HANDLING EMPLOYEE BENEFITS
IN
MERGERS AND ACQUISITIONS

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# TABLE OF CONTENTS

I. IMPORTANCE OF EMPLOYEE BENEFIT PLANS IN ACQUISITIONS ........................................ 1

II. TYPES OF PLANS ................................................................................................................. 2
A. Defined Contribution Plans ................................................................................................. 2
B. Defined Benefit Plans ....................................................................................................... 3
C. Welfare Benefit Plans ................................................................................................... 4
D. Executive Compensation Plans ....................................................................................... 5

III. PLANS TO WATCH OUT FOR ............................................................................................ 6
A. Defined Benefit Pension Plans ......................................................................................... 6
B. Nonqualified Defined Benefit Pension Plans ..................................................................... 7
C. Collective Bargaining Agreements .................................................................................... 8
D. Retiree Medical and Life Insurance Benefits ..................................................................... 10
E. Severance Benefits ......................................................................................................... 13
F. Qualification Defects ....................................................................................................... 13
G. Plan Loans .................................................................................................................... 14
H. COBRA ........................................................................................................................... 16

IV. TECHNIQUES FOR DEALING WITH PLANS ..................................................................... 19
A. Adoption of the Plan, As Is .............................................................................................. 20
B. Adoption of the Plan With Modifications .......................................................................... 21
C. Plan Spin-off or Split-up ................................................................................................ 23
D. Plan Merger ..................................................................................................................... 24
E. Plan Freezes ..................................................................................................................... 27
F. Nonadoption of the Plan .................................................................................................. 28
G. Clone-Offset Plan ........................................................................................................... 30
H. Plan Termination ............................................................................................................. 31
I. Partial Termination .......................................................................................................... 32

V. OVERVIEW OF THE ACQUISITION PROCESS ................................................................. 36
A. The Dynamic of the Negotiations .................................................................................... 36
B. Structure of the Acquisition ............................................................................................ 36
C. Impact on the Purchase Price .......................................................................................... 36
D. Letter of Intent ................................................................................................................. 40
E. Investigation of the Employee Benefit Plans .................................................................. 42
F. Determination of the Approach to the Plans ................................................................... 42
G. Analysis of Coverage Problems ....................................................................................... 43
H. Reportable Events .......................................................................................................... 44
I. The Purchase Agreement .................................................................................................. 47
VI. CONCLUSION...
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I. IMPORTANCE OF EMPLOYEE BENEFIT PLANS IN ACQUISITIONS


Employee benefit plans can be the source of major off-balance sheet liabilities which have to be dealt with by the parties to the transactions. In some cases, employee benefit plans will dictate whether the transaction will be structured as a sale of stock or a sale of assets. In a few cases, employee benefit plans may result in the deal falling through. In still other situations, employee benefit plans can be utilized to accomplish the transaction.
The purpose of this article is to analyze the major considerations involving employee benefit plans in corporate transactions and the alternative methods of dealing with potential problem areas. This article will provide an overview of the considerations affecting employee benefit plans in a merger or acquisition setting including a brief introduction into the types of plans and the techniques for combining or separating plans.

II. TYPES OF PLANS

For purposes of these materials, employee benefit plans have been divided into several major categories. The following is intended to be a brief introduction into each type of plan.

A. Defined Contribution Plans

Defined contribution plans include a vast array of qualified plans under §401(a) of the Internal Revenue Code of 1954 ("Code"). These plans include profit sharing plans, thrift plans, money purchase pension plans, stock bonus plans, employee stock ownership plans, and cash or deferred profit sharing plans.

All of these plans are characterized by each participant having an individual bookkeeping account under the plan which records the participant’s total interest in the plan assets. As contributions are made to the plan, they are allocated among the participants in accordance with rules contained in the plan document and credited to the bookkeeping accounts in the names of the specific participants. Investment earnings and, in some cases forfeitures, are also allocated to the accounts of participants. When an employee retires or terminates employment, the amount of his benefits under the plan are determined solely on the basis of the amounts then credited to his account under the plan.
Because the accounts of participants only reflect amounts actually held on their behalf by the plan’s trustees, defined contribution plans do not involve the possibility of unfunded past service liabilities. The greatest amount of underfunding involved with most defined contribution plans will be the liability for the contribution to the plan for the current year and, if it has not yet been made, the prior year.\textsuperscript{21}

It is important to note that just because an employer is making a specific contribution to a plan pursuant to a collective bargaining agreement, the plan is not necessarily a defined contribution plan. The plan is most likely a defined benefit plan because the benefits to participants are determined by reference to a benefit formula contained in the plan rather than account balances.\textsuperscript{22} Such plans are multiemployer defined benefit plans and involve potential unfunded liabilities.

**B. Defined Benefit Plans**

Defined benefit plans are pension plans which base the benefits payable to plan participants upon a formula contained in the plan.\textsuperscript{23} The formula will usually involve factors such as the age and service of the employee when he retires and, in many cases, the salary of the employee. The benefits under the plan are normally payable as a joint and survivor annuity to a married participant or a single life annuity to an unmarried participant.

Because of the nature of the benefits promised by a defined benefit plan, it is not possible to fund it using individual accounts. The plan is funded on a group basis based upon the calculations of an actuary. While there are minimum standards for the funding of this type of plan contained in ERISA,\textsuperscript{24} they are in no way a guarantee that the plan will have enough assets to cover accrued benefits. In fact, defined benefit plans can have large amounts of unfunded accrued benefits or can have large surpluses in funding.
Union-sponsored plans covering more than one employer are invariably defined benefit plans even though individual employers may have their contribution rates spelled out in their collective bargaining agreements. The employers may not realize it but, should they ever stop contributing to the plan or otherwise withdraw from the plan, they will be required to fund their proportionate share of the unfunded liabilities of the plan, if any.²⁵

C. Welfare Benefit Plans

The name “employee welfare benefit plan” or “welfare benefit plan” covers a broad group of employee benefit plans. The term includes hospitalization, surgical and major medical benefit plans, life insurance plans, short and long-term disability benefit plans, salary continuation plans, medical reimbursement plans, severance plans, supplemental unemployment compensation plans, dependent care plans, group legal services, cafeteria plans, and apprenticeship plans.²⁶ If the plan covers a broad group of employees and is not a defined contribution or defined benefit plan, then it is probably a welfare benefit plan.

Welfare benefit plans are often funded through the purchase of insurance. There are, however, a number of employers who self-insure or self-fund some or all of these benefits. In some cases the self-insured benefits are being handled on a pay-as-you-go basis--in other cases the employer is funding the benefits through the use of a trust fund established under §501(c)(9) of the Code.²⁷ These trusts may be overfunded or underfunded depending on the strategy of the employer and the benefits promised under the plan and, as a consequence, can be a major hidden asset or liability of an employer.²⁸

A common practice of employers has been to provide retired employees with post-retirement benefits such as medical benefits and group term life insurance. In many cases,
these post-retirement benefits are not funded and can represent a monumental liability of the business to be acquired.

Another type of welfare plan which may have a substantial unfunded liability is a severance pay plan. In the context of a corporate disposition, there is the question of whether the sale of the business may trigger the payment of severance pay to all the employees of the business being sold.

D. Executive Compensation Plans

Executive compensation plans include a vast array of methods by which businesses provide fringe benefits to their executives. Executive compensation plans can be supplemental retirement programs such as deferred compensation plans, top-hat plans, and supplemental pension agreements. Executive compensation programs can include special insurance benefits for the executives including extra life insurance, split dollar life insurance, and post-retirement life and medical insurance. Finally, executive compensation plans can include various types of stock plans including incentive stock options, non-qualified stock options, restricted stock, stock appreciation rights, phantom stock plans and executive stock purchase plans. Because of adverse tax rules, many executive compensation programs, other than stock plans, are not funded. The executive is relying on the unsecured promise of the employer to pay the benefits promised under the plan. However favorable rulings from the Internal Revenue Service (“IRS”) and the Department of Labor allow unfunded executive compensation plans to be quasi-funded plans through the use of “rabbi trusts.”

Unlike other employee benefit plans which are usually silent about corporate acquisitions or changes of control, executive compensation plans will often contain explicit provisions for substantial enhancements for the executives. The enhancements may range from
acceleration of stock options or immediate vesting of accrued deferred compensation benefits to
golden parachute provisions which far exceed the value of the executive’s accrued benefits. In
any corporate transaction, it is important to evaluate the effects of the transaction on existing
executive compensation plans and the resulting after-tax liabilities for buyer and seller.\textsuperscript{31}

\textbf{III. PLANS TO WATCH OUT FOR}

There are two types of plans to watch out for: plans which by their very nature
can result in unfunded or unexpected liabilities and plans which will have an administrative
problem because of the merger or acquisition. The following sets forth a list of the plans which
need to be watched out for.

\textbf{A. Defined Benefit Pension Plans.}

As noted above, defined benefit pension plans involve the funding of a promise of
a formula benefit using actuarial techniques and assumptions. The techniques are not intended to
require an employer to fund past service liabilities immediately. In fact, under ERISA, an
employer is given an extended period to fund past service liabilities.\textsuperscript{32} While it is not required
that an employer take advantage of the extended period to fund past service liabilities,\textsuperscript{33} many
employers do. In addition, it is not possible to fund certain contingent event benefits, such as
plant shutdown benefits or job elimination benefits, in advance.\textsuperscript{34} Finally, many employers have
implemented early retirement window benefits\textsuperscript{35} in recent years which result in the creation of
unfunded pension liabilities.

An additional problem with the funded status of defined benefit pension plans is
the use of actuarial assumptions which reflect long term projections of economic factors and do
not necessarily represent the current conditions. For example, most pension plans are funded
using a 6.5-9\% interest assumption. However, if the plan were to terminate in May, 2003, the
Pension Benefit Guaranty Corporation (“PBGC”) would use interest rates ranging from 4.9% to 5.25%. The difference in interest rates can make the difference between a plan being overfunded and being substantially underfunded. Similarly, other assumptions can have a significant effect on the funded status of a defined benefit pension plan.

The buyer should also make sure that any actuarial valuation of the plan includes all benefit increases included in any amendments to the plan. It is not required that an actuarial valuation include a benefit increase until the end of the year during which it was adopted or became effective, whichever is later.36

In addition to examining the value of the liabilities of a defined benefit pension plan, it is also important to determine the value of plan assets. It is possible to have plan assets which are carried on the books of the plan at an unrealistic value. For example, it is common to carry an insurance contract at the contract’s book value. However, if the contract were to be surrendered, the amount payable to the plan could be subject to market value or other charges which could severely impact on the value of the contract.37 In addition, the contract might be issued by a troubled insurance company in which event the plan could realize even less. Similarly, it is common to value bonds at their amortized yield to maturity rather than fair market value.38 In times of increasing interest rates, such bonds would have less value than they are carried on the plan books.

B. Nonqualified Defined Benefit Pension Plans

It is important to remember that not all defined benefit pension plans are funded. Executive compensation plans which are defined benefit pension programs are typically not funded at all. Thus, such plans always have unfunded benefit liabilities. The only issue is the amount of the liabilities -- an issue which requires the parties to agree on the proper actuarial
methods and assumptions to be used. The issue of nonqualified executive compensation plans has taken on greater importance in recent years as the limitations on qualified pension plans have gotten more stringent. Nonqualified plans are now covering more and more employees and are amassing greater and greater unfunded liabilities.

C. Collective Bargaining Agreements

The collective bargaining agreements applicable to the employees of the businesses to be acquired should always be examined. Such agreements will indicate whether the employer has agreed to pension or other benefit increases which are not reflected in either the plan documents or the actuarial report. If so, then the buyer should evaluate the plans’ unfunded liabilities taking into account the agreed to benefit increases.

Union agreements will also indicate whether the employer is providing retiree medical benefits to the employees subject to the collective bargaining agreement. The liabilities related to such benefits can be significant and will have to be negotiated between the buyer and seller.

The collective bargaining agreement will also indicate whether the employer is contributing to a multiemployer pension plan on behalf of the covered employees. If so, the buyer will have to determine whether the multiemployer pension plan is well-funded or poorly funded and whether to structure the acquisition as a stock acquisition, an asset acquisition or a merger. If the deal is structured as a stock acquisition, the employer that is contributing to the plan does not change and there is no withdrawal which can trigger withdrawal liability to the plan. However, the buyer will succeed to the entire contribution history of the seller which may result in a large withdrawal liability if the buyer should have a partial or complete withdrawal in the future.
If the acquisition is structured as an asset sale and the seller makes no other contributions to the multiemployer pension plan, the sale will constitute a complete withdrawal triggering withdrawal liability for the seller.\textsuperscript{39} Similarly, if the seller makes contributions to the multiemployer plan on behalf of the employees of another business but such contributions represent less than 30\% of the total contributions which the employer previously made to the plan, the sale will lead to a partial withdrawal from the multiemployer plan.\textsuperscript{40} The partial withdrawal will also result in withdrawal liability for the seller.

In a sale of assets which will result in either a complete withdrawal or a partial withdrawal for the seller, it is possible to avoid the imposition of withdrawal liability on the seller by complying with the sale of assets rules of ERISA §4204. Under these provisions, the buyer must have an obligation to continue to make contributions to the plan for substantially the same number of base units as the seller and to post a bond or deposit funds in escrow in case it ceases to contribute to the plan or withdraws during the subsequent five years.\textsuperscript{41} The seller must agree to be secondarily liable for the withdrawal liability it would have had in the event the buyer withdraws during the subsequent five years and fails to make buyer’s withdrawal liability payments.\textsuperscript{42} Compliance with these provisions has a dramatic effect on the potential withdrawal liabilities of the buyer and seller. First the seller’s possible exposure is changed to a secondary liability which will only be triggered in limited circumstances. Second, the buyer does not pick up the full contribution history of the seller. The buyer picks up only the last five years of the seller’s contribution history.\textsuperscript{43} In many instances, the last five years contribution history will not result in any potential withdrawal liability for the buyer.\textsuperscript{44} The net effect of complying with the sale of asset rules can be to totally expunge the possible withdrawal liability that the seller might have had.
Finally, if the acquisition is structured as a sale of assets and the seller continues to contribute to the multiemployer plan for the employees of another business where the continuing contributions exceed 30% of the seller’s historic contribution level, the sale is neither a complete withdrawal nor a partial withdrawal. In this situation, it is not necessary to comply with the sale of asset rules -- seller will not incur any withdrawal liability because of the sale. If the buyer and seller do not comply with the sale of asset rules of ERISA §4204, the buyer does not inherit any of the seller’s contribution history -- it starts as a brand-new employer under the plan.

D. Retiree Medical and Life Insurance Benefits

As noted above, some employers have promised their employees post-retirement medical and life insurance benefits which can represent large unfunded liabilities of the employers. In some cases, sellers will maintain that the liabilities related to retiree benefits are not true liabilities since, it is claimed, the employer can terminate the retiree benefits at any time. This may or may not be true. It will generally be dependent upon whether the employer has explicitly retained the right to modify and terminate the retiree benefit plan in the plan document, the summary plan description and in any applicable collective bargaining agreement. Thus, if the employer has retained the right to terminate retiree medical benefits in the plan document and has communicated such retained right to the plan participants, the courts will generally uphold such right.45

However, the right of an employer to terminate retiree benefits may not be relevant. Unless both seller and buyer want to terminate the retiree benefits, then it is 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 ("FASB") when it adopted FAS 106 -- FASB required 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.

The major difficulty in dealing with retiree liabilities is determining the amount of the liability -- especially the liability related to retiree medical benefits. In a typical case, the employer has promised employees that if they retire from the employ of the employer, the employer will provide them with medical benefits, on a heavily subsidized basis, for the rest of the lives of the retirees and, in some cases, for the rest of the lives of the spouses of the retirees. Usually, once the retiree becomes eligible for Medicare benefits, the coverage provided by the employer will cease to be primary and will convert to Medicare supplement coverage. While Medicare supplement coverage is less expensive than primary coverage, it has experienced substantial cost escalation in recent years because of cutbacks in Medicare benefits -- that is, every time Congress reduces Medicare benefits in an attempt to cut the rate of increase in Medicare deficits, it has, in effect, increased the cost of retiree medical benefits in the private sector.

In order to determine the liabilities related to retiree medical benefits, an actuary must make assumptions as to whether employees will work to retirement age, when they will retire, how long they will live after they retire, what will be the rate of medical cost inflation during the retirees’ lives, and what will be the rate at which Medicare benefits will be reduced. The latter two factors are particularly difficult because they take the actuary away from factors which have been developed in the pension and life insurance area and into projecting economic and political trends. In this regard, it should be noted that FAS 106 requires that the employer make a good faith estimate of the rate of inflation of medical costs.
In the negotiations between sellers and buyers relating to retiree benefits, the problems of determining the present value of the liability become acute. Where the sale is a sale of assets and the seller is a continuing enterprise, the most common resolution of such negotiations has been 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 extent greater than other employees and retirees of the seller. Even still, it will be necessary to negotiate the benefits for 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, sellers will also remain liable for the retiree benefits of persons who are eligible to retire on the date of the sale of the business -- treating the termination of the employee’s employment on sale of the business as a retirement. This approach is actually a windfall to the buyer since most of the employees will continue in the active employment of buyer. The most equitable arrangement would be for the buyer to be responsible for the medical benefits of the employees until they retire from the employ of the buyer. At that time, the seller would pick up the retiree medical benefits of the employee under seller’s plan with no pre-existing condition exclusion. Finally, with respect to employees who are not yet eligible to retire, negotiations have gone a variety of ways depending upon whether the buyer intends to continue the retiree benefits. If so, then the issue becomes whether buyer can get the seller to agree to pick up a part of the cost based upon the relative length of the employees’ service with the seller and the buyer. Where the buyer does not intend to continue the retiree benefits after the acquisition, employees who are not eligible to retire on the date of the sale will generally not receive retiree benefits from either the seller or the buyer.
E. Severance Benefits

Severance benefits are another type of employee benefit which is earned during employment and is paid after termination of employment. Unlike pension benefits, severance benefits are not covered by the funding requirements of ERISA. As a consequence, severance benefits are usually an unfunded liability of an employer.

In the context of a corporate disposition, there is the question of whether the sale of the business triggers the payment of severance pay to all the employees of the business being sold -- even those who will continue to work for the purchaser. When faced with this question, most courts have held that severance pay plans were designed to provide benefits in the event an employee was rendered unemployed and were not applicable to employees who continued in the employ of the buyer. A few courts have, however, found that a sale triggers severance pay benefits. As a consequence, the parties to a corporate transaction should closely scrutinize, and perhaps clarify, any applicable severance pay plans or programs so that it is clear that a sale of a division or subsidiary does not entitle an employee who is employed by the buyer to benefits. Because severance pay plans are also not covered by the vesting provisions of ERISA and the Code, it is possible to amend a severance pay plan immediately prior to a corporate transaction to clarify that the payment of severance benefits will not be triggered by the transaction.

F. Qualification Defects

In most corporate transactions the business being acquired will have one or more pension, profit sharing or stock bonus plans which are intended to be qualified plans under Code §401(a). Significant tax and financial results hinge on the continued qualification of such plans. If a plan which has been presumed to be a qualified plan should be determined not to be qualified, it would have a significant adverse tax and financial impact on the business being
acquired - the employer would lose its tax deductions for contributions which are not immediately vested, the trust would be subject to income taxes on its investment income, and the employees would be subject to tax on the vested benefits under the plan even though the employees had not yet received the benefits. All in all, the loss of the tax qualified status of a retirement plan can be disastrous.

Tax qualified status of a retirement plan can be lost in any one of three ways:

(a) the form of the document may not comply with the extensive form requirements of Code §401(a) et seq.;

(b) the plan may not be administered in accordance with the provisions of Code §401(a) and the provisions of the plan document; or

(c) the plan may become discriminatory in favor of officers, shareholders or highly compensated employees either with respect to coverage, contributions or benefits.

In connection with a corporate transaction, the buyer should be very careful to verify that the retirement plans which will be adopted or assumed by buyer as a part of the transaction meet the qualification requirements. This should be done through document review, representations and warranties, and covenants.

It is not unusual during a corporate transaction for the parties to discover one or more defects relating to the qualification of the retirement plans of the business being acquired. Once defects are uncovered, the buyer and seller must decide what to do about the defects or the plans. Possible solutions may include correcting the defect under the Self Correction Program (“SCP”), which was formerly the Administrative Policy Regarding Self-Correction (“APRSC”), or submitting an application to the IRS under its Voluntary Correction with Service Approval Program (“VCP”) which is the combination of the former Voluntary Compliance Resolution (“VCR”) and Walk-in Closing Agreement Programs (“Walk-in CAP”), or revising the transaction so that buyer does not adopt or assume the plan.
G. Plan Loans

In many acquisition situations, the buyer is purchasing a division or subsidiary of a large company which has a 401(k) plan with participant 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 due and payable - a result which neither the buyer, the seller, nor the employees want to occur. In such situations the buyer and the seller will usually work out an arrangement whereby the buyer will cover the employees of the business in either buyer’s 401(k) plan or in a newly created 401(k) plan for the employees of the business. 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 and payable.

The transfer of plan loans from seller’s plan to buyer’s plan has sometimes run into opposition from one of the parties. For example, buyer may not want to have a direct transfer of assets from the seller’s plan because seller’s plan contains a method of distribution or optional form of benefit which buyer does not want to have to add to its plan. In such cases, the parties can arrange for a bridge loan to the participants which can be used to pay off the loan under the seller’s plan. The seller’s plan can then give the employee an election of receiving a distribution or having the account balance rolled over to the buyer’s plan. Finally, buyer’s plan can make a loan to the participant so that the participant can pay off the bridge loan.

The problem used to be more acute if the transaction did not meet the requirements of Code §401(k)(10) as that existed prior to January 1, 2002. In such a case, it was not possible to have a distribution to the participants being transferred to buyer’s plan. Parties to a transaction were required to have a direct plan to plan transfer of the loan and other plan assets to buyer’s plan, thereby subjecting buyer’s plan to any optional forms of benefits.
which were applicable to the transferred assets under seller’s plan. This problem has been eliminated by amendments to the regulations under Code Section 411(d)(6) which now allow for the elimination of all optional forms of benefits other than lump sums, and by the amendment of Code §§401(k)(2) and 401(k)(10) to eliminate the “same desk rule” for 401(k) Plans.

H. COBRA

COBRA included provisions requiring employers to offer continued health care to certain employees and dependents when their health care coverage would otherwise terminate upon certain events. The penalty for a violation of these rules is $100 per day for each employee and qualified beneficiary involved.

The COBRA rules present three types of problems for a corporate transaction:

(a) first, the transaction itself may be a COBRA event triggering COBRA notifications to the employees of the business being sold;

(b) second, the seller will generally be responsible for the COBRA beneficiaries who had “Qualifying Events” under COBRA prior to the date of the corporate transaction and, in the case of an asset transaction, for the active employees who continue to work for the buyer even though the seller may not be the party who is most logical; and

(c) third, COBRA liabilities are potentially quite large and the buyer may not be willing to risk being liable for the pre-acquisition COBRA violations of the seller.

With respect to the first issue, under final Treasury regulations, if the transaction is a sale of assets, the sale of the business will be deemed to be a Qualifying Event under COBRA for the active employees unless the buyer adopts and continues the medical plan covering the employees of the business being acquired. In contrast, if the transaction is a sale of stock, the transaction is not a Qualifying Event for the employees who continue to be
employed by the business which was sold even if they cease to be covered by the medical plan which had previously covered them. Thus, in a sale of assets transaction, under the regulations, the transaction is sometimes a Qualifying Event for the employees who continue to be employed by the business and, for a stock transaction, it is never a Qualifying Event for the continuing employees.

For the employees who lose their jobs as a part of the corporate transaction, the transaction is always a Qualifying Event the same as any other termination of employment, and such employees are entitled to COBRA continuation coverage. In addition, employees or qualified beneficiaries who had a Qualifying Event prior to the transaction need to have their COBRA continuation coverage provided by one of the parties to the transaction.

Under the regulations, any COBRA continuation coverage for active employees, former employees and qualified beneficiaries will normally be required to be provided by the seller regardless of whether the transaction is a sale of assets or a sale of stock. The parties to the transaction can negotiate a different responsibility among themselves but, if the party to whom the responsibility was delegated in the contract fails to perform, the seller will remain legally responsible to provide the coverage. While the normal rule is that the seller remains responsible for the COBRA coverage, the buyer will become responsible if the seller ceases to offer any group health plan as a result of the transaction and if, in the case of a sale of assets, the buyer is continuing the business operations without interruption or substantial change.

Thus, under the regulations, the seller will be required to provide COBRA continuation coverage to all persons where the Qualifying Event occurs on or before the date of the transaction. This may not seem logical when the transaction is a sale of the stock of a subsidiary or when the buyer adopts and continues the plan of the business enterprise. In
addition, in a transaction involving the sale of assets, the sale is a Qualifying Event even if the employees of the business continue to be covered by an equivalent plan to the plan they had with the seller and experience no loss of coverage.

In the event of a sale of assets where the buyer does not assume and continue the same plan that had previously covered the employees, the seller should provide COBRA notices to the active employees and allow them to elect COBRA continuation coverage. In addition, in all types of transactions, the seller will have to continue the COBRA coverage to the qualified beneficiaries where the Qualifying Event occurred on or before the date of the transaction. To the extent that the plan has been transferred to the buyer, the seller will have to provide the COBRA continuation coverage under a different plan of the seller.65

With respect to active employees, seller’s offer of COBRA coverage may be wasted effort if the buyer will be providing the employees with equivalent coverage after the acquisition with no pre-existing condition exclusion.66 In the past, where the purchase agreement assures the seller that the buyer will provide equivalent coverage to the employees so that the employees and qualified beneficiaries will not have any interruption or gap in their coverage, some sellers have adopted the position that there has been no loss of coverage and the COBRA notice and continuation coverage is not required. This approach is not permitted in an asset sale under the final COBRA regulations.67 An alternative is to have the parties agree that the buyer will provide the COBRA coverage to the qualified beneficiaries.

Where the seller offers COBRA coverage under its medical plan, the seller should be wary of the buyer trying to manipulate its medical costs by inducing employees or dependents who are incurring large medical claims to elect COBRA coverage under seller’s plan rather than becoming covered by buyer’s plan.68 To protect from this, the seller may want to insist that the
buyer agree not to provide any financial or other inducement to the employees to elect COBRA coverage.

The third problem related to COBRA arises out of the large penalties for noncompliance - $100 per day for each employee and qualified beneficiary involved. Under final Treasury regulations, uncorrected prior COBRA violations of an acquired company can adversely impact on the buyer in a merger transaction. The successor by merger assumes all of the acquired company’s COBRA violations. Under the regulations, this would not appear to be the case in the event of a sale of stock or of assets. Thus, buyers should be cognizant of the liabilities involved with COBRA in merger transactions but need not be as concerned in asset or stock transactions. Because of the magnitude of the potential penalty involving COBRA violations, buyers of businesses sometimes consider structuring the deal as an asset or stock purchase rather than a merger. If there is a purchase of assets and the buyer does not assume seller’s group health plans, the liability for prior uncorrected COBRA violations can be avoided. If, however, the deal is structured as a merger, the penalties will apply and the buyer should take every possible effort to ensure that the acquired company has complied with COBRA in all respects or has corrected any prior violations. In addition, where possible, the buyer should require the seller to give a warranty to the effect that COBRA has been fully complied with by the seller.

IV. TECHNIQUES FOR DEALING WITH PLANS
There are several techniques for dealing with employee benefit plans in a corporate acquisition, merger or disposition in order to achieve the objectives of the parties to the transaction. The following summarizes some of the major techniques:

A. **Adoption of the Plan, As Is**

If the plan covers solely the employees of the business enterprise being acquired, it is possible for the buyer to adopt the plan, as is. The buyer should require that the seller represent and warrant the funding status of the plan and should require that the purchase price be adjusted for any unfunded accrued liabilities.

In a purchase of assets transaction, 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. That is, 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 rules,\(^71\) the reporting and disclosure rules,\(^72\) the fiduciary rules\(^73\) of ERISA, the vast array of requirements set forth in the Code, or the COBRA rules. All such prior violations should normally remain the responsibility of the seller.

The purchase agreement should cover 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 the filings of Forms 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 the period up to the date of acquisition. The buyer should normally handle Form 5500
and the audit for the current plan year and should be responsible for contributions for the period subsequent to the date of acquisition.

If, on the other hand, the transaction is structured as a purchase of stock or a statutory merger, the buyer does not have the ability to avoid responsibility for the prior operation of a plan. As a consequence, 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 representations and warranties that the operations of the plan have conformed with all requirements of law, such representations and warranties may be of limited usefulness after the acquisition has occurred. In addition, in a stock purchase or statutory merger, the buyer should be careful to ensure that current contributions to all plans are reflected in the financial statements of the acquired company or that there is a special adjustment in the purchase price for them.

B. Adoption of the Plan With Modifications

There are a vast number of possible modifications to a plan that can be made prior to the adoption of the plan by the buyer. In fact, any modification which seller can otherwise make is possible. Thus, a plan’s benefit formula may be changed to reflect buyer’s ideas as to plan design, or the covered employees may be changed to reflect personnel adjustments. In some cases, a seller may require that the plan become fully vested on the sale of the business in order to protect the plan participants from possible forfeiture as a result of their being discharged by the buyer. In several cases, special early retirement features have been added or expanded immediately prior to the sale to protect the employees of the selling company.

Not all modifications relate to plan design. The funding of a plan may be modified substantially in a corporate transaction. Such funding changes may involve structural
changes such as withdrawing the plan assets from seller’s pooled investment fund or master trust or might involve major shifts in the funding levels of the plan. For example, a plan amendment increasing benefits or adding special early retirement features to a defined benefit plan may result in the plan going from being overfunded to being underfunded.

In contrast, the transaction may cause the seller to make a final contribution to the plan. In the case of a defined contribution plan, such a final contribution would generally involve no more than the prior year’s contribution together with a pro rata portion of the current year’s contribution. Such final contributions do not usually present any problems or difficulties. With respect to defined benefit plans, however, the contribution necessary to fully fund the plan may be of such magnitude that it is not financially feasible. Even if the seller wanted to and was able to make a full funding contribution to a defined benefit pension plan, such a contribution might not be fully deductible and might be subject to a penalty tax on nondeductible contributions.74

In cases where the seller does not bring the plan up to full funding, the purchase price can be adjusted downward by the amount of the underfunding. This is usually acceptable to the buyer but may be unsatisfactory to the seller since there is no assurance that buyer will use the increased cash flow resulting from the lower purchase price to fund the plan. Seller may feel strongly that, if it is receiving a lower purchase price because of the pension plan, the money should go into the plan.

Another type of modification to a plan could occur when it is discovered that the plan has a qualification defect. Frequently, the seller will be required to correct the defect under the SCP program (formerly APRSC) or to go through the VCP program (formerly the VCR
Program or the Walk-In CAP program) in order to have the IRS approve the method of correction.

C. **Plan Spin-off or Split-up**

Frequently, the employees of the business being acquired are covered by a plan which covers employees of other divisions or subsidiaries of the selling company. If it is the desire of the parties, 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 seller’s operations remains the seller’s plan.

Spin-offs of plans with individual accounts are relatively simple -- the accounts of the employees of the enterprise which is being sold are transferred to the spun-off plan. Spin-offs of plans without individual accounts are more complex. 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. Depending upon the size of the spun-off plan, the actuarial calculations necessary to accomplish a spin-off may be extremely burdensome. In such cases, a spin-off may not be economically feasible.

In spinning off a portion of a defined benefit plan that has surplus plan 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.\textsuperscript{78}

Whenever there is a spin-off or split-up of a qualified plan, the buyer and the seller have to be mindful of the requirements of Code §411(d)(6). Code §411(d)(6) prohibits the elimination of optional forms of benefits under a qualified plan with respect to accrued benefits at the time of the spin-off or split-up.\textsuperscript{79} §411(d)(6) thus requires that the spun-off plan contain all the optional forms of benefits and subsidized early retirement benefits which the prior plan contained. Such optional forms of benefits would have to be eliminated from the spun-off plan subsequent to the spin-off and only to the extent allowed by Treas. Reg. §1.411(d)-4.

§411(d)(6) also requires that the defined benefit features of a defined benefit plan or the defined contribution features of a defined contribution plan be preserved.\textsuperscript{80} Thus, it is generally not possible in the course of a spin-off or split-up to convert a defined benefit plan to a defined contribution plan or vice versa.\textsuperscript{81}

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.

D. Plan Merger
Where the purchaser is an on-going enterprise, it will have employee benefit plans of its own and will often want to incorporate the employees of the acquired company into its employee benefit plans. One mechanism of integrating the existing employee benefit plans of the acquired company and the buyer is a plan merger. In a plan merger, the two plans become combined 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 his respective account balances in the two predecessor plans immediately prior to the merger.\textsuperscript{82} Of course, Code §411(d)(6) applies to a merger of plans. Thus, if the plans are money purchase plans, the joint and survivor form of benefits provided by the two pre-merger plans must be preserved in the merged plan. Even if the plans are converted to profit sharing plans, the joint and survivor form of benefit must be preserved for the assets previously held in the money purchase pension plans. It should be noted, however, that even in a money purchase pension plan, all other forms of payment, other than the qualified joint and survivor form of payment, can be eliminated under Treas. Reg. §411(d)-4 Answer 2(e).

If a defined contribution plan, other than a money purchase plan, contains joint and survivor or other annuity provisions, the participants who were covered by that plan must continue to be covered by similar provisions after a plan merger unless the annuity provisions are eliminated in accordance with Treas. Reg. §411(d)-4 Answer 2(e). By being able to eliminate unwanted forms of benefit payments including joint and survivor or other annuity forms of payment, one of the greatest impediments to plan mergers has been eliminated.
If the merger involves two defined benefit pension plans, 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. There are no rules which apply to the merger of two welfare benefit plans.

When two defined benefit plans merge, it is very rare to find that the benefit structures of the two plans are identical. 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 the two benefit structures into a single structure with certain noncontinuing features grandfathered for those employees who were previously covered by them. This approach will have to be carefully analyzed under the final regulations under Code §401(a)(4). Under the Code §401(a)(4) regulations, certain types of grandfathered benefits and features will have to meet mechanical nondiscrimination tests throughout the period that the grandfathered benefit or feature remains in the plan and applies to future plan accruals. Since grandfathered benefits apply to a shrinking group of employees which typically becomes more and more weighted toward highly compensated employees, the Code §401(a)(4) regulations will likely be violated at some time in the future. The Code §401(a)(4) regulations do, however, allow certain benefits, rights and features, such as the right to a lump sum payment, 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.\textsuperscript{86} Testing nondiscrimination of the grandfathered benefit, right or feature on the basis of buyer’s workforce may present a problem if the grandfathered group is disproportionately high paid compared to the rest of buyer’s employees. If the grandfathered group is not a nondiscriminatory group, the buyer will have to freeze the benefit, right or feature so that it only applies to benefits which accrued prior to the end of the plan year following the plan year during which the acquisition was made.\textsuperscript{87}

E. Plan Freezes

Rather than merging the acquired company’s plan into the plan of the buyer, the plan can be frozen either as to future eligibility or future accruals, or both. If future eligibility is frozen, no new employees are allowed to enter the plan. They are covered by the buyer’s plan instead. Current employees are allowed to remain in the plan and to accrue future benefits.

In contrast, the decision may be made to freeze both eligibility and accruals. If this is done, the current plan participants are not allowed to earn any further benefits under the old plan. Benefits for future service are provided under the buyer’s plan. Service with the buyer continues to count in the old plan for purposes of vesting and eligibility for retirement benefits.

In order to freeze pension accruals in connection with a merger or acquisition, participants and certain other persons must be given notice of the freeze at least 15 days prior to the effective date of the freeze.\textsuperscript{88} Because of the advance notice requirement, it will not be possible to freeze a plan’s benefits as of the date of acquisition if the acquisition is to be kept secret prior to its effective date. Where secrecy is important, the freeze will have to be delayed until at least 15 days after the announcement of the acquisition to the employees.

The income tax provisions applicable to qualified plans present several problems for frozen plans. First, a plan with frozen eligibility but not frozen accruals has the same
problem with the nondiscrimination regulations under Code §401(a)(4) that a grandfathered benefit formula would have within a merged plan. In addition, under Code §401(a)(26), any defined benefit plan, including a frozen plan, must cover at least 50 employees or, if fewer, 40 percent or more of all employees of the employer. By its nature, a frozen plan will cover fewer and fewer people each year and will, at some time, have to be terminated or merged into another plan. The harshness of this rule has been somewhat softened by regulations issued by the Treasury Department. The regulations under Code §401(a)(26) provide that a plan will be exempt from the 50/40 percent rule if the plan is not top heavy—that is, no more than 60% of the plan’s benefits are for key employees—and no highly-compensated employees currently accrue any benefits under the plan. In addition, an underfunded defined benefit plan which is not top heavy is exempt from the 50/40 percent rule provided that all accruals under the plan are completely frozen.

F. Nonadoption of the Plan
In a number of situations, either the buyer or the seller may be unwilling for the seller’s plan to be adopted by the buyer. The buyer may not want to adopt the seller’s plan because of its unfunded liabilities, because the plan does not fit into the benefit structure of the buyer, or because of concern about becoming liable for seller’s violations of law, such as COBRA, in the administration of the plan prior to the acquisition. The seller may not want to transfer the plan to the buyer because it wants to defer the funding of the plan’s unfunded accrued liabilities for as long as possible or may not agree with the buyer as to the magnitude of the unfunded liabilities. In addition, the seller may not want the buyer to obtain control over the plan and its assets and somehow dissipate the benefits that have accrued for the benefit of the employees.

In a sale of assets, the buyer and the seller have almost total discretion whether a plan will or will not be adopted by the buyer. In a sale of stock or a merger, the discretion is substantially lessened. Nonetheless, where the buyer is purchasing the stock of a subsidiary of the seller, the parties have discretion to transfer the plan to the parent company prior to the transaction in order that the plan not be transferred to the buyer.

When a plan is not transferred to the buyer, the sale normally causes a termination of employment of the employees of the acquired company under the plan. For a retirement plan, this could cause a forfeiture of the benefits of those employees who had not yet completed sufficient service to become vested. In addition, employees who had not yet satisfied the conditions for early retirement could lose special subsidized benefits under the plan.92

To avoid the premature forfeiture problem, buyer and seller usually agree to one of two approaches. The first approach is for the employees who are transferred to buyer to become fully vested under seller’s plan regardless of the length of their service. The second
approach is for seller’s plan to count service with the buyer for purposes of vesting. In addition, service with the buyer may also count with respect to eligibility for subsidized early retirement benefits.

With respect to severance pay plans, at least one court has deemed that the failure of the buyer to adopt the seller’s severance pay plan was significant in ruling that the sale of the business constituted a severance of employment which entitled the employees to receive severance pay. In the mind of the court, since the severance pay plan was not adopted by the buyer, the employees would forever lose their right to severance pay if it was not triggered by the sale of the business. As a result, sellers may want to require that buyers adopt sellers’ severance pay plans or an equivalent plan.

G. **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 formulas. 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 formulas 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, 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 final regulations under Code §401(a)(4). 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 buyer or allows the accrued benefits to increase by reason of compensation increases. Thus, it is possible to count post-disposition service for vesting and eligibility for benefits and to recognize increases in the compensation of the employees with the buyer under 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 employees’ benefits under seller’s plan.94

H. 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 pension plan or a retiree medical benefit plan because of large unfunded liabilities. Buyer may also not want to adopt a plan because it does not fit into its employee benefits package. The seller may not want the employees subjected to any risks that the buyer will somehow cause them to lose their accrued benefits under seller’s plan.

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, in many cases, single lump sum payments which can be rolled into an individual retirement account or into buyer’s plan.95

Termination of a qualified retirement plan subsequent to the acquisition is often 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.\textsuperscript{96} In this situation, the purchase agreement might provide that, in the event of the termination of the plan, a portion of the surplus recovered by buyer will be paid to the seller unless the purchase price had been increased to reflect the overfunding. Similarly, if the seller has not transferred the plan to the buyer, but has agreed to give the employees credit for service with the buyer for purposes of vesting and eligibility for retirement benefits, the termination of the plan by the seller could result in the employees receiving reduced benefits under the seller’s plan.\textsuperscript{97} To prevent this, the buyer should consider requiring that the seller will not terminate the plan as to buyer’s employees unless their full accrued benefits are funded.

With respect to 401(k) plans, it has become common practice for sellers to terminate their plans prior to the transaction in order to make distributions to the covered employees. The practice of terminating 401(k) plans arose out of a combination of concerns. First, buyers were concerned about being saddled with unwanted forms of distribution which could not be eliminated under Code §411(d)(6). Second, buyers were concerned about disqualification defects in sellers plans which if seller’s plan were merged into buyer’s plan could cause the disqualification of buyer’s own plan. With the change of the regulations under Code §411(d)(6) and recent modifications in EPCRS reflected in Rev. Proc. 2001-17, these concerns are substantially lessened. That is, under Treas. Reg. 411(d)-4 Answer 2(e), a plan sponsor can eliminate any form of payment under a 401(k) plan other than a lump sum payment. In addition, Rev. Proc. 2001-17 makes it clear that if two plans are merged and only one has a defect, the correction need only apply with respect to the portion of the plan that had the defect.

I. 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. A “partial termination” can be either of two types of events: an event which causes a significant group of employees to cease to participate in a plan (“vertical partial termination”) or an amendment to a plan which reduces the benefits provided by the plan and increases the likelihood that the employer will receive a reversion of surplus plan assets (“horizontal partial termination”). Partial terminations can occur by reason of the acquisition or disposition or can occur subsequent to the acquisition.

The sale of a subsidiary or division of a company may be a vertical partial termination if the plan is not going to be transferred to the buyer and the employees of the subsidiary or division will cease to be participants in the plan. Such a sale may have the same effect for the employees of the subsidiary or division 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 becoming vested under the plan.

Whether a partial termination occurs because of the sale of a division or subsidiary will depend upon the facts and circumstances of each case. Not all events that defeat an employee’s 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 constitute 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 act of the employer; 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 office; and whether the group of employees is a significant group in terms of numbers or as a percentage of the plan participants.101

There is no question that the sale of a division or subsidiary is an event that can cause a partial termination.102 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 regulation or has been developed under case law, 20 percent has emerged as an ad hoc threshold percentage necessary for a partial termination to occur.103 Since the sale of a division or subsidiary is a voluntary act by the employer, any reduction at or above the 20 percent level, while not conclusive, has a high likelihood of being considered a partial plan termination.

In calculating the 20 percent 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 closings to reach the 20 percent threshold depending on the facts and circumstances. For example, if a company sells four different widget factories 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 widget 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 decision of the company to get out of the widget business.104
Despite the generally applied 20 percent reduction rule, the number of plan participants affected by the event should also be considered. If a sufficiently large number of participants are involved in the event, a partial plan termination may have occurred event though the percentage reduction in the number of plan participants is less than 20. Just what numbers are necessary in order to trigger a partial plan termination, if any, are not known. In one situation, the closing of a facility resulting in the termination of 415 employees out of 16,444 did not constitute a plan termination.

In the context of a sale of a division or a subsidiary, the existence of the partial termination rule provides the buyer with some leverage to compel the seller to treat the employees fairly under seller’s plan. In many cases, the seller will realize that agreeing to provide the employees with full vesting is not a concession to the buyer but merely compliance with the partial termination rule.

Assuming that a sale of a division or subsidiary would otherwise constitute a partial termination, the question arises whether it is necessary to provide the employees with full vesting in their accrued benefits. Does it suffice to continue to count their service with the buyer for purposes of vesting and eligibility for retirement benefits? In such a case, the sale does not give them the windfall that full vesting might provide. Technically, continued counting of service may not suffice if the event is a partial termination, but when taken into consideration with other facts and circumstances, would, perhaps, prevent the sale from being deemed to be a partial termination.

The partial termination need not occur at the time of the acquisition--it can occur subsequent to the acquisition. In the 1991 decision In re: Gulf Pension Litigation, actions taken by Chevron subsequent to the acquisition of Gulf resulted in both types of partial
terminations. A 34.7% reduction in the employees of Gulf and a 45.2% reduction in the number of nonvested Gulf plan participants over a two and one-half year period was deemed to be a vertical partial termination\textsuperscript{109} while plan amendments eliminating certain benefits from the Gulf pension plans were deemed to be horizontal partial terminations.\textsuperscript{110}

V. OVERVIEW OF THE ACQUISITION PROCESS

A. The Dynamic of the Negotiations

The process of the negotiations involves the identification of the employee benefit plans of the seller, the identification of the funding status of the plans, and the negotiation of any adjustment in the purchase price for the business because of unfunded employee benefit liabilities.

In the case of a sale of assets, the buyer is not obligated to assume the plans of the seller. This decision will depend on the nature of the plans, their funding status, their past history of compliance with the laws, and the nature of the adjustment in the purchase price with respect to the plans.

B. Structure of the Acquisition

Generally, employee benefit plan considerations do not dictate the structure of a corporate acquisition. There are, however, a few exceptions. A seller which faces a potentially large withdrawal liability with respect to a multiemployer pension plan may insist on a sale of stock rather than a sale of assets. On the other hand, a buyer which does not want to inherit a burdensome plan from the seller may insist on a sale of assets.

C. Impact on the Purchase Price
To the extent that an employee benefit plan involves a liability of the business enterprise, it should impact on the purchase price of the enterprise. Similarly, to the extent that the plan represents a hidden asset of the enterprise, an upward adjustment in the purchase price may be appropriate in certain circumstances.

1. **Plan Liabilities**

Employee benefit plans can represent one of the largest potential liabilities of a business enterprise. The types of employee benefit plans involving the greatest potential liabilities are defined benefit pension plans, post-retirement medical and life insurance benefits, and deferred compensation programs for executives.

In many cases, the liability for an employee benefit plan shown on the financial statements may not be an adequate portrayal of the true liability. A buyer is well advised to have an actuary compute the liabilities relating to employee benefits, both retirement plans and retiree medical plans, in order to be sure that the balance sheet provision is adequate.

The accounting rules for pension plans are contained in Statements 87 and 88 of the Financial Accounting Standards Board. F.A.S. 87 and 88 require that all or a part of the unfunded liabilities of a defined benefit pension plan be reflected on the financial statements of the employer. However, when F.A.S. 87 and 88 were implemented in 1987, employers were allowed to include an intangible asset on their balance sheets in an amount equal to the initial unfunded liability of the employer under the plans. The effect of this intangible asset was to allow employers to continue to show the same net worth for their businesses as was shown before the accounting change. These intangible assets still appear on financial statements of companies and Buyers should not be fooled by them -- they are a truly bogus numbers and do not represent any true asset of the business enterprises. A buyer should not, in any event, rely upon
the pension liability shown on the financial statements of the seller, but should have its own actuary review the funding status of the pension plan since the balance sheet liability may not reflect the full extent of the liabilities of the plan.\footnote{112}

2. \textit{Off-Balance Sheet Assets}

Employee benefit plans are not always a hidden liability--they can be a hidden asset. An employee benefit plan can be overfunded. That is, the assets of the plan can exceed the liabilities of the plan. The overfunding of a pension plan represents a potential asset of the enterprise to the extent that the employer is willing to terminate the plan\footnote{113} and pay substantial excise taxes or other amounts\footnote{114} in order to recapture the remainder of the surplus plan assets. However, since the net return to the employer is so low from a termination/reversion, it is unlikely that an employer will terminate a plan that covers active employees in order to get the surplus pension assets unless the employer is in a loss position or is in desperate need for the money. It is more likely that the employer will try to utilize the surplus assets in other ways including merging the plan into an underfunded pension plan or freezing contributions to the plan until future benefit accruals use up the surplus. One way to utilize surplus pension assets is to transfer a portion of the surplus to pay retiree medical benefits on a completely tax free basis which may be attractive to an employer which has large unfunded retiree medical liabilities and has an overfunded pension plan.\footnote{115}

The potential also exists for there to be surplus assets in any other funded employee benefit plan. Thus, if an employer has a medical benefits program or disability program which is funded through a Code §501(c)(9) trust, it is possible that the trust contains excess assets which are a hidden asset of the business enterprise. Unlike retirement plans, surplus assets in a Code §501(c)(9) trust cannot revert to the employer.\footnote{116} Nonetheless, surplus
funds can be used to provide other employee benefits to the employees of the employer thereby relieving the employer of the cost of funding the benefits. For example, if a disability plan is overfunded, it is possible to add the employer’s medical benefits plans to the Code §501(c)(9) trust and utilize the surplus to pay medical benefits until the surplus is exhausted.

3. **Amount of the Adjustment of the Purchase Price**

The biggest difficulty related to employee benefit liabilities is to determine the appropriate adjustment of the purchase price. Since the liabilities involve actuarial calculations, they are totally dependent upon the assumptions as to interest rates, life expectancies and other factors which will impact on the ultimate liability under the plan. The parties have to agree to these assumptions or to a method of arriving at these assumptions in order to calculate whether the plan is overfunded or underfunded. One such method for a pension plan would be to value the plan’s liabilities using the PBGC’s assumptions for terminated pension plans. While the PBGC rates are not the most favorable rates in the market place, they do represent the rates which will be utilized to determine whether the plan is underfunded in the event the plan should terminate. Another approach is to value the liability on an on-going basis rather than on a termination basis. If this is done, it is more appropriate to utilize the FAS 87 and FAS 88 assumptions and methods rather than the PBGC assumptions. By using FAS 87 and FAS 88 assumptions, the parties to the transaction will be able to minimize the financial statement impact on both the buyer and the seller.

A major difference between PBGC and FAS 87 and 88 calculations of pension liabilities relates to future increases in pre-acquisition accrued benefits by reason of increases in compensation that occur subsequent to the acquisition. If the plan liabilities are determined on a termination basis, future increases in pre-acquisition accrued benefits because of post-acquisition
increases in compensation will be ignored and the plan has a greater chance of being overfunded. If, however, the plan liabilities are determined on an on-going basis under the F.A.S. 87 rules, the projected benefit obligations with respect to the pre-acquisition accrued benefits will be calculated based upon future projected pay levels. This will serve to increase the liability attributable to the pre-acquisition benefits. Whether, in any specific acquisition, the funding status should be determined on a termination basis or on an on-going basis will depend upon whether the plan will terminate or continue subsequent to the acquisition and upon the negotiations between the parties.

Determining the amount of the liability related to post-retirement medical and life insurance benefits is even more difficult than for pension plans. Projecting the liabilities for such plans requires an actuary to predict the rate of increase in medical expenses over the next 40 years and the degree to which Medicare benefits will be reduced in addition to predicting life expectancies and interest rates. It is not unusual for the buyer and the seller to be so far apart in their calculations of the amount of this liability that the parties will ultimately decide that the seller will retain the liability rather than having to agree to its value.

D. Letter of Intent
In a negotiated merger or acquisition, the letter of intent dictates the direction of the negotiations. Most importantly, it sets the purchase price. Because of this, the letter of intent will often determine whether employee benefit plan liabilities will impact on the purchase price and the extent of the impact. This will be the case even though the purchaser has not even begun its investigation of the plans. Since employee benefit plans are more often hidden liabilities than hidden assets, the letter of intent is a potential opportunity for the seller and a potential trap for the unwary buyer.

The seller’s approach to the letter of intent should be that it is selling an on-going business and that the buyer is buying the business “as is”. The seller should have made a preliminary determination as to the employee benefit plans which it wants the buyer to assume and to provide for such assumption in the letter of intent. By doing so, the seller hopes to establish that the purchase price will not be reduced by the liabilities associated with the employee benefit plans being assumed.

The buyer’s approach should be extremely cautious. Since the buyer has not had an opportunity to investigate the plans, it should condition any agreement to assume a plan on the plan being sufficiently well funded so that there are enough assets to cover the projected benefit obligations of the plan under FAS 87 and 88. In addition, because of the various methods used to fund employee benefit plans, the buyer should also condition its assumption of the plan upon there being sufficient assets to maintain the current levels of employer contributions. When in doubt, the buyer’s attitude at the letter of intent stage should be that it is not assuming any employee benefit plan that has any potential unfunded liability.

The buyer has less flexibility if the transaction is structured as a merger or sale of stock since the buyer cannot refuse to assume plans that it does not want. Because of this the
buyer should be careful to require that the purchase price be subject to adjustment for unfunded employee benefit liabilities.

E. Investigation of the Employee Benefit Plans

The most important aspect of the acquisition process for the buyer is to start its investigation of the employee benefit plans early and to do as thorough a job as possible. The buyer should be especially concerned with identifying items which are hidden liabilities.

Obviously, a buyer should review the plans and their summary plan descriptions. To the extent there are actuarial reports for the plans, the buyer should examine copies of them, and make sure they reflect any recent plan amendments increasing benefits. Collective bargaining agreements should also be checked to determine if they call for benefit increases which were not contemplated in the most recent actuarial report. If a union negotiated plan bases benefits on the compensation of the employees, the buyer should check to see if large wage increases have been negotiated. Finally, the buyer should review any post-retirement medical or life insurance benefits provided by the seller.

F. Determination of the Approach to the Plans
Once the buyer has completed its investigation of the plans, it is in a position to determine the approach it favors with respect to the plans. As was noted earlier, the buyer has broad discretion as to which plans it will adopt in an asset acquisition, limited discretion in a stock acquisition and no discretion in a merger. Whether a plan is adopted by buyer will depend upon the funding status of the plan, the burdens the plan places on the enterprise, buyer’s concerns as to the impact of change on the employee group, and the ultimate objectives of the buyer with respect to the benefit package it wants for the acquired enterprise.

G. Analysis of Coverage Problems

Every pension, profit sharing, and stock bonus plan is subject to strict requirements that the plan cover a nondiscriminatory group of employees\textsuperscript{117} and provide nondiscriminatory benefits or contributions.\textsuperscript{118} Some welfare benefit plans are subject to similar rules.\textsuperscript{119} For retirement plans, there are potentially complex mathematical nondiscrimination tests which must be met.\textsuperscript{120} A corporate acquisition or disposition can affect compliance with these tests and both buyer and seller should analyze how they are impacted. For example, if seller’s plan qualifies because it covers more than 70 percent of seller’s non-highly compensated employees, the sale of a participating division might result in the plan covering less than 70 percent and being disqualified. On the other hand, the addition of a new group of employees to buyer’s workforce might create coverage problems for the buyer’s plans especially if buyer’s plans have better benefits than the plans covering the acquired business. Under the nondiscrimination rules, the buyer is given until the end of the following plan year to meet the coverage requirements taking into account the new acquisition.\textsuperscript{121} Since, at the end of this period, the coverage of all of buyer’s plans will have to comply, the buyer should analyze any
acquisition to determine the increased pension expense which will result from having to comply with the coverage requirements.\textsuperscript{122}

In addition to mathematical coverage tests, a plan may be subject to mathematical limitations on the benefits which can be provided to certain participants in order to qualify for favorable tax treatment.\textsuperscript{123} These limits could also present a problem for the parties to the transaction. For example, a 401(k) plan must satisfy certain deferral percentage tests in order for the plan to be a qualified plan. These tests require that the average deferral percentage for the highly compensated participants be no greater than certain multiples of the average deferral percentages for the non-highly compensated participants.\textsuperscript{124} The sale of a division or subsidiary will often change the composition of the highly compensated and non-highly compensated groups and could result in significant changes in the deferral percentages of the respective groups. It is possible that simply by selling a division or subsidiary the seller may adversely impact its 401(k) plan.

H. Reportable Events

The corporate transaction may constitute a reportable event under Title IV of ERISA for a number of reasons. The transaction will be a reportable event if:

(a) the transaction results in a 20\% reduction in the number of participants since the beginning of the year or a 25\% decrease since the beginning of the preceding year in an underfunded pension plan unless:

(1) the plan has fewer than 100 participants;

(2) the plan does not pay a variable rate premium;

(3) the plan has less than $1,000,000 of unfunded vested benefits;

(4) the plan has no unfunded vested benefits calculated using IRS assumptions and fair market value of assets; or
(5) the closing of one or more facilities did not cause the 20%/25% decrease in the number of active participants in the plan and the plan is at least 80% funded;\textsuperscript{125}

(b) the transaction results in a person leaving the controlled group that maintains the plan unless:

(1) the person leaving the controlled group is either:

   (A) a de minimis business segment;\textsuperscript{126}

   (B) except for Advance Reporting Companies,\textsuperscript{127} a foreign entity other than a foreign parent;

(2) except for Advance Reporting Companies, the plan does not pay a variable rate premium;

(3) except for Advance Reporting Companies, the plan has less than $1 million of unfunded vested benefits;

(4) except for Advance Reporting Companies, the plan does not pay a variable rate premium;

(5) except for Advance Reporting Companies, the plan has no unfunded vested benefits calculated using IRS assumptions and fair market value of assets; or

(6) except for Advance Reporting Companies, the employer is a reporting company under the Securities Exchange Act of 1934 and the plan is at least 80% funded for vested benefits.\textsuperscript{128}

(c) a member of the employer’s controlled group liquidates (including liquidation into another controlled group member) unless any plans maintained by the liquidating company continue to be maintained by a member of the controlled group and unless:

(1) the person being liquidated is either:

   (A) a de minimis business segment;

   (B) except for Advance Reporting Companies, a foreign entity other than a foreign parent;

(2) except for Advance Reporting Companies, the plan does not pay a variable rate premium;
(3) except for Advance Reporting Companies, the plan has less than $1 million of unfunded vested benefits; or

(4) except for Advance Reporting Companies, the plan has no unfunded vested benefits calculated using IRS assumptions and fair market value of assets; or

(5) except for Advance Reporting Companies, the employer is a reporting company under the Securities Exchange Act of 1934 and the plan is at least 80% funded for vested benefits.\(^{129}\)

(d) a member of the employer’s controlled group declares certain dividends or makes certain redemptions of its own stock unless:

(1) the person paying the dividend or making the redemption is either:

(A) a 5% de minimis business segment;

(B) except for Advance Reporting Companies, a foreign entity other than a foreign parent;

(2) except for Advance Reporting Companies, the plan does not pay a variable rate premium;

(3) except for Advance Reporting Companies, the plan has less than $1 million of unfunded vested benefits;

(4) except for Advance Reporting Companies, the plan has no unfunded vested benefits calculated using IRS assumptions and fair market value of assets; or

(5) except for Advance Reporting Companies, the plan is at least 80% funded for vested benefits.\(^{130}\)

(e) within a 12 month period, more than 3% of the benefit liabilities of a plan are transferred to a person or plan that is not related to the controlled group that sponsors the plan unless:

(1) All the plan assets and liabilities are transferred;

(2) except for Advance Reporting Companies, the amount being transferred is calculated using PBGC assumptions and utilizing a safe harbor method determined under Code § 414(l); or
(3) both the transferee plan and the transferor plan are fully funded after the transfer.\textsuperscript{131}

Generally, notice of a reportable event must be filed within 30 days after the event. However, if the employer is an Advance Reporting Company, notices of the events described in paragraphs (b), (c), (d), and (e) need to be filed at least 30 days in advance of the transactions.\textsuperscript{132}

I. The Purchase Agreement

The purchase agreement should contain detailed and explicit provisions with respect to the handling of employee benefits. If responsibility for a benefit program has to be divided between the buyer and the seller, it is easier to have a fair division of the responsibility if it is negotiated in advance. Parties to a transaction rarely get significant concessions from the other party after the deal has closed.

VI. CONCLUSION

Since the passage of ERISA, liabilities with respect to employee benefit plans have become less and less contingent. Because these liabilities may no longer be erased by a plan termination or plan amendment, the treatment of the employee benefit plans in corporate acquisitions, mergers and dispositions has taken on greater importance. Both buyers and sellers should be aware of the problem areas and potential pitfalls and through the negotiation process arrive at a method of dividing these responsibilities and liabilities.

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12 General Agreement on Tariffs and Trade, Pub. L. No. 103-465.
16 F.A.S. 87 and 88 apply to retirement plans while F.A.S. 106 applies to post-retirement welfare benefit plans such as retiree medical and life insurance plans.
17 ERISA §3(34); 29 U.S.C.A. §1002(34) (1985).
Cash and deferred profit sharing plans are most commonly known as “401(k) plans” by reason of the section of the Code which provides for special discrimination tests applicable to such plans. See Code §401(k).

Defined contribution plans are permitted to provide that forfeitures of accounts of non-vested employees are reallocated to the accounts of the then current active participants. See Rev. Rul. 71-313, 1971-2 C.B. 203 and Code §401(a)(8).

ERISA §3(34); 29 U.S.C.A. §1002(34) (1985).

Employer contributions for a taxable year need not be made until the due date of the employer’s tax return including any extensions. Code §404(a)(6).


ERISA §3(1); 29 U.S.C.A. §1002(l) (1985).

Code §501(c)(9) provides an exemption from federal income taxes for certain voluntary employees’ beneficiary associations designed to provide life, accident, sickness or similar benefits to a group of employees and their beneficiaries.

The funding of welfare benefit plans is subject to limitations contained in Code §§419 and 49A.

Under Code §83, funded executive compensation programs are taxable to the executive upon the earlier of the date his benefits are no longer subject to a substantial risk of forfeiture or the date the benefits are transferable. Under Code §404(a)(5) the employer is allowed a deduction in the year the executive is taxed but only if separate accounts are maintained for the executives. Thus, if the executive benefit program is a funded defined benefit program, the employer is denied any deduction.

A “rabbi trust” is a trust which is established by the employer to provide benefits to an executive subject to the condition that the trust assets are available to satisfy the claims of creditors of the employer. The IRS has ruled that the assets of such a trust are subject to a substantial risk of forfeiture and are consequently not taxable to the executive even though the benefits under the executive compensation plan are fully vested. See e.g. I.R.S. Ruling Letters 999910002 (March 12, 1999); 199906008 (February 12, 1999); PLR 9846003 (November 13, 1998); 9743003 (October 24, 1997); 9504006 (January 27, 1995); 9420015 (February 16, 1994); 9332038 (May 18, 1993); 9022032 (March 2, 1990); 9021056 (February 27,1990); 8951025 (September 22,1989); 8844020 (August 5, 1988); 8744024 (August 3, 1987); 8743065 (July 29, 1987); 8711108 (Dec. 18, 1986); 8711033 (Dec. 12, 1986); 8708063 (Nov. 28, 1986); 8702021 (Oct. 10, 1986); 8641039
(July 15, 1986); 8634031 (May 21, 1986). The Department of Labor has determined that such arrangements are not “funded” programs and are, therefore, exempt from ERISA’s participation, vesting, funding and fiduciary responsibility provisions. See Letter from Elliot Daniel, assistant administrator for regulations and interpretations, to Richard Manfreda, chief of the Individual Income Tax Branch (December 13, 1985) reprinted in 13 BPR 702.

See Code §280G and 4999 which impose substantial tax penalties on certain “excess parachute payments” as defined in Code §280G(b). The tax penalties can significantly increase the after-tax liabilities of excess parachute payments.

Originally, ERISA §302(b)(2)(B)(ii) and Code §412(b)(2)(B)(ii) provided that past service liabilities could be funded over a 30 year period for single employer plans. Subsequent legislation has added ERISA §302(d) and Code §412(l) which provide for a deficit reduction contribution which requires that sponsors of severely underfunded plans make additional deficit reduction contributions.

Code §404(a)(1)(D) allows an employer which has more than 100 employees who participate in defined benefit pension plans to make a contribution to such plans up to the amount of their unfunded current liabilities as defined in Code §412(l) and to deduct the full amount of the contribution. Employers with less than 100 employees who participate in defined benefit pension plans can fund past service liabilities at least as fast as over a 10 year period.

An early retirement window benefit involves an enhancement to the regular early retirement benefit provided by the pension plan for any employee who retires early during a specified period of time - the “window period.”

During the early 1980s when interest rates were substantially above historical levels, it was not uncommon to find an insurance contract which would impose a 25-30% market value adjustment upon an employer terminating the contract. Even when interest rates are stable, it is not unusual to find insurance contracts with 5-10% surrender charges or “market value adjustments.”

See ERISA §302(c)(2)(B) and Code §412(c)(2)(B).


ERISA §4204(a)(1); 29 U.S.C.A. §1384(a)(1) (1985)

ERISA §4204(a)(1)(C); 29 U.S.C.A. §1384(a)(1)(C) (1985)
ERISA §4204(b)(1); 29 U.S.C.A. §1384(b)(1) (1985)

Under MEPPAA, a Multiemployer Plan can allocate unfunded vested pension liabilities in a number of different ways. Under some of the methods, unfunded vested benefits are attributed to certain periods during which they were created. They are then allocated proportionately among the employers based upon their contributions during such period. If no unfunded vested benefits were created during the last five years then under certain methods, the buyer will not have any allocable share of the unfunded liabilities and will consequently not have withdrawal liability based on such five years. See ERISA §4211.

See e.g. Sengpiel v. B.F. Goodrich Company, 156 F.3d 660 (6th Cir. 1998); Musto v. American General Corp., 10 EBC 1441 (6th Cir. 1988) and Howe v. Varity Corp., 896 F.2d 1107 (8th Cir. 1990). However, if the employer has not reserved the right to amend or terminate retiree benefits, courts have found that the benefits were life-time benefits. See e.g. Helwig v. Kelsey-Hayes Company, 93 F.3d 243 (6th Cir. 1996); UAW v. Yard-Man, Inc., 716 F.2d 1476 (6th Cir. 1983), cert. denied, 465 U.S. 1007 (1984); UAW v. Cadillac Malleable Iron Co., 728 F.2d 807 (6th Cir. 1984); Keffer v. H.K. Porter Co., Inc., 872 F.2d 60 (4th Cir. 1989).


“Highly Compensated Employee” is defined as including:
(a) five percent owners; and

(b) persons earning more than $80,000 (plus cost of living increases subsequent to September 30, 1996) and, if the employer so elects, who are in the highest paid 20% of the employees.

See Rev. Proc. 2002-47 for a complete description of the SCP Program as a part of the Employee Plans Compliance Resolution System (EPCRS).

See Rev. Proc. 2002-47 for a complete description of the VCP Program as a part of the Employee Plans Compliance Resolution System (EPCRS).


Code §411(d)(6) provides that an employer cannot take away any optional forms of benefits under a plan through the mechanism of transferring account balances to another plan. Treas. Reg. §1.411(d)-4 Answer 3(a)(1). However, once the assets are received, all optional forms of benefits in a profit sharing plan other than a lump sum can be eliminated by complying with the provisions of Treas. Reg. §411(d)-4 Answer 2(e).

A distribution to a plan participant which is subsequently rolled into a qualified plan expunges 411(d)(6) protected benefits. Treas. Reg. §1.411(d)-4 Answer 3(b).

Prior to January 1, 2002, Code §401(k)(10) only allowed a 401(k) plan to make a lump sum distribution of the account balance of a plan participant in the event of the sale of a subsidiary company or the sale of substantially all the assets of a trade or business.


See ERISA §§601-608 and Code §4980B.

Code §4090B(b)(1). The $100 per day penalty is subject to a number of adjustments. First, if the COBRA violation is not corrected until the employer is notified that its tax return is being examined by the IRS, the penalty will not be less than $2,500 per qualified beneficiary ($15,000 if the violations in any tax year are more than de minimis). The maximum penalty for unintentional violations of the COBRA coverage rules will be the lesser of 10% of the employer’s total health benefit expense for the year or $500,000. Finally, the IRS is given discretion to waive all or any part of the penalties if the failure to comply with COBRA was due to reasonable cause and not willful neglect.

ERISA §603(2) and Code §4980B(f)(3)(A).


Treas. Reg. §54.4980B-9 Answer 5.
Treas. Reg. §54.4980B-9 Answer 8(a).


Treas. Reg. §54.4980B-9 Answer 8(b) and (c).

Treas. Reg. §54.4980B-9 Examples 2 and 3.

Under the provisions of the Health Insurance Portability and Accountability Act of 1996, the pre-existing condition exclusion contained in buyer’s medical plan must be limited to persons who were not covered by the medical plan of the selling employer for the preceding 12 months.


In one case, a buyer requested the father of a child with leukemia to elect COBRA coverage under seller’s plan and reimbursed the employee for the cost of the COBRA premium.

Treas. Reg. §54.4980B-2 Answer 2(c).

Contributions to a defined benefit plan are deductible in accordance with the limitations contained in Code §404(a)(1). The treatment of full funding contributions is governed by Code §404(a)(1)(D) which allows employers other than small employers to deduct any contribution to a defined benefit plan up to the unfunded current liability of the plan. The foregoing provision does not apply to an employer which does not maintain plans covering at least one hundred participants. Even for an employer with defined benefit plans covering at least one hundred participants, there may be a portion of a full funding contribution which will not be deductible. In order to be fully funded, a plan must have assets sufficient to satisfy “benefit liabilities” which include unpredictable contingent event benefits such as plant closing benefits. The deduction is allowed only up to “unfunded current liabilities” which do not include unpredictable contingent event benefits if the event has not occurred. Thus, if a plan contains contingent event benefits, a part of the final contribution may still not be deductible. As a consequence, either because the employer does not maintain plans covering at least one hundred employees or because the terminating plan contains contingent event benefits, some portion of a final contribution designed to fully fund a plan may not be deductible in the year it is made. Any such non-deductible contributions will be subject to a 10 percent excise tax under Code §4979 in addition to regular income taxes.
Treas. Reg. §1.414(1)-1(m).


Under Treas. Reg. §1.414(1)-1(n), the assets of the plan must be allocated among all participants in the plan as though the plan were terminating. Such an allocation requires that the accrued benefits of every participant be calculated and then divided among six different priority categories set forth in ERISA §4044, 29 U.S.C.A. §1344 (1985). It is possible for certain participants to have a portion of their accrued benefits allocated to each of up to five categories. Where the plan bases benefits on a participant’s covered compensation over a period of years, the gathering of historical salary data for every plan participant may be an extremely burdensome task. Treas. Reg. 1.414(1)-1-(n)(2) provides a de minimis rule where the present value of accrued benefits of the participants in the spun-off plan equal less than 3% of the assets of the original plan. In such a de minimis situation, the spin-off rules will be satisfied if the spun-off assets equal the present value of the spun-off accrued benefits. It is much easier to comply with the de minimis rule since salary data is only required for the employees who are transferred to the spun-off plan. In addition, it is only necessary to calculate their accrued benefits--it is not necessary to divide their accrued benefits among the six priority categories.

ERISA §208 and Code §414(l).

Treas. Reg. §1.411(d)-4 Answer 3(a)(1).

Treas. Reg. §1.411(d)-4 Answer 3(a)(2). See also Gillis v. Hoechst Celanese Corp., 4 F. 3d 1137 (3d Cir. 1993) where the court held that after a sale of a business, employees were still entitled to earn enhanced early retirement benefits and that the seller should have transferred sufficient assets to buyer’s plan to cover the cost of the enhanced benefits.

Under Treas. Reg. §1.411(d)-4 Answer 3(b) transfers between defined benefit and defined contribution plans are only allowed in the event that the participant is given the election to make the transfer at a time when the participant is otherwise permitted to receive a distribution from the plan.

Treas. Reg. §1.414(1)-1(d).

Treas. Reg. §1.414(1)-1 provides two options with respect to the merger of defined benefit plans. The first option is to compute the accrued benefits of the participants in each plan immediately prior to the merger and allocate the assets of each plan to the accrued benefits in accordance with the six priority categories contained in ERISA §4044, 29 U.S.C.A. §1344 (1985). The calculations for the two plans are then combined to form a special schedule for the allocation of plan assets should the merged plan be terminated or be the subject of a plan spin-off within the five year period after the merger. The second option is for an actuary to certify that the data necessary to create the special schedule is being maintained so that the special schedule can be created should the merged plan terminate or spin-off assets within the five year period. Since
maintaining the data for five years is much easier and cheaper than doing the calculations (which may never be used), there is no reason to create the special schedule at the time of the merger.

Treas. Reg. §1.401(a)(4)-1 et. seq. requires that every on-going benefit formula and every ancillary benefit, right and feature contained in a qualified plan cover a nondiscriminatory group of employees determined by reference to the definition of a nondiscriminatory classification contained in Treas. Reg. §1.410(b)-4. In simplified terms, a certain percentage of the non-highly compensated employees must be covered by a benefit formula, ancillary benefit, right or feature with the percentage determined by reference to the demographics of the employer.

In one situation involving an acquisition in 1968, grandfathered benefits covered all nonunion employees at the time of the acquisition with 5% of the covered employees being highly compensated employees. By 1991, because of pay increases and promotions among the employees who remained employed by the employer, over 50% of the employees covered by the grandfathered benefits were highly compensated.

Treas. Reg. §1.401(a)(4)-4(d)(1) allows new employees to become covered by an optional form of benefit, right or feature for a period of time determined by the buyer. This period need not be tied to the transition period set forth in Code §410(b)(6)(C)(ii)--the period until the end of the plan year following the plan year during which the merger or acquisition took place. This special provision applies to optional forms of benefits and rights or features of the plan other than benefit formulas and ancillary benefits.

Treas. Reg. §1.401(a)(4)-4(b)(3) provides that, if an optional form of benefit, right or feature is eliminated as to all future accruals but is retained for accruals through the elimination date, it will be deemed to satisfy Code §410(b)(4) if it passes the nondiscriminatory classification test on the elimination date. In applying the nondiscriminatory classification test, it would appear that the special transition rule of Code §410(b)(6)(C)(ii) applies.

ERISA §204(h), Code §4980F, and Prop. Treas. Reg. §54.4980F-1(b) Question and Answer 9(c). It should be noted that the normal rules for notice of a reduction in the rate of future benefit accrual under the Proposed Treasury Regulations is 45 days. Prop. Treas. Reg. §54.4980F-1(b) Question and Answer 9(a).

See Section IV.D. Plan Merger supra.

Treas. Reg. §1.401(a)(26)-1(b)(1).

Treas. Reg. §1.401(a)(26)-1(b)(3).

Defined benefit plans often contain early retirement benefits which are more valuable than the vested accrued benefits of plan participants. An example of such a benefit is a “30 year and out benefit” where an employee who has completed 30 years of service is entitled to an immediate pension which is not actuarially reduced even though his age is less than the normal retirement age specified in the plan. If an employee has
completed 29 years of service on the date of sale, failure to count his service with the buyer for purposes of the “30 year and out benefit” under seller’s plan will deny him the opportunity of obtaining a very valuable benefit.


Code §402(a)(5).

The amount of the windfall to the buyer will generally be less than half of the surplus plan assets. Code §4980 imposes a special excise tax on the amount of reversion that an employer receives from the plan. The amount of the excise tax is in addition to regular income taxes and is dependent upon whether certain portions of the surplus are directed to participants. The combined effect of the amounts used for plan participants, the excise tax and the regular taxes will range from 64% to 85% of the surplus, as follows:

(a) if 25% of the surplus is transferred to a qualified replacement plan, the excise tax will be 20% and, after paying an additional 34% as regular income taxes, the net amount to the employer will be 34.5% of the surplus (if the employer has taxable income in excess of $10,000,000 and is therefore in the 35% bracket, the net amount realized by the employer will be 33.75% of the surplus);

(b) if 20% of the surplus is used to provide participants and beneficiaries with pro rata benefit increases, the excise tax will be 20% and, after payment of an additional 34% as regular income taxes, the net amount to the employer will be 36.8% of the surplus (if the employer has taxable income in excess of $10,000,000 and is therefore in the 35% bracket, the net amount realized by the employer will be 36% of the surplus); or

(c) otherwise, the excise tax will be 50% and, after payment of an additional 34% as regular income taxes, the net amount to the employer will be 16% of the surplus (if the employer has taxable income in excess of $10,000,000 and is therefore in the 35% bracket, the net amount realized by the employer will be 15% of the surplus).

Upon termination of an underfunded pension plan, the rights of employees will depend upon the degree of underfunding and the type of termination. Terminations are characterized as either “standard terminations” or “distress terminations” with the rights of employees being different for the two types of terminations. If a termination is a “standard termination”, employees will be entitled to their share of the “benefit liabilities” of the plan. With respect to non-vested participants, they will have to be either fully vested or provided with an annuity which will pay the benefit if the requirements for vesting are subsequently satisfied by the participant. Similarly, if the plan has subsidized early retirement benefits, the annuity contract must provide for the subsidized benefit if the employee subsequently satisfies the requirements for it. In the event of a “distress termination”, the employees will be entitled to the greater of the benefits which are funded and their guaranteed benefits under ERISA §4022, 29 U.S.C.A. §1322 (1985). Employees whose benefits are not vested and employees whose
benefits are not entirely guaranteed could lose all or a part of their accrued benefits.

Code §411(d)(3).

The terms “vertical” and “horizontal partial terminations” were coined by Stuart M. Lewis in his article “Partial Terminations of Qualified Retirement Plans -- An Evolving Doctrine” to describe the two different types of partial terminations described in Treas. Reg. §1.411(d)-2(b). The terms were used extensively in In re: Gulf Pension Litigation, 764 F. Supp. 1149 (S.D. Tex. 1991).

It is not necessary that the employer do anything improper for there to be a partial plan termination. In Tipton and Kalmbach, Inc. v. Commissioner, 83 T.C. 154 (1984) there was a partial termination when lack of work required the employer to lay-off 34% of the work force in one year and 51% of the remaining employees in the next year. But see, In re: Gulf Pension Litigation, supra note 90, where evidence of bad faith played an important part in the court holding that a partial termination had occurred.


Treas. Reg. §1.411(d)-2(b).

See e.g. IRS Document 6678 (4-81), Explanation for Worksheet, Form 6677.

The court in In re: Gulf Pension Litigation, supra note 90, coupled staff reductions and the sale of two operations to two separate buyers over a three year period to find a partial termination.

Ehm v. Phillips Petroleum Co., supra note 92. See also Beck v. Shaw Industries, Inc., supra note 92, where termination of 100 employees out of 1,600 was not a partial termination and In re: Gulf Pension Litigation, supra note 90, where termination of 8,534 employees out of over 24,000 employees was determined to be a significant number of terminated employees as well as a significant percentage.

Code §411(D)(3) requires that the accrued benefits of participants be fully vested to the extent funded at the time of the partial termination. To the extent that the benefits are fully funded, continued crediting of service for purposes of vesting would not suffice. If nonvested benefits are not funded, then the continued crediting of service would go beyond the requirements of Code §411(d)(3).

See note 90 supra.

The court in the Gulf Pension Litigation determined that the number and percentage of terminated participants was significant regardless of whether it focused on
just the nonvested participants or the total plan participants.

Chevron made a number of changes in the Gulf pension plans which had the cumulative effect of reducing the benefits of Gulf plan participants by almost $84,000,000. Since the plan was overfunded by $125,000,000, the court determined that Chevron had increased its likelihood of receiving a reversion of surplus plan assets and that a horizontal partial termination had occurred.

The intangible asset created pursuant to F.A.S. 87 must be amortized by expense charges over the remaining future service of the participants in the plan on the initial effective date of F.A.S. 87—the fiscal year of the employer which began subsequent to December 15, 1986 in most cases.

Unfunded liabilities created by plan amendments and actuarial gains and losses can be amortized over the remaining future service of the participants in the plan and are, therefore, not fully reflected on the financial statements for many years. In addition, the interest rates historically used by accountants to calculate the amount of pension liability are substantially higher than current interest rates—especially the rate of interest which would be used by the PBGC to value plan liabilities if the plan were to terminate. Finally, the pension liabilities reflected on the financial statements may not include benefit increases which are not yet in effect but which are required by a collective bargaining agreement.

Upon termination of an overfunded pension plan, surplus assets (net of excise taxes or other amounts, see Note 87 supra) can generally revert to the employer if the plan so provides. ERISA §4044(d), 29 U.S.C.A. §1344(d) (1985). Under Guidelines issued by the Internal Revenue Service, Department of Labor and Pension Benefit Guaranty Corporation on May 23, 1984, it is also possible to access the surplus in a defined benefit plan by engaging in either a “termination/re-establishment” or a “spin-off/termination” in accordance with the rules and restrictions contained in the Guidelines. See Note 87 supra.

Code §420 allows employers to transfer surplus pension assets to pay for the current cost of medical benefits for retired employees, other than key employees. In order to transfer surplus pension assets to pay for retiree medical benefits, the employer must fully vest all participants in the overfunded pension plan including former participants whose termination of employment occurred within one year of the transfer. In addition, the employer will be required to maintain its level of employer cost for each retiree for medical benefits for the taxable year of the transfer and the four succeeding taxable years. Finally, the assets in the overfunded pension plan cannot be reduced below 125% of the current liability of the plan as defined in Code §412(c)(7)(B). This provision expires for taxable years beginning after December 31, 2005.

Treas. Reg. §1.501(c)(9)-4(d).

Code §410(b)(1).
Code §401(a)(4).

See Code §79(d) with respect to group term life insurance plans, Code §105(h) with respect to self-insured medical expense reimbursement plans, Code §125(b) with respect to cafeteria plans, Code §129(d) with respect to dependent care programs, Code §501(c)(17) with respect to supplemental unemployment compensation benefits, and Code §505(b) with respect to voluntary employee beneficiary associations.

Under Code §410(b), the plan must satisfy any one of three mathematical tests. Under the first test, at least 70 percent of the non-highly compensated employees of the employer’s controlled group must be covered by the plan. (See Code §414(q) and note 48 supra for the definition of highly compensated employee.) Under the second test, the percentage of non-highly compensated employees who are covered by the plan must be at least 70 percent of the percentage of highly compensated employees covered by the plan. Thus, for example, if 50 percent of the highly compensated employees are covered by the plan, at least 35 percent of the non-highly compensated employees must be covered by the plan. Under the third test, the Internal Revenue Service must determine that the classification of employees covered by the plan does not discriminate in favor of highly compensated employees (Treas. Reg. §1.410(b)-4 deems a classification as nondiscriminatory if a specified percentage of the non-highly compensated employees are covered by the plan with the percentage determined by reference to the demographics of the employer). In addition, the third test requires that, on a controlled group basis, the average benefits of non-highly compensated employees as a percentage of their compensation must be at least 70 percent of the average benefit percentage for the highly compensated employees. In calculating each of the three tests, the employer may exclude certain employees who do not meet certain allowable age and service requirements, non-resident aliens, and unionized employees where retirement benefits were the subject of good-faith bargaining.

Code §410(b)(6)(C).

There is a method permitted by the final regulations under Code §414(r) which allows the employer to delay the impact of the nondiscrimination rules to an acquisition. The law allows an employer to apply the coverage rules separately to each of its lines of business, as defined by Code §414(r). Under the regulations, an acquisition will have fewer tests to pass to be treated as a separate line of business for up to 4 plan years after the acquisition. Treas. Reg. §1.414(r)-5(d).

See Code §125(b)(2) with respect to cafeteria plans, Code §129(d)(4) with respect to dependent care plans, Code §401(a)(4) with respect to contributions and benefits under qualified pension and profit sharing plans, Code §401(k) with respect to cash or deferred profit sharing plans and Code §401(m) with respect to employee after-tax contributions and employer matching contributions.

The allowable average deferral percentage of the highly compensated participants depends on the average deferral percentage of the non-highly compensated participants in accordance with the following:
An employer can avoid performing the Average Deferral Percentage and Average Contribution Percentage test if either:

(a) the plan contains a fully vested employer contribution equal to at least 3% of the compensation of all eligible employees; or

(b) the plan contains a fully vested employer matching contribution equal to 100% of the first 3% of the employee’s salary reduction contributions plus 50% of the next 2% of the employee’s salary reduction contributions.

125 ERISA §4043(c)(3) and PBGC Reg. §4043.23.

126 ERISA §4043(c)(9) and PBGC Reg. §4043.29. For purposes of the Regulations, in most cases, a business segment is considered to be de minimis if it meets all of the following requirements:

(a) it has revenues which do not exceed 10% of the revenues of the employer’s controlled group;

(b) it has annual operating income which does not exceed the greater of:

   (1) 10% of the annual operating income of the employer’s controlled group;

   or

   (2) 5% of the controlled group’s net tangible assets up to $200 million;

   or

   (3) $5 million; and

(c) it has net tangible assets which do not exceed the greater of:

   (1) 10% of the net tangible assets of the employer’s controlled group;

   or

   (2) $5 million.
For Advance Reporting Companies, see note 128 below, a business segment is considered to be de minimis if 5% is substituted for 10% wherever 10% appears in the above definition. PBGC Reg. §4043.2.

Advance Reporting Companies are companies with more than $50 million in unfunded pension liabilities where the pension plans are less than 90% funded and the companies are not reporting companies under the Securities Exchange Act of 1934. ERISA § 4043(b)(1) and PBGC Reg. § 4043.61.

PBGC Reg. § 4043.29.

ERISA §4043(c)(10) and PBGC Reg. § 4043.30.

ERISA §4043(c)(11) and PBGC Reg. § 4043.31.

ERISA §4043(c)(12) and PBGC Reg. § 4043.32.

ERISA §4043(b) and PBGC Reg. § 4043.61.