Lowenstein Sandler's Employee Benefits & Executive Compensation Podcast: Just Compensation

Episode 23 -
401k Plan Considerations in M&A Transactions

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Andrew Graw: Welcome to the latest edition of Just Compensation. My name is Andrew Graw, I chair the firm's executive compensation and employee benefits practice. Delighted to be joined today by Megan Monson, a partner in the group and Taryn Cannataro, a counsel in the group. So today we're going to talk about what happens to 401k plans in the context of mergers and acquisitions. Almost every company has a 401k plan, so it's bound to come up in almost every merger and acquisition. As always, this is not intended to be an exhaustive discussion, so we encourage you to consult with your legal counsel if you are considering an M&A transaction and are looking to understand the impact on and options available with respect to employee benefits and retirement plans. With that out of the way, we'll get right into it. Megan, let's start with you. What are some of the choices an acquiring company has with respect to a target company's 401k plan in connection with a stock deal or a merger?

Megan Monson: Thanks, Andy. So there really are three alternatives in that scenario. The first is maintaining two or multiple 401k plans, kind of post-closing of the transaction. And I'll start off with prefacing that this is not typically done, and I'll get into it in a minute, why. Unless you're dealing with a transaction where the buyer is a private equity company, and this is a new platform acquisition. So instead of having to set up new benefit plans, it may be attractive and simple to just assume the ongoing plan, but certainly you run the risk of inheriting any sort of historic liabilities on a go forward basis.

The challenges with this approach are if both the buyer and the seller in a transaction maintain their own 401k plans on a go forward basis, those plans will need to be aggregated for non-discrimination testing purposes, once you're outside the transition period. The 401K plan rules and regulations provide some relief for a limited period of time following the closing of a transaction.

And so you have to the end of the year following the year in which the deal closes, where you don't have to look at the plans on an aggregate basis, but beyond that period of time, you do. And so that could be challenging for plans to pass testing when you're looking at plans with different features and different employee populations. Another alternative that I'll see more frequently than maintaining the sellers plan or multiple 401k plans post-closing, although not the most common, is merging the seller's 401k plan into the buyer or acquiring company's 401k plan. That's done following the closing of the transaction.

And there's a couple of different considerations to be aware of there. One, it could be administratively difficult, costly, and time consuming, to do that. You're going to be dealing with coordinating between both the buyer and seller entities' 401k plan providers. There's certain documentation and processes that need to be followed, and so there's just a lot more work involved in doing that.

You also run the risk of potentially tainting the buyer's 401k plan if there are any historic liability or operational issues with the targets' plan. And so if that's something that's being done, you may want to consider doing a deeper dive in terms of what diligence you perform on the seller's 401k plan.

A couple of other items to just be aware of and consider if you're thinking about merging a plan, is if you're dealing with safe harbor plans, best practice is to merge those plans at the end of the year, to avoid running into any sort of issues with that. And so again, that creates a timing challenge. And again, you need a lot of lead time to coordinate with the various 401k plan providers in order to make sure that the plan merger is done properly and timely. If you're dealing with a plan merger, you also have to do what they call an anti-cutback analysis for the plan that's merging into the new plan, to make sure that there are no certain benefits rights and features, that need to be maintained on a go forward basis since you cannot cut back protected benefits. This is something that the 401k plan administrators can typically assist with. But again, it's just another consideration in terms of what needs to be done.

And there's also a heightened audit risk for the three years after the final form 5500 is filed. So again, for the plan that's merging into the new plan, you want to be sure that you're comfortable with that plan because it is at a heightened risk for audit in addition to, as I mentioned, potentially tainting the new plan.

There's just also practical implications that I've come across in practice that could be challenging in terms of getting all the folks aligned and getting people on the same page about how to merge the plans, getting them to understand what the process is involved and getting the 401k plan providers to coordinate and provide the information needed to do the plan merger. And so those are all the things that can run into this being kind of a more costly and time-consuming, process is because you're just dealing with a lot of different parties and a lot of different interests.

Andrew Graw: So in addition, you mentioned doing enhanced diligence on the target company's 401K plan, but also it's important to think about whether or not to “beef up” the indemnity provisions in an agreement to cover anything that might not come up in the way of diligence as well.

Megan Monson: That's a great point, Andy, because there's a whole practice area where you could really do a deep dive, an audit of a 401k plan. Even in the course of doing more course and diligence, you're not going to be getting into that level of detail because of the time, information and cost involved. And so you really want to be as protective of the buyer and the buyer's plan if you are going down the plan merger approach.

Andrew Graw: Taryn, what other choices are available here for a company with a 401k plan?

Taryn Cannataro: The choice that we see most often is requiring the target company to terminate their 401k plan no later than the day immediately before closing. And it's important that it's done the day immediately before closing and not on closing, to avoid implicating successor plan rules. 401K regulations restrict an employer from terminating a 401k plan if they have another defined contribution plan in place. Typically, we see purchasers include a covenant in the transaction agreement requiring termination of a target company's 401k plan, no later than the day before closing, and that will get the conversations started about what needs to be done.

Megan Monson: And I can't tell you how often I hear clients be surprised about this. And so if it's a transaction where either us or no legal counsel was involved, a buyer may acquire the seller's 401k plan and don't realize the implications that they can no longer terminate it. I've had clients ask me, "Well, why can't we just terminate this? The deal happened and closed a month ago. Why can't we just terminate the plan?" And the reason is those successor plan rules that Taryn mentioned, that by virtue of having another 401k plan, it restricts their ability to do so. And so it is really important to have this kind of flushed out as Taryn suggested, earlier in the transaction, and so really the best way to do that, is to have something in the purchase agreement to get the parties discussing, what is going to happen with the 401k plan post-closing.

Andrew Graw: Yeah, I would agree with that completely. It is one of the things that takes clients by surprise that they go through a transaction and only realize afterwards. Of course, those are transactions that we have not been counseled on, because otherwise we would tell them. But it is one of the things that we see come up from companies who come to us and say that they want to terminate this 401k plan and only to learn that they can't because they did not terminate it prior to the closing. But just one point, I know that it matters that if a company has a plan through a professional employment organization, a PEO, that terminating the plan is not available. So we're going to talk about getting into what happens with a PEO 401k plan a little later in the conversation. Since a termination is the most typical choice that we see taken in a stock deal or merger, Taryn, can you tell us what the termination process is?

Taryn Cannataro: Sure. The main pre-closing requirement from a legal standpoint is to have board resolutions approving terminations as of the day immediately prior to closing. And of course, it's important to review the terms of the plan itself, to make sure that you're complying with the termination rules in the plan. Also, as of the termination date, the plan must not allow new participants or any contributions for services rendered on or following the closing date.

There are exceptions for corrective contributions, contributions based on compensation earned before the closing date and repayment of loan balances. Again here, the most important point is that you're not allowing contributions for services that were rendered after the date the plan was terminated. It's also important to coordinate with the 401k provider and the payroll provider, as early as possible, to ensure a smooth transition and avoid any unwanted delays. Sometimes it's required that you run a special payroll, or you make manual adjustments to ensure that you have the right contributions being remitted to the plan, and that could sometimes require lead time, so getting these conversations started as early as possible can help avoid any inadvertent delay to closing.

Andrew Graw: And Megan, I know you have some war stories about that situation, right?

Megan Monson: Yeah. It's funny, Andy, because as Taryn mentioned, while the only legal requirement is having board action taken, there still might be administrative paperwork or other things that a 401k plan provider may need internally in order to process the plan termination. And you really don't want to be in the situation where you're telling your client that the deal's not going to close and it has to delay the closing, when everyone's sitting there waiting to get their money, because of a 401k plan issue. I've had that happen at least once before and it's really showed me kind of how imperative it is to have clients having those conversations early with their payroll and 401k plan providers, to avoid that from happening.

One other point I want to mention is, so we've been talking about what's done and what's needed from a legal standpoint to terminate the plan. I also see that there tends to be a lot of confusion I get from clients in what's needed to legally terminate it, versus what we'll call some post-closing windup matters, because there's a lot that goes into the plan termination process, and we'll get into some other specifics in a minute, but there's things such as plan might need amendments, you might need to terminate third party contracts, notify participants of the plan termination, ultimately filing a final form 5500 when all of the accounts are ultimately distributed and potentially filing for a final IRS determination letter.

And all of those things I just mentioned we'll say, are not things that are required prior to the closing of a deal for a plan to be considered terminated under the 401k plan rules. And I just want to preface that because there tends to be a lot of confusion in terms of the terminology used and folks saying, "Oh, we can't get this plan terminated in time for a deal because we have to do X, Y, and Z." Well, that's not really the case. It's really the board action and any potential coordination or administration with the provider.

Andrew Graw: Right. All you're really doing to terminate the plan, to get the process started, so that you can follow through and actually distribute the money after the closing is to have that board resolution adopted prior to the closing terminating the plan.

Megan Monson: Exactly. So again, I think it just goes back to the importance of having these conversations and making sure that the parties are aligned and understand what is needed and when.

Andrew Graw: I think that's a great lead in into, once the plan is terminated prior to the closing, what happens to account balances and plan loans under the plan after the closing?

Megan Monson: I'll take the easier piece of that first in terms of, we'll say general account balance distributions, employees are going to receive documentation from the target company's 401k plan provider, that's basically going to tell them what are their options with respect to receiving distributions. And so, they can roll those either over into an IRA or another qualified plan or the acquirer's plan, and most often we will see them rolling their account balances over to the acquirer's plan if they are continuing employment because again, just from their standpoint, it's easy to have all your money in one place. There's less documentation that you need, you have less logins you have to remember. And so that's kind of the path of least resistance, and we tend to see a lot of people do that.

With respect to the plan loans that could be a little bit thornier of an issue. Sometimes it's going to require if there are outstanding plan loans, review of the acquirer's 401k plan to see if an amendment is needed to even allow for either a rollover of loans or issuance of new loans to these participants. And not all buyers are going to be willing to accommodate that, whether it's for administrative reasons, internal policies, so that is something to be aware of.

If there are outstanding loans in the target's plan and that plan's being terminated, the various alternatives are, again, as I mentioned, kind of rolling over loans to the acquirer's plan. That's pretty uncommon just because of the logistics involved with that. Continuing to pay off plan loans to the target company by either checks or wire transfer during that wind down period. And in order to do that, you may need an amendment to the plan to allow for that. Again, I'll say that tends to be a little less common.

Having the entire balance of the loans due when the plan's terminated, is something to consider. The number of folks involved in the amount of the outstanding loans because that could present potential hardship for folks. And I've seen this become an issue frankly in deals where the seller is asking for a rollover of loans and people aren't really paying attention. The buyer says, "Sure, we'll allow for it." And doesn't really realize then what headache can be involved in terms of allowing for rollover of loans into their plan. And especially if there's again, a large amount of employees with large outstanding loan balances, it's going to be similar to the plan merger point, require coordination with the various target and buyer, 401k plan providers, getting exchange of information, figuring out how that's going to work. And so it's just something that you want to make sure that you get a handle on before even agreeing to it and before the plan's terminated.

Taryn Cannataro: And sometimes it can even be best practice to request information on the outstanding plan loans and the target company's plans in the course of diligence just to make sure that you know what you're getting into.

Megan Monson: Yeah, that's a great point, Taryn, because if it's something that's impacting one or two people, you may be willing to accommodate. If it's a much larger population, you may not. And to the point I mentioned earlier, you want to make sure that the buyer, again understands if this is something that their plan allows and if not, what the process would be for their plan to be able to accommodate that.

Andrew Graw: So up until now, we've only talked about what happens to a 401k plan and connect connection with a stock deal or a merger, but there's different considerations in connection with a sale of assets. Taryn, can you speak to that?

Taryn Cannataro: Sure. Typically, in an asset sale, the 401k plan is not assumed by the purchaser and will remain an asset of the seller, which means that the purchaser is not inheriting the liabilities associated with the plan like they would in a stock deal or merger. That said, we often see sellers terminating their 401k plan prior to closing anyway, to allow employees to roll over their balances into the purchaser plan. If the plan wasn't terminated, as a result of just the employees' becoming employees of the purchaser, there would likely be a partial plan termination anyway if the plan remained outstanding, which would result in the employees vesting in their balances. So practically speaking, sometimes terminating the plan is the best course of action even in an asset deal.

Andrew Graw: But I'd weigh in and say that if you're a purchaser of the assets and you're requiring the employees, then you could also consider requiring the seller to fully vest employees in their account balances under the plan, even if it's not a partial termination. And also assuring that the seller will make whatever matching contributions the employees might be entitled to, any profit sharing contributions that they might be entitled to, and otherwise making sure that the seller sort of does what's right by the employees, so that you don't end up with an unhappy workforce because of something that happened with their old 401k plan or some benefits they lost under that plan as a result of the deal. Megan, I'll direct this to you. Anything else related to 401k plans transitioning in the M&A context that are worth highlighting?

Megan Monson: Yeah, there's a couple of things I want to touch on that didn't really get flushed out in our earlier discussion. So the first is, you alluded to Andy, as with respect to a plan that's maintained by a PEO or a professional employer organization. You can't terminate that plan, because the target or seller is not the sponsor of that plan. They're participating in a multiple employer plan that's sponsored by another entity. But what can be done is having that company who's the seller in the transaction, withdrawing as a participating employer and the plan documents will set forth kind of the process for doing that. There could be a spinoff and termination of the portion of the plan that's associated with the account balances for the target employees, and there can also be accounts transferred from the PEO to the buyer plan.

Those are kind of just in broad strokes what can be done. There is a lot of complexity and special circumstances when you're dealing with the PEO, and so keep on the lookout for an upcoming episode of Just Compensation that's going to be focused on

PEO considerations and M&A transactions generally and get into more detail on what to do in a 401k plan in that context.

One other point I want to mention in kind of shifting gears a little bit is, most of the time a buyer is going to allow for the seller's employees to participate in their 401k plan on a go forward basis. And so one of the things to think about is, are you going to provide service crediting for the service and period of time that they had worked for the seller entity? And if so, that may require an amendment to their plan. So kind of thinking through the implications of how that's going to work and what needs to be done to ensure a smooth transition for those folks.

Taryn Cannataro: Another thing to keep in mind is that you want to consider the messaging that you're going to be giving to employees, especially if the new plan that they are going to be participating in has different terms than the plan that's being terminated. Often, we see third party administrators that offer education sessions on the plan, so that could help with the messaging to the employees as well.

Megan Monson: Yeah, and I'll just add on that, that while not specific to 401k plans in general, the messaging to employees in terms of what's happening to their benefits in the context of an M&A transaction is really important, and especially if you're dealing with a smaller company that's being acquired by a larger company, they really want to understand how this is going to impact them. And so that kind of goes back to the point I made about potentially crediting service, trying to make the transition as smooth as possible, so that way they're not feeling that their employment is disrupted, if you will, by things that are beyond their control, because I tend to see that as a pain point in deals.

Andrew Graw: Well, this has been great. Thanks so much Megan and Taryn. I think everyone listening to this can really get a sense that it's extremely important to deal with 401k plans in the proper way in connection with a transaction. Same could be said for other benefits as well, but when it comes to tax qualified plans like 401k plans and other kinds of pension plans, that dealing with those potential liabilities is extremely important, not just from a dollars and cents standpoint, but if they're not dealt with properly, you could end up with an unhappy workforce, and obviously the buyer does not want that, and I'm sure neither does the seller.

So hopefully listeners will have gotten some guidance from this short session on the considerations around 401k plans and how they can plan ahead for dealing with 401k plans in connection with an M&A transaction. If your company could be engaging in an M&A transaction in the future, whether as a seller or as an acquirer and there is a 401k plan involved, we encourage you to consult with counsel, to navigate those issues and make sure that you avoid pitfalls and unknown liabilities. Thank everyone for listening to this episode of Just Compensation, and hopefully you'll come back and listen to our other episodes.

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