

# **Benefits Issues in M&A Transactions**

## **A Practical Guide to Benefits Due Diligence for Potential Investors**

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If your company is considering or has recently made an acquisition, many important issues need to be addressed regarding the benefits programs you acquire simultaneously. Possession of a new company usually brings a host of challenges in the form of existing benefit programs. Knowing the right questions to ask **before** finalizing an agreement to purchase will save your company money and time. This article will provide a practical guide to due diligence in assessing the benefits of a company targeted for acquisition. The company doing the purchasing is known as "Buyer" and the company being purchased is known as "Target Company".

### **Step One: Identify Plans**

The first step in the due diligence process is to identify all benefits plans of the Target Company. The plans must be identified to fall into one of the three distinct categories:

1. Qualified Retirement Plans
2. Health and Welfare Benefit Plans
3. Nonqualified Benefit Plans and other Executive Compensation Arrangements

Next, the Buyer needs to acquire an exhaustive set of documents as follows:

1. All plan documents, to include any plan amendments
2. Administrative procedures
3. Committee meeting minutes
4. Investment Policy Statement
5. Insurance contracts
6. Employee communication materials
7. Employment contracts
8. Copies of proxy/private placement memorandums

If the Buyer has identified all the plans (more information will follow on how to identify all plans), and has acquired all necessary documents (again, more detail is provided later), the Buyer is ready to begin the process.

## **Step Two: Review Retirement Plans**

A review of a Target Company's Retirement Plans encompasses five major focus areas, which are:

1. Tax Qualification of Plans
2. Reporting and Disclosure
3. Fiduciary Compliance
4. Funding Obligations (Defined Benefit Plans Only)
5. Service Provider Contracts and Liabilities

Each area is covered in detail.

### Retirement Plans: Tax Qualification

The first step in determining the tax qualification of the Target Company plan is to verify whether or not the Target Company has current IRS Determination Letters for its retirement plans. This letter opines on the form of the plan, not the operation of the plan. Recently, the IRS revised the procedures for Determination Letter Applications. The new application procedures include five-year staggered cycles for individually designed plans and six-year staggered cycles for master prototype and volume submitter plans, both based on the employer's EIN number. If the Target Company's plans are merged or maintained by the Buyer, the cycle reverts to the Buyer's EIN.

The Buyer should ensure that the Target Company has plan administrative procedures in place that can be checked against the plan operations. The Buyer needs to be sure the plan has been operating in accordance with the Target Company's plan document language. The Buyer also needs to make sure the Target Company's plans are in compliance with current legislation and regulations. Many times a gap exists between the written plan amendments and the actual implementation of the amended changes in a plan. The Buyer should also review the Target Company's plan features which may include items such as loans, hardship withdrawals, and distribution provisions. Reviewing these items will help ensure the Target Company has made proper withholding, correct IRS reporting on Form 1099-Rs, and that they have complied with rollover rules.

The final area surrounding tax qualification is plan testing. For Non-discrimination Testing, if the Buyer continues the Target Company plans after the acquisition, for the transition period as defined in Section 410(b), make sure that the definition of Employee is amended so that it does not include employees of

the Buyer's company. Also, a review of the Target plan's 410(b) test should be conducted to ensure control groups and affiliated service groups have been properly identified and classified. Have the proper 415 limits been applied to contributions and benefits? Remember, even if the Target Company outsourced the plan testing to a third party, the plan sponsor is ultimately responsible for ensuring that the testing has been done correctly.

#### Retirement Plans: Reporting and Disclosure

The second major focus area surrounding the Target Company's retirement plans is reporting and disclosure. As a Buyer, make sure the Target Company's plan counted Eligible Employees correctly, as the number of Eligible Employees determines whether or not a plan audit is required. Also, the Buyer should make sure the Target Company has been providing participants and beneficiaries the Summary Plan Descriptions and Summary Annual Reports on a timely basis.

#### Retirement Plans: Fiduciary Compliance

The third major focus area surrounding a Target Company's retirement plans is fiduciary compliance. Have the Target Company's plans been involved in any prohibitive transactions, and if so, have they been corrected? Corrections would include filing Form 5330s and paying excise taxes. As the Buyer, make sure the plan trustees, administrators, investment managers and all plan committees have been identified. Did the Target Company have bonds for the individuals who handled the plan monies? Are there any Fiduciary Liability Policies? Were the Target Company's plan investments held in the trust's name? Is there an Investment Policy Statement, and if so, have the plan investments been monitored in accordance with the Investment Policy Statement?

Also, the Buyer should obtain copies of all plan committee meeting minutes, as they are also important.

Fiduciary compliance also enables the Buyer the ability to identify any parties in interest to the plans. Be sure the Target Company made timely deposits of employee contributions and participant loan payments. Also, be sure to confirm that no pending lawsuits or DOL investigations are under way or have taken place. For plans that have undergone IRS or DOL audits, ensure any issues raised have been corrected. The new IRS Revenue Procedure for the Employee Plans Compliance Resolution System, also known as the EPCRS, was issued in May of this year and it expanded the type of failures that could be corrected and also provided allowable correction methods. When the Buyer does its due diligence and an error is found, have the Target Company correct the errors found in accordance with EPCRS, or adjust the purchase price to account for the latent liabilities.

## Retirement Plans: Funding Obligations (Defined Benefit Plans Only)

The fourth major focus area surrounding the Target Company's retirement plans is funding obligations, which is specific to Defined Benefit plans. The Buyer should review the actuarial reports related to the Target Company's Defined Benefit Plans to obtain the funded status of the plan. The Financial Accounting Standards Reports (FAS) 87 and 88 should also be reviewed. Changes to the FAS 87 and 88 reports are supposed to be made final and released by the Financial Accounting Standards Board (FASB) in September of this year. Some of the changes would include requirements for plan sponsors to recognize full, over-funded, and under-funded positions of its Defined Benefit post-retirement benefit plans, direction on recognizing costs of providing post-retirement benefits in earnings, and how to measure benefit obligations.

The Buyer also needs to review the Target Company's Pension Benefit Guaranty Corporation (PBGC) filings. Recently the PBGC issued a final rule that requires sponsors of insured Defined Benefit Plans to submit their premium filings electronically. Large plans containing 500 or more participants must file electronically for 2006 plan year filings that are made on or after July 1, 2006. For smaller plans, the rules apply for plan years beginning on or after January 1, 2007.

Have the PBGC premiums been paid on time? The Deficit Reduction Act of 2005 that was signed into law in February of this year and effective beginning with the 2006 plan year increased the per participant flat rate premium for single employer plans from \$19 to \$30 per participant and for multi-employer plans it went from \$2.60 to \$8 per participant. The Buyer needs to confirm there are no due and unpaid contributions. For union plans, the Buyer needs to be concerned about potential withdrawal liability. Does the Target Company have a facility where employee benefits are subject to a Collective Bargaining Agreement that requires the Target Company to make contributions to a union sponsored pension plan?

## Retirement Plans: Service Provider Contracts and Liabilities

The fifth and final major focus area surrounding the Target Company's retirement plans is service provider contracts and liabilities. What services are associated with the Target Company plans and who is providing the services? Are there gaps or overlaps in services? Have all service providers been paid? If not, are the unpaid fees identified in the Target Company's Financial Statements?

As a final item which impacts retirement plans, on August 3, 2006, Congress passed HR4, the Pension Protection Act of 2006, legislation aimed at reforming the funding of defined benefit pension plans, making permanent those provisions enacted in 2001 (EGTRRA) that were due to expire in 2010, and addressing investment education and diversification issues for participants in defined contribution plans. A complete review of the provisions associated with this new

legislation is recommended as there are many additional items which may impact your qualified retirement plans.

### **Step Three: Review Health and Welfare Plans**

Health and Welfare Plans: Tax Issues

- Review cafeteria plan issues
- Confirm that applicable nondiscrimination testing has been done
- Review Form 5500s to determine
  - Required filings have been made
  - Audits have been conducted when necessary
- Confirm tax deductions for VEBA funding (if self-insured) are within Code limits
- Confirm that plan documents are up to date with:
  - COBRA
  - HIPAA
  - USERRA
  - Family Medical Leave Act
  - Newborn's and Mother's Health Protection Act
  - Americans with Disability Act
  - Age Discrimination in Employment Act

### **Tax Issues for Health and Welfare Benefits**

Health and welfare plans do not have the same set of complex rules in the Internal Revenue Code as tax qualified retirement plans. A determination letter does not need to be applied for with respect to health and welfare plans; therefore, a lot of things can fall through the cracks. This is an important issue because significant tax benefits are granted to employers who sponsor health and welfare benefit plans.

The first area to cover is cafeteria plan issues. Both the employer and employee enjoy FICA tax savings on contributions made to a cafeteria plan. Many times an employer's insurance provider will give the employer a prototype cafeteria plan, especially if the only benefit being provided under the plan is medical and dental insurance. These cafeteria plans are generally referred to as premium only plans or POPs. This raises the issue as to whether the employer should have withheld FICA taxes on contributions under the cafeteria plan. If the IRS audits the Target Company, it may attempt to assess a tax deficiency for the FICA on employee contributions. This liability can be significant if the cafeteria plan has been in place for several years.

Another area to focus on with cafeteria plans is the “at risk rules”, if they offer a medical reimbursement account. These rules mean that the employer has to be at risk for expenses that are incurred early in a plan year when an employee has large medical expenses. For example, an employee elects to have \$100 per month taken out of their paycheck to pay for medical expenses during the year and incurs \$1,200 in medical expenses in February. The employee’s medical reimbursement account will have a balance of \$200 in February. The employer must advance the remaining \$1,000 for medical expenses since the employee will contribute \$1,200 by the end of the year. If the employee is terminated after the acquisition it may be very difficult for the Buyer to recover that money.

The next area to focus on is nondiscrimination testing. Historically the IRS has not focused on nondiscrimination testing in the health and welfare plan arena. However, it is a good idea to require the Target Company to conduct those discrimination tests for at least all of the open tax years to make sure the Buyer has identified any potential issues where there could be additional taxable income to the executives that have participated in the plans. If the IRS determines that the plans are discriminatory it will tax the benefits that have been paid to highly compensated employees. In most instances the IRS will look to the employer to pay the tax on the discriminatory benefits rather than going after each highly compensated employee. This could be a potential liability to the Buyer at the end of the day.

The fourth item is to review the 5500s. The Buyer wants to confirm the 5500s have been filed for all health and welfare benefit plans. A health and welfare benefit plan may easily fall through the cracks with respect to filing. DOL has a voluntary compliance program that makes it simple to correct delinquent filings as long as the plan is not under audit. Therefore, it is important to look at all benefit programs and make sure the 5500s have been filed. One way to do that is to request an employee handbook and compare this to plan documents and 5500s and ensure the Target Company has a 5500 for everything that could be classified as an employee benefit plan under ERISA. Some benefits in the employee handbook may look like health and welfare benefit plans and are exempt from filing as payroll practices. Examples of payroll practices include vacation programs, paid time off, and sick leave. However, the Target Company may have a severance program that does fall under ERISA and has not filed a 5500.

Another situation that occurs is when 5500s have been filed for welfare benefit plans showing that the plan is either unfunded, i.e., paid out of the employer’s general assets, or partially paid out of the employer’s general assets and through an insurance arrangement but, in fact, those plans have been funded through some type of trust. If any of the benefits provided are funded through a trust, then the welfare benefit plan requires an audit. An employer’s failure to audit a plan is considered as a deficient filing and is subject to substantial penalties. This area can also be corrected through the DOL voluntary compliance program.

If not corrected and found by the DOL, significant penalties may be attached to these delinquent filings that the Buyer would be responsible for paying.

The final tax area to cover relates to Target Companies that sponsor a VEBA, or 501(c)(9) trust. The Buyer wants to confirm the deductions that have been taken fall within the limits in the Internal Revenue Code. The sponsor is allowed a deduction for all current claims paid during the employer's tax year plus a reasonable reserve for incurred, but not reported claims, also known as IBNR. Many times plan sponsors, particularly smaller companies, use the safe harbor percentage in the Code. This percentage can only be used if it is reasonable. In most cases the review of the employer's claim lag report indicates that the safe harbor percentage overstates the employer's liability for IBNR. In most instances the employer's liability for IBNR is closer to 20 to 25 percent for medical claims rather than the 35 percent safe harbor.

### **Other Non-Tax Issues that can Result in Liabilities**

Other issues the Buyer needs to ensure are included in the Target Company's health and welfare plans are things such as the latest provisions of COBRA, the proper HIPAA requirements, making sure the proper business associate agreements are in place between the Target Company and their service providers, compliance with the new USERRA rules for those involved in active duty and then return to the company, the Family Medical Leave Act requirements, Newborn's and Mother's Health Protection Act, Americans with Disabilities Act provisions, and the Age Discrimination in Employment Act. All the aforementioned provisions should be incorporated into the policies and procedures and plan documents.

#### Health and Welfare Plans: ERISA Fiduciary Issues

- Compliance with reporting and disclosure rules
- No apparent fiduciary breaches
- No MEWA issues

While the ERISA fiduciary issues are not nearly as great with respect to health and welfare plans as they are with respect to retirement plans, the Buyer still needs to worry about fiduciary issues. The Buyer needs to confirm the Target Company is complying with the reporting and disclosure rules, and also ensure no fiduciary breaches exist. For example, in many situations a corporate officer who is a fiduciary to the plans has a relationship with a broker for an insurance company who is receiving commissions with respect to the plans. The payment of commissions can be a prohibited transaction unless the conditions of a statutory or class exemption have been met. The failure to correct the prohibited transactions can result in penalties being assessed against the acquirer.

One final area to address in fiduciary issues is whether there have there been any inadvertent MEWAs created in deals done by the Target Company. An example of an inadvertent MEWA could be a situation where the Target Company has previously sold a division. In connection with the sale of the division, the Target Company agreed with the purchaser of the division to continue health insurance coverage for the sold division's employees for a period of time after the division was sold. All at once these two employers (the Target Company and the sold division) are no longer related, i.e., the Target Company does not own any stock in the sold division, so a MEWA has been inadvertently created. Most states govern the operation of MEWAs as they are considered insurance companies under state law. Therefore, the Target Company may have to comply with certain state insurance laws including premium reserves. This is just an issue to be aware of and to check whether a MEWA has occurred and if it has been handled properly under state insurance laws.

#### Health and Welfare Plans: Funding and Review

- Review:
  - Insurance contracts
  - Service provider contracts
  - Funding of benefits
- Identify any changes in control provisions for need to obtain third party consents
- Review accounting policies for the plans

Insurance contracts should be reviewed for the benefits. If it is a small company all the benefits may be provided through insurance contracts. These contracts include medical, dental, AD&D, group term life, and disability. Particularly group term life and AD&D policies can be participating or non-participating contracts. If they are participating contracts, have they taken full advantage of dividends that can offset premiums? If not, the Target Company is required to go back and recoup all benefits for which they are entitled. For group term life the Buyer needs to ensure the Target Company has properly included imputed income for group term life in excess of \$50,000 per employee.

The next area is to examine the service provider contracts. Larger Target Companies may have self-insured medical plans where administration is outsourced to a third party administrator (TPA). The Buyer needs to confirm the TPA is complying with the terms of the plan, that it has loaded the proper plan provisions, and that claims are processed properly during claim adjudication. The Buyer also wants to examine any appeals that have occurred on the claims to make sure any latent issues with the TPA have been addressed. Is there a contract for auditors to audit the plan and have they been auditing the plans when required? Who is responsible for determining if an audit needs to be done?

Another area to review for self-insured medical plans is when companies use an outside consultant or actuary who helps set the rates and sharing percentages between the employer and employee. The contract should be examined to make sure they are complying with the terms of the agreement and the plan documents. This same approach should be used with outside consultants or actuaries who help companies with their retiree medical or post-employment obligations.

Benefits can be funded in several different ways: out of the general assets of the plan sponsor, a combination of general assets, and an insurance contract or a trust. If a trust is used, the Buyer will want to study the trust funding methodology. What process is used to fund the trust? Is it in writing? Have they been complying with this process? Fiduciaries are responsible to operate the plan as instructed in the governing plan documents.

The Buyer wants to verify employee contributions have been contributed in a timely manner to the trust or used to pay benefits in the health and welfare benefit area. The rules are a little bit different in terms of DOL regulations with respect to health and welfare compared to retirement plans, funds do not need to be submitted to the trust in the same time frame but the funds do need to be used for benefit payments or deposited into the trust.

Many states mandate a certain amount of short-term disability benefits for employees. Some states require these benefits to be self-funded or funded through an insurance contract. The Buyer needs to validate that the Target Company has complied with these state regulations.

#### Health and Welfare Plans: Self-Insured Plans

- Examine timeliness of deposit of employee contributions to trust or expenditure of plan assets
- Evaluate incurred but not reported claims for accuracy of reporting
- Review any operational claim audits for consistent issues identified by TPA
- Review results of any dependent eligibility audits
- Evaluate payment of claims for accuracy and assess whether any latent liability exists for improperly denied claims

In stop-loss contracts the Buyer needs to review the stop-loss policy to ensure that it does not terminate at the date of acquisition. This can be avoided by renegotiating the contract for an extension and making sure the change of control provision is not activated. The Buyer also needs to confirm the Target Company continues to apply the deductibles and limits and does not start them over at the date of acquisition for the Buyer. Next, the Buyer needs to review the accounting policies for the plan. How does the Target Company account for IBNR and reported but not paid claims? Are they reported in the company's financial

statements? Are they reported monthly or quarterly? How do they look at the claims in that situation? The Buyer also wants to examine the assumptions and any FAS 106 reports for retiree medical liability. Are the rates used in the actuarial report reasonable for that type of industry and are they based on the company's experience?

The Buyer looking at a self-insured plan should check how timely the employee contribution deposits are being made to the trust, insurance carrier, or TPA used to pay for benefits. The Buyer should also evaluate the incurred but not reported claims (IBNR) for accuracy in reporting. One way to do this is to look at the employer's claim lag report. In that report the time period from when the claim is incurred to when the claim is paid is illustrated, after this the Buyer can calculate the average claims paid per month. This allows the Buyer to evaluate if the claim experience the Target Company is reporting in its financial statements for IBNR is accurate or not, or whether it needs to be adjusted. If it needs to be adjusted, this can impact the purchase price.

Another point the Buyer will want to review is operational claim audits that have been done with the TPA in a self-insured plan. Have they processed the claims in accordance with the plan? Have any errors been made? Are the errors consistent? Have the errors been corrected? The Buyer should verify the claims in the claim lag report are neither under reported nor over reported.

Recently Buyers have focused on dependent eligibility. Many companies are doing dependent eligibility audits. If the Target Company has recently conducted a dependent eligibility audit, the Buyer will want to review the results. For example, if a large claim is submitted to a stop-loss carrier and the carrier determines the dependent is not eligible to file the claim, it will come back to the plan sponsor to be paid. This can be another liability that is not reported in the plan sponsor's financial statements.

The Buyer should evaluate the payment of claims for accuracy and to see if any latent liability for improperly denied claims exists. Looking at claims appeals is a good way to see what issues have been raised. Additionally, the Buyer can determine how often the claim denials are overturned on appeal. This will indicate whether the claims reported in the claim lag report are accurate and can be relied on in estimating the Target Company's liability for IBNR.

#### Health and Welfare Plans: Retiree Health Obligations

- Review FAS 106 Reports
- Evaluate ongoing liability to retirees
- Identify whether plan permits amendment or termination at employer's option

Retiree health obligations has become a hot topic lately, FASB is now looking at how they will amend the accounting for not only pension obligations but also medical obligations made to retirees. The Buyer clearly wants to look at any FAS

106 reports that are available with respect to the Target Company. The Buyer will probably want to use a healthcare actuary to evaluate the liabilities in the report. The actuary will be able to assess whether the assumptions used in the calculation are accurate based on the Target Company's industry and experience. The proposed FASB changes would require that this liability be reported as an expense in the plan sponsor's financial statements rather than footnote disclosure which is the current reporting method.

The Buyer also needs to evaluate any on-going liability to the retirees it acquires. In situations where the Buyer is only acquiring a portion of the Target Company's business, it will want to leave the post-retirement liabilities with the seller. If the Buyer is acquiring the Target Company, the Buyer needs to evaluate the plan documents to see whether it has the ability to amend or terminate the post-retirement benefits. The Buyer's initial review of the plan documents may lead it to believe that once the Target Company is acquired the benefits can be terminated. Several court cases have supported employers eliminating post-retirement benefits and/or curtailing the benefits since the vesting provisions that apply to retirement plans are not applicable to other types of plans. However, before eliminating the post-retirement benefits, the Buyer needs to review employee communications as well as the plan documents. A Supreme Court case from a few years ago dealing with employee communications is notable. In this case an employer convinced several of its employees to transfer to another subsidiary of the employer, and in employee communications regarding the transfer the company stated that their benefits would remain the same. The new subsidiary later decided that the retiree medical obligation was hurting their financial performance and decided to terminate the plan. The employees said they were told their benefits would remain unchanged, and the Supreme Court sided with the employees and required the employer to honor the post-retirement benefits. This case highlights the importance of reviewing employee communications as well as the plan documents in order to assess the Buyer's ability to change and/or terminate benefits after the acquisition.

Many companies do not sponsor broad based post-retirement plans. However, some of the Target Company's executives may have employment contracts that guarantee them certain benefits for life or a fixed period of time. These obligations may not be reported on the Target Company's financial statements either because the amounts are immaterial or because the auditors are unaware of the executive's employment contract terms. Therefore, the Buyer needs to review all of the executives' employment contracts for any post-retirement obligations and assess whether these benefits can be curtailed or eliminated.

#### **Step Four: Review Executive Compensation Agreements**

**Ascertain which executive compensation arrangements are defined as "deferred compensation" under §409A. Potential 409A plans include:**

- Nonqualified Deferral Plans (elective or non-elective)
- SERPs
- Employment agreements with deferral feature
- Severance plans
- Multi-year bonus arrangements
- Stock-based plans (options and SARs) issued below market value
- Restricted stock units
- Phantom stock plans
- Anything that “smells” like a deferral...

The first step is to understand the impact of new code section 409A on deferred compensation and various other types of executive compensation and to ascertain which types of the Target Company’s executive compensation arrangements are considered deferred compensation. The tricky part here is that plans that were never before considered to be deferred compensation are now subject to the rules of 409A.

The first thing to look for is Nonqualified Deferral Plans, either elective or non-elective. The second area is Supplemental Executive Retirement Plans (SERPs), the third area to look at is employment agreements. Often, executive employment agreements contain some type of deferral feature for compensation. Severance plans can also have deferral features as can multi-year bonus plans like Long-term Incentive Plans (LTIPs). Stock based plans, particularly option plans and Stock Appreciation Rights (SARs) plans issued below market value also need to be examined to see if they fall under 409A. This can be particularly tricky if the Target Company is a private company for which it may be difficult to substantiate that the options or SARs were issued at “fair market value”. Also subject to 409A are restricted stock units, phantom stock plans, and any other plan that “smells” like a deferral and that is not specifically exempted under 409A.

When the Buyer is sure it has identified each plan that is subject to 409A, a careful analysis of any potential negative issues associated with those plans should begin.

### **409A Issues**

- Require 409A representations and warranties, but “Buyer beware”...
- Differentiate between “grandfathered” and 409A amounts.
- Carefully review any amendments that were written after October 3, 2004, which could create a material modification and remove grandfathered treatment.
- Verify 409A qualification (good faith compliance) of all non-grandfathered amounts.

- Deferral elections.
  - Distribution elections.
  - Changes in form or timing of distributions.
  - Prohibition of distribution “acceleration”.
- Ascertain any potential tax-withholding obligations, gross-up payments or other indemnity rights if plan has not met qualification requirements.
  - Take a close look at severance plans and employment agreements. For 409A plans, distributions to “key employees” of public companies must be delayed by six months.
  - “Same Desk” rule: Following a change of control, an employee who maintains the same job for the new employer has likely experienced a “separation from service”.
  - Evaluate stock option and SAR plans to ensure pricing at “Fair Market Value”.
  - Discounted stock options not 100% vested on December 31, 2004.

First, the Buyer should require 409A representations and warranties from the Target Company, but “Buyer beware”! Often times, as stated, the Target Company is not aware of all the issues involved with 409A, so receiving representations and warranties does not end the process. The Buyer will want to do an independent analysis of all plans. Several steps are in the analysis process. Differentiate between grandfathered amounts in plans and those amounts in the plans that are subject to 409A. In general, any dollars that were granted or become vested after January 1, 2005 are subject to 409A. However, the Buyer will want to carefully review any plan amendments written after October 3, 2004 which would create a material modification and remove grandfathered treatment. A Target Company might think it has a grandfathered plan but amendments that create a material modification would bring all amounts in the plan under the rules of 409A.

These plans are unlikely to have been amended to reflect compliance with 409A. A transition period is taking place and it is not necessary to have the plan fully amended to comply with 409A, but the plan must be operated in “good faith compliance” with the provisions of 409A. So, the Buyer should verify the qualification of all non-grandfathered amounts as relates to deferral elections, distribution elections, changes in the form or the timing of distributions, and to be sure the prohibition of distribution acceleration has not been violated. Deferral elections and distribution elections under 409A require extensive knowledge, but that is beyond the scope of this article. The Buyer needs to understand those provisions and make sure the plan has been operated in compliance with 409A.

The Buyer should ascertain any potential tax withholding obligations, gross-up payments or other indemnity rights if the plan is subject to 409A but has not met qualification requirements. If the Buyer ascertains that a plan has been operating in violation of 409A, the Buyer should also ascertain whether the tax withholding

obligations have been made, and if there are any gross-up payments to the executives required to help pay taxes, interest and penalties under 409A.

The Buyer needs to look closely at severance plans and employment agreements. For 409A plans, distributions to key employees of public companies must be delayed by six months. Thus, any distributions from a 409A plan to key executives must be delayed by at least six months following the date of acquisition.

The “same desk” rule is still an unresolved area under 409A. Following a change in control, an employee who maintains the same job with the new employer has likely experienced a separation from service. This is different from the old rules under 401(k) where the employee who occupies the “same desk” for the acquiring company would not be considered to have experienced a separation from service. Since the language addressing this issue comes from the preamble to the proposed 409A regulations, clear guidance is not yet given. Final regulations are expected that will address this issue directly. However, from reading the preamble today it would appear that an employee who maintains the same job at the same desk for the acquiring company has experienced a separation from service, and the provisions of the plan that apply to a separation from service in a change of control would apply to this individual.

The Buyer must evaluate stock option and SAR Plans to ensure pricing at fair market value, particularly if the Target Company is alleging the plan is not subject to 409A. If the Buyer discovers discounted stock options or SARs that were not 100% vested on December 31, 2004, the Buyer should know that they are subject to 409A and some important corrective measures need to be taken.

### **Additional Executive Compensation Issues**

- Review employment contracts for special arrangements.
- Evaluate the impact of the transaction on stock based programs; e.g. vesting.
- Confirm that SEC requirements have been met for stock-based programs including Rule 16b-3.
- Confirm that top hat plans have:
  - ◆ Met DOL filing requirements.
  - ◆ Covered only a select group of management of highly compensated employees.
- Review Target Company’s financial statement to determine whether executive compensation arrangements are properly accounted for under FAS 87 and FAS 88.
- Evaluate change of control provisions.
- Determine whether golden parachute liabilities are triggered by transaction.
  - ◆ Evaluate excise tax to employee(s).

- ◆ Evaluate possible loss of deduction to employer (162m).
- ◆ Review total compensation package for compliance with tax deductibility provisions of the IRC.

Beyond 409A the Buyer needs to address several issues. The Buyer must review employment contracts for special arrangements. Any number of special arrangements may exist, but the Buyer must guarantee it has all the executive employment contracts. The Buyer needs to evaluate the impact of the transaction on stock based programs, for example: does it create accelerated vesting for stock options and does that create a new expense? The Buyer should confirm that SEC requirements have been met for stock based programs including Rule 16-b3 which provides exemptions from insider trading rules. The Buyer will want to verify that in the event of a change of control, which would eliminate those exemptions, that due consideration has been given.

The Buyer also needs to confirm that top hat plans have met the Department of Labor (DOL) filing requirements. This is one of the most overlooked areas in nonqualified plan implementation. Target Companies who have never issued a letter to the DOL are constantly being found. The letter itself is a simple one-page declaration that the company is implementing a nonqualified deferred compensation plan and that it expects to cover only a select group of management and highly compensated employees, but many companies fail to send that letter to the DOL. The Buyer must verify that this letter has been properly filed with the DOL, confirm that the Target Company has met the filing requirements, and more importantly, only a select group of management or highly compensated employees is covered. Those Buyers familiar with top hat rules understand that the rules are very murky and are not clearly defined, and are dependent on case law and based on best good faith estimates on what constitutes a particular top hat group. The Buyer needs appropriate counsel involved in ascertaining the top hat nature of the Target Company's plan.

The next step is to review the Target Company's financial statement to determine whether the executive compensation arrangements are properly accounted for under FAS 87 and 88. This would apply to defined benefit-type SERP plans and the Buyer will want to be sure it has been accounted for. This is an area of SERP plans in which particular attention needs to be paid because the Buyer can find such variance in the design of SERP plans in the definition of compensation, the definition of benefits, with integration with other retirement benefits, social security, and other plans. This can be a very difficult thing to determine. The Buyer wants to ensure the FAS 87 has been done correctly and that the financial statements account for that.

Finally, the Buyer should evaluate the change of control provisions. First of all, will the change of control trigger a golden parachute liability? Will a golden parachute payment create onerous excise taxes for employees under 280(g)? The Buyer should evaluate the possible loss of deduction to the employer under

162(m) in the event of a change of control and golden parachute payment. The Buyer must review the total compensation package for compliance with tax deductibility provisions of the Internal Revenue Code.

Does a Springing Rabbi Trust create the necessity to fund deferred compensation liabilities? Typically, a Springing Rabbi Trust would be underfunded or not funded at all. However, the change of control would require the complete funding of the liability of the plan. Therefore, the Buyer needs to understand if the change of control is going to create the necessity to fund this liability.

## **Summary**

As stated at the beginning of this article, if the Buyer is considering an acquisition, many important issues need to be addressed regarding the benefits programs also being acquired. Acquiring a new company usually brings a host of challenges in the form of existing benefit programs. Knowing the right questions to ask and investing the time in proper due diligence **before** finalizing an agreement to purchase will save money and time and, ultimately, simplify life!