, buyers should take steps to protect their interests via due diligence with respect to union negotiated benefits, retiree medical plans and executive retirement plans. In addition, buyers should negotiate indemnification provisions to address outstanding liabilities with respect to these types of plans.

Summary

As some of these tips indicate, there are situations in which employee benefits plans should be taken into account in deciding whether to pursue an acquisition opportunity or how an acquisition should be structured. It is important that a buyer proceed with caution when dealing with these situations.

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