Compliance Watch

A Primer on the Approach to Retirement Plan Negotiations

An overview of the impact of mergers and acquisitions on retirement plans.

By Richard McHugh

Retirement plan issues increasingly demand more attention in the context of corporate mergers and acquisitions. Part of the reason for this increased attention is the ever-growing complexity of laws governing retirement plans. In addition, the volume of plan assets in the private pension system compels attention. Many questions arise in the context of corporate transactions, ranging from whether asset transfers are advisable to whether distributions from tax-qualified retirement plans may be made.

It is essential to consider retirement plan issues early in negotiations between buyers and sellers. It may be too late to resolve strategic issues in the most advantageous method after transaction documents are complete.

Contract negotiations vary considerably depending on the nature of the transaction, the goals of the parties thereto, and the types of plans involved. Probably the most crucial fact is whether the transaction is structured as an asset purchase or as a stock purchase. In a purchase of assets, generally no plan liabilities flow to the buyer without express provisions or agreement to that effect (although exceptions have arisen in the successor employer context). Alternatively, a stock purchase involves the automatic transfer of benefit liabilities *unless* contractual provisions prevent such a transfer. Consequently, in a stock purchase it is imperative the buyer know what benefit liabilities it is assuming *before* the purchase is consummated.

Parties to a transaction generally approach the deal with varying goals. The buyer might be interested in preserving its new employees' pre-transaction benefits as closely as possible or may be more interested in assuring the new employees are covered by the same benefits available to other employees of the buyer. The seller's interests often are less pressing. Some sellers like to ensure that the level of benefits provided to former employees will continue unchanged after the transaction, but many are more interested in arranging a transfer of benefit liabilities.

Although variation is common depending on whether a contract relates to an asset transaction or to a stock transaction, benefit provisions in a purchase agreement should include some or all of the following:

1. seller representations as to sponsored plans, including an obligation to provide copies of all such plans and documents related thereto (disclosure should not be limited to employee benefit plans covered under ERISA);
2. seller representations regarding operational compliance with various Internal Revenue Code ("Code") and ERISA requirements, including discrimination, funding, coverage and reporting requirements;
3. seller representations about termination liability (including pension plan underfunding and multiemployer pension plan withdrawal liability);
4. seller representations regarding the disposition of welfare plan liability, including the existence of any retiree obligations;
5. affirmative (and perhaps negative) covenants relating to the disposition of benefit plan liabilities; and
6. appropriate limitation in liability and indemnification provisions relating to non-compliance with contractual provisions or legal requirements.

Many choices are available regarding the disposition of retirement plans. Generally, a tax-qualified defined contribution plan can be terminated at any time by the sponsoring employer. Termination of a defined benefit pension plan may not be permitted depending on its funding status (the rules for termination of such pension plans are beyond the intended scope of this article). However, a pension plan that is not fully funded on a termination basis, as defined under the Code and ERISA, generally may be terminated only if the employer funds the shortfall needed to reach full funding (a potential trap for a buyer that fails to study the funding status of a plan it assumes).

Plan termination raises several issues:

1. the accrued benefits of all plan participants must become 100 percent vested at termination (this rule applies to terminated participants who are partially vested but who deferred distribution of their accrued benefits unless applicable breaks in service rules disregard previous vesting service prior to the effective date of plan termination);
2. the sponsor should consider filing a request for the effect of termination upon plan qualification from the Internal Revenue Service (if such a determination is sought, it may be advisable to defer distribution of assets until the determination letter is received); and
3. participants entitled to lump sum distribution should be entitled to elect a tax deferred rollover into an individual retirement account or another tax-qualified plan.

Even if complete plan termination is not contemplated in a corporate transaction, it is possible the transaction could trigger a partial termination, in which the accrued benefits of affected participants must become 100 percent vested (as a rule of thumb, a drop of 20 percent or more in plan participation is sufficient to indicate that a partial termination has occurred).

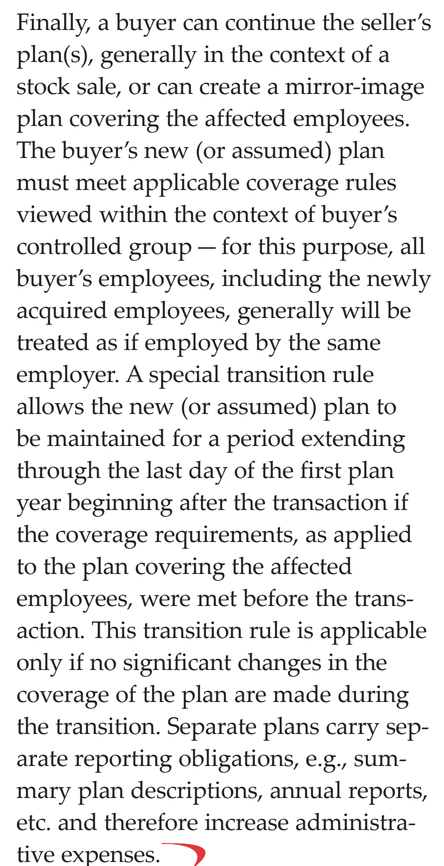
In a defined contribution plan context, a plan merger generally is fairly simple. Affected participants' account balances are commingled into one separate plan. A plan merger between two defined benefit pension plans also is permissible, although depending on funding, special scheduling or data retention responsibilities may be necessary. Except as permitted under applicable regulations, the merged plan must be careful to ensure no participant loses an optional form of benefit or other protected benefit available to him/her before the merger, at least as to the benefit accrued before the merger. Preservation of optional forms of benefit, even if required, can create other qualification problems. The existence of certain plan features that are limited to a subcategory of plan participants can violate the non-discrimination rules, although special rules make carrying these provisions in the plan after the merger somewhat easier. Full vesting of accounts is not necessary in a plan merger (subject to partial termination rules, as discussed above).

Assets from the seller's plan may, under certain circumstances, be transferred to the buyer's plan. The mechanics of this transfer in the context of defined contribution plans are fairly easy — the rules simply require plan account balances be transferred. The following ramifications apply:

1. full vesting of accrued benefits may not be required;
2. optional forms of benefit will have to be protected, generally with the same implications discussed under plan mergers above and subject to applicable regulations; and
3. in the context of a transfer between two defined benefit plans, it is necessary to measure the value of liabilities to be transferred (applicable regulations allow liabilities, which must be measured on a termination basis, to be calculated on the basis of reasonable actuarial assumptions).

In some circumstances, parties to a transaction should consider benefit distribution to affected plan participants from the seller's plans. However, current distribution is not always permitted under the law. The following ramifications apply:

1. current distribution is not permitted without employee consent if the accrued benefit's value at the time distribution commences is in excess of $5,000;
2. lump sum distribution tax treatment may not be available, although tax deferred rollover should be available;
3. certain pension plans cannot distribute plan assets unless the transaction constitutes a "separation from service" with respect to the affected employees; and
4. 401(k) plans likely can distribute plan benefits since 401(k) rules allow distribution upon severance from employment.



Finally, a buyer can continue the seller's plan(s), generally in the context of a stock sale, or can create a mirror-image plan covering the affected employees. The buyer's new (or assumed) plan must meet applicable coverage rules viewed within the context of buyer's controlled group — for this purpose, all buyer's employees, including the newly acquired employees, generally will be treated as if employed by the same employer. A special transition rule allows the new (or assumed) plan to be maintained for a period extending through the last day of the first plan year beginning after the transaction if the coverage requirements, as applied to the plan covering the affected employees, were met before the transaction. This transition rule is applicable only if no significant changes in the coverage of the plan are made during the transition. Separate plans carry separate reporting obligations, e.g., summary plan descriptions, annual reports, etc. and therefore increase administrative expenses.

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