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Benefits & Compensation Issues in M&A

Benefits Issues in Corporate Transactions: Anatomy of a Deal

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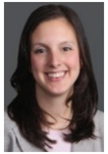

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Outline

- Background
- Types of Transactions
- Due Diligence
- Operative Agreement Provisions
  - Equity treatment and conversion
  - Earn-outs
  - Representations and warranties (including R&W insurance)
  - Interim covenants
  - Post-closing covenants
  - Indemnities

Background

- Unlike many areas of employee benefits and executive compensation where we have specific rules about what to do and what not to do, doing a transaction is more of an art than a science (although some aspects of science (law) are also important).
- Accordingly, it is not possible to provide a checklist of everything a benefits or HR person (whether lawyer or HR professional) will need to consider in a transaction.
- We can, however, talk about common issues that arise in transactions, how those are addressed in the operative documents, and legal and practical considerations that arise in connection with some of the issues.

Types of Transactions

- Asset sale/purchase: One company/individual(s) sells assets to another company/individual(s). Note that assets can include STOCK in a subsidiary or other entity and when that is the case, many of the same issues that arise in stock transactions are presented.
- Stock sale/purchase: One company is buying the stock of another company; may be stock of the entire seller, a subsidiary or just some of the stock (in which case the amount of stock is relevant to the analysis of controlled group issues, which usually require common related ownership of at least 80%).

Types of Transactions

- Merger: One company is being merged into another company; raises many of the same issues as a stock purchase.
  - Direct merger: Merger in which the company being acquired is merged into the acquiring company without using a merger sub; not very common. (Company A merges into Company B; Company B is the survivor.)
  - Forward triangular merger: The acquisition of a target company by a subsidiary of the purchasing company **where the subsidiary of the purchasing company is the survivor**; structure is not common because usually when there is a merger it would be important for the target to survive so that all of the contracts, etc. do not have to be transferred. (Company A owns Subsidiary C; Target B merges into Subsidiary C and Subsidiary C is the survivor.)

Types of Transactions

- Reverse triangular merger: The formation of a new company that occurs when an acquiring company creates a subsidiary, the subsidiary acquires the target and **the subsidiary is then absorbed by the target company (i.e., the target company is the survivor)**; easier to accomplish than a direct merger (only one shareholder of subsidiary) and identity of target does not change. (Company A establishes Subsidiary C, Target B merges into Subsidiary C and Subsidiary B is the survivor.)

Types of Transactions

- Other common transactions that we will not discuss in detail today but you may have heard about:
  - Initial Public Offering: A transaction where a formerly privately owned company offers its securities to the public for the first time.
  - Spin-off: The creation of an independent company through the sale or distribution (dividend) of new shares of an existing business or division of a parent company.
  - SPAC (Special Purpose Acquisition Company) Transaction: A transaction where a company has done an IPO to raise money to invest in a specific industry or geographic areas—very often with a specific target in mind; the funds raised in the IPO are then used to acquire the target through a merger with an operating company where the operating company is the survivor in the merger.

Due Diligence

- Once we know the structure of the transaction, the next step is due diligence.
  - A buyer and its advisors (lawyers, accountants and consultants) will conduct due diligence on a seller's benefit plans.
  - The seller and its advisors may need to (or want to) do due diligence on a buyer's plans (particularly when stock consideration is being given in the transaction, where there is a "merger of equals", or to understand the transaction's impact on seller's employees).
  - Each of the buyer and the seller will also often need to do some level of due diligence on their own plans in order to properly address issues that might be in the transaction documents or in the integration process.

Operative Agreement Provisions

- Simultaneously, before and in connection with the due diligence process, the operative documents for the transaction will need to be reviewed and negotiated and benefits "people" (lawyers and HR need to be involved).
- Significant benefits/HR considerations in the operative documents include:
  - Equity treatment and conversion
  - Earn-outs
  - Representations and warranties (including R&W insurance)
  - Interim covenants
  - Post-closing covenants
  - Indemnities

Equity Treatment

- If a selling (target) company has outstanding equity awards (such as stock options, restricted stock, or stock units), the purchase agreement will need to address treatment of the awards in the transaction.
- One of the first steps is to determine what treatment is permitted by the applicable plan documents and award agreements.
- Another early step is for the parties to determine how they want the awards to be treated in the transaction:
  - Cancellation/Payout: Vested? Non-vested? Accelerated vesting?
  - Assumption/Substitution/Conversion: Existing awards assumed by, and substituted with or converted to awards of, acquiring company?

Equity Treatment

- Some concepts to keep in mind relating to equity treatment in a transaction include:
  - If the desired treatment is not consistent with the plans/award agreements, consent of the equity holders may be needed.
  - If the awards are to be assumed by the acquiring company and converted into/substituted with awards of the acquiring company, the holder of the award cannot receive more value after the assumption/substitution/conversion than they had immediately before the transaction.
  - If the awards are deferred compensation (subject to Code Section 409A), the payment timing generally needs to remain the same under the assumed/substituted/converted award as it was under the original award.

Equity Treatment

- The valuation and payment timing rules relating to converted equity are very important to ensure compliance with Code Section 409A but also may be important in other contexts as well (such as incentive stock options and tax rules applicable to restricted property).
  - This involves an analysis of the payment timing applicable under the award prior to the transaction and whether payment is permitted in connection with the transaction. (E.g., Was the award previously subject to Code Section 409A? Is the payment timing changing in a permissible way? Is the transaction a permitted payment event under Code Section 409A (and the plan documents)? Does the payment timing meet the short-term deferral rules if applicable?)

Equity Treatment

- Ex. If an option is being converted, the exercise price and the number of shares subject to the option will need to be adjusted so that the "spread" does not increase in connection with the conversion.
- Ex. If RSUs are being converted and they provide for payment at a specified time or upon a specified event, those payment dates/events generally cannot be changed (whether to an earlier or later time) without carefully considering the tax consequences.

Equity Treatment

- If an award is to be paid out in connection with the transaction, consideration needs to be given to the tax treatment and the payment schedule (even if it is not being changed in the transaction).
  - Almost always, the payment of an equity award that was originally granted in connection with the performance of services will be taxable as compensation and will be subject to withholding.
  - The withholding is almost always taken from the proceeds of the sale but, as a practical matter, the withholding normally needs to be processed through the target's payroll and the withholding then needs to be paid to the tax authorities within applicable time frames.

Earn-Outs

- Earn-outs raise interesting (and usually hard) questions both as to the timing of payments and the tax treatment of the earn-out.
- A typical earn-out payment that is paid over a period after the closing of the transaction could constitute deferred compensation and it would be important to make sure that the payment timing either satisfies Code Section 409A or that the payments are exempt from Code Section 409A.
  - Payments related to a change in control that occur because of the purchase (such as a cash-out) of a stock right (option or SAR) or that are calculated by reference to the stock of the target are subject to special payment rules under Code Section 409A (and the compensation payable is referred to as "transaction-based compensation").

Earn-Outs

- Transaction-based compensation satisfies the payment timing rules of Code Section 409A if it is paid on the same schedule and under the same terms and conditions as apply to shareholders generally in the transaction and to the extent that the compensation is paid no later than five years after the change in control.
- It is also possible to subject transaction-based compensation to a "substantial risk of forfeiture" (i.e., vesting conditions, such as continued service or performance conditions) and thereby treat the compensation as fitting within the short-term deferral exception from Code Section 409A as long as the payments are made under the same terms and conditions as those that apply to shareholders generally.

Earn-Outs

- Issues relating to taxation of earn-outs also arise in connection with payments to management sellers who become employees of the acquiring entity following the transaction where the right to the earn-out is tied to the individual's continuing employment after the transaction.
  - The goal of the selling shareholders will be to defer tax on the earn-out payments until the payments are actually received and to have the payments treated as deferred purchase price (capital gain/loss treatment) rather than compensation (taxed at ordinary income rates; subject to withholding and employment taxes; may factor into 280G analysis; deferred compensation rules apply).
  - The "correct" treatment depends on the facts and circumstances and is often the subject to negotiation.

Earn-Outs

- Some factors to consider in determining tax treatment:
  - Whether the payments are based on factors traditionally used to determine employee compensation, i.e., the value of the services performed, the length of the services, and the individual’s prior wages?
    - If payments exceed reasonable compensation without regard to the earn-out, less likely to be treated as compensation.
    - If amount of payments based on things other than services (e.g., proportionate to stock holdings), less likely to be treated as compensation.
  - Total payments made to all selling shareholders represent a reasonable value for the company, suggesting that continued service is not the primary reason for the payments (more likely to be treated as purchase price).

Rollover Equity

- In addition to earn-outs, rollover of equity is a common feature of transactions involving management sellers.
  - Generally, rollover of equity involves a selling equity holder exchanging fully vested equity in the target for restricted equity in the acquiring company that vests based on continued employment of the selling equity holder.
  - The restricted equity would be subject to tax as compensation under Code Section 83 but current taxation (and compensation tax treatment) is avoided by following these steps (authorized by Rev. Rul. 2007-49):

Rollover Equity

  - Recipient makes an 83(b) election with respect to the restricted equity at the time of the grant by acquiring company (restricted equity equal in value to vested equity exchanged for restricted equity).
  - No tax is recognized upon the filing of the 83(b) election because vested equity and restricted equity have the same value.
  - No tax event upon vesting of restricted equity.
  - Capital gains/loss treatment on subsequent disposition of restricted equity (after vesting).

– Rev. Rul. 2007-49 addresses only stock rollovers although most practitioners agree that it should apply to rollovers of other property as well (such as LLC interests); some practitioners have argued that the analysis should be expanded to a variety of other types of consideration (including cash) with varying degrees of success in a specific transaction.

Representations and Warranties

- Where do we find them?
  - Employee benefits
  - Labor and employment
  - Tax
  - Material contracts
  - Absence of changes
  - Capitalization
- Reps are often a great way to uncover information for due diligence.

Representations and Warranties

- Employee benefits reps typically cover the following issues:
  - Plan definition and documents provided to buyer
  - General compliance, often with specific reps related to qualified plans, Affordable Care Act, Code Section 409A, COBRA, prohibited transactions, reporting/disclosure, payments/contributions/accruals, etc.
  - Transaction benefits and Section 280G
  - Absence of any actions, suits or claims, and audits or investigations by a government agency
  - No (i) Title IV, (ii) multiemployer plan, (iii) multiple employer plan, (iv) MEWA, or (v) retiree medical liabilities
  - No limits on ability to amend or terminate plans

280G Issues (Golden Parachute Payments)

- Section 280G of the Code generally provides that if payments **by a corporation** that are contingent on a change in control exceed a certain threshold, a portion of those payments are subject to a 20% excise tax (which must be withheld by the employer) and the corporation loses it deduction for such payments (these payments are typically referred to as "parachute payments" and the taxes are typically referred to as "parachute taxes").
- There are certain limited exceptions to these rules, one of which applies to parachute payments that have been approved by the shareholders of a non-public corporation.

280G Issues (Golden Parachute Payments)

- While many rules apply to the obtaining of shareholder approval (and even determining who the proper shareholders are), the shareholder approval process generally is that the recipients of the payments would “waive” their rights to the payments subject to subsequent shareholder approval of the payments and then the contingent payments would be presented to the shareholders for approval.
- If the payments are not approved, the individuals do not receive the payments.
- Purchase agreement language is normally included in the interim covenants for this process because it is in everyone’s best interest to avoid the parachute tax.
- **IMPORTANT**: The transaction **cannot be conditioned** on receipt of shareholder approval.

Representation & Warranty Insurance

- Representations and warranties insurance (RWI) protects a party from financial losses resulting from any breach of the representations and warranties about a target business in connection with a transaction.
- Employee benefits coverage typically lasts 3-6 years following the closing.

Representation & Warranty Insurance

- R&W Insurance is one of the biggest trends in M&A in decades with no sign of reversing.
- Use rate in private equity deals is very high. Strategic acquirers are behind private equity, but definitely catching up. Less common in certain industries where insurance coverage is less available (health care, banks and other financial institutions, environmental).

Buyer Advantages

- Broader reps and warranties (within reason)
- Better indemnification (i.e., longer coverage and fewer limitations)
- May distinguish bid in auction/competitive process
- Avoids post-closing adversarial proceedings with sellers (including management sellers)
- Reputational considerations for insurers should result in an easier claims process

Seller Advantages

- Much lower post-closing indemnification exposure = "cleaner" exit
- Generally a 0.75% to 1% cap for non-fundamental reps
- Avoid funds trapped in escrow at low interest rates

Representation & Warranty Insurance

- While buyers want to make sure as much as possible is protected under the RWI policy, there are typically some exclusions. These exclusions come in two forms: (1) standard policy exclusions, and (2) transaction-specific exclusions.
  - Standard policy exclusions depend on the underwriter, but often include losses related to pension underfunding or multiemployer plan withdrawal liability, new and uncertain areas of law (such as COVID-19 impact), and future or forward-looking reps.
  - Transaction-specific policy exclusions are based on the diligence and the language used in the reps and warranties.
    - In general, the less thorough the diligence, the broader the exclusions under the RWI policy. More detail in the written diligence report and quantitative estimates of exposure typically help to narrow exclusions.
    - Issues known to buyer are often carved out of coverage.
    - It is important to keep in mind that a materiality threshold for a RWI exclusion is often less than what would be considered “material” in the scope of the transaction.

Interim Covenants

- Typical interim covenants for employees/benefits:
  - Salary/benefits increases
  - Hiring/firing authority
  - Equity award grants
  - Acceleration of vesting, funding, etc.
- Exceptions are typically detailed on a schedule.

Interim Covenants

- Non-compliance corrections
- Gun-jumping
- 280G waiver and vote process (previously discussed)
- 401(k) plan termination

401(k) Plan Termination

- Common provision in stock transactions (and sometimes asset transactions): a covenant requiring the seller/company being purchased to terminate its 401(k) plan prior to closing.
  - This is because 401(k) monies can only be distributed upon certain events, including a plan termination, and a buyer may not want to merge a target's plan into its own or to keep the plan going indefinitely.
- Regulations provide that no distribution can be made on account of plan termination if the employer establishes or maintains an alternative defined contribution plan.
  - Regulations make clear that the "employer" for this purpose is tested at the time of termination – so a company that only maintains one defined contribution plan (on a controlled group basis) can terminate the plan and make distributions as a result of the termination. That way, the buyer does not need to worry about plan mergers or continuing the plan.
- BUT....

401(k) Plan Termination

- Even though the plan is terminated, we still have to worry about the consent rules. Generally, the consent rules require a participant to consent to a distribution prior to a certain date if the balance is above the small cash out limit (generally $5,000). These consent rules are included in Section 411(a)(11) of the Code.
  - The applicable regulations under that Section permit distributions from defined contribution plans that do not offer annuity options (most don't) without participant consent in certain circumstances.

401(k) Plan Termination

- Sounds like good news….except that the Section 411(a)(11) rules provide that the "no consent" requirement does not apply if any member of the controlled group maintains another defined contribution plan (other than an ESOP). Unlike the 401(k) rules regarding plan termination, this is NOT tested at the time of termination.
  - The regulations do not say when it is tested but the import of the language is that it is tested at the time of distribution so consent to a distribution would most likely be required since a purchaser that requires termination of a 401(k) plan in connection with a transaction will most likely maintain its own plan and distributions would not be made until after the closing.
  - You will find that minds (and often TPAs) differ on this interpretation, and will argue that the 401(k) plan termination rules override the consent rules of Section 411(a)(11).

Post-Closing Covenants

- Asset Transactions:
  - Employees will terminate employment and must be offered employment by the buyer.
  - Consideration must be given to employees out on disability or leave of absence.
- Stock Transactions/Mergers:
  - Employees employed by the target or subsidiaries will continue their employment.
  - If employed by the parent of the target, consider whether to move employees via intra-company transfer prior to close.

Post-Closing Covenants

- Post-closing covenants typically include certain protections for employees.
  - Protection period, generally up to two years:
    - Salary
    - Bonuses
    - Equity
    - Benefits (measured against seller's benefits or buyer's benefits)
    - Geographic location

Post-Closing Covenants

- Employee protections, continued.
  - Service crediting:
    - Vesting
    - Eligibility
    - Benefit accrual
    - Carve outs for certain types of plans vs. limited to certain benefits
  - Waiver of waiting periods, evidence of insurability, or pre-existing condition limitations
  - Credit for co-pays, deductibles, and out-of-pocket expenses

Halliburton Case

- This case is relevant for purposes of understanding the importance of what is said in the employee matters section and what rights we give to employees by what is in that section.
- In the merger agreement, there was a three year protection period for active employees but no specific time period of protection for retiree medical benefits.
- About six years after the closing, Halliburton amended the retiree medical benefit plans and the retirees sued.
- The court ultimately held that the purchase agreement was an effective amendment of the retiree plan.
- The court further held that the "no third-party beneficiary" language did not preclude the participants from making the claim under the retiree medical plan as amended by the merger agreement. Therefore, they were entitled to enforce the terms of the plan as amended.

Halliburton Case

- As a result, we now recommend adding language into the "no third-party beneficiary" provision in the employee covenants to the effect that the entire employee matters section is not a plan amendment and does not restrict the company's ability to amend and does not provide any third party the right to enforce.
- It also covers all persons—because one of the issues in Halliburton was that the protection period did not apply to retirees.

Cafeteria Plan Transfers

- Generally, the cafeteria plan rules prevent plan participants from changing their elections unless there is a change in status.
- A corporate transaction that is an asset sale is likely to be a change in status because the individual will be terminated from employment with the seller and will begin employment with the buyer.
- That may be sufficient to give rise to the ability to change the elections but it **DOES NOT** address the fact that the seller's plan may have a large account balance for that employee that cannot be used for claims incurred after the transaction.
- Rev. Rul. 2002-32 addresses various ways that the amounts in the seller's plan may be transferred to the purchaser's plan or may be otherwise used post-closing so that the employees do not lose the benefit of those funds.
- **IN PRACTICE**, these concepts are often extended to other situations where the employees may lose their benefits, including stock sales where the cafeteria plan will not come with the employees.

W-2 Reporting

- Employees need to receive W-2s which report the amount of wages that they were paid during a calendar year.
- The normal rule is that the employer that employs the individual and pays wages to the individual provides the W-2 reflecting the amount of wages that that employer paid to the individual.
- In the context of a corporate transaction, there may be circumstances where two employers pay the employee for the same year and they only want to provide one W-2 for the entire year (the “alternate method”).

W-2 Reporting

- Rev. Proc. 2004-53 addresses a "standard" method of providing W-2s and an "alternate" method:
  - If the parties agree to use the standard method, this is often not addressed in the purchase agreement (it is the default).
  - If the parties want to use the alternate method, it is typically addressed in the purchase agreement, because: (1) the Rev. Proc. provides that the parties have to agree to use the alternate procedure and (2) it relieves the predecessor from liability for the W-2s, so if we are representing a seller we want that covenant in the agreement.

TSAs, MEWAs and More

- Occasionally, employees may not be able to transition to Buyer immediately, or Buyer may not be able to stand up benefit plans immediately.
- These situations must be addressed very thoughtfully, with consideration of the following issues/solutions:
  - MEWAs
  - Multiple employer plans
  - Joint employer liability
  - ACA coverage/reporting
  - TSA or Buyer assumption of plans

Section 3121(a)(1)

- Generally, when an employee begins employment with a new employer, his/her social security taxes restart (i.e., he is treated as a new employee of the new employer and the new employer cannot take into account any taxes previously paid by the employee).
  - Thus, the employee may end up paying social security taxes on amounts above the wage base and must request a refund of any excess amounts. In addition, two employers will have paid the employer portion of social security tax on the same wage base.
- Section 3121(a)(1), however, provides that if an employer is a "successor" employer, the successor employer can take into account compensation paid by the predecessor employer for purposes of determining compensation paid up to the wage base.
  - A successor employer is one that, in a calendar year, purchases substantially all of the property used by another employer (the "predecessor") in a trade of business or used in a separate unit of a trade or business and if, immediately following the transaction, the successor employs in its trade or business an employee who was employed by the predecessor immediately prior to the transaction.
- This provision does not require a specific agreement provision (it is self-executing) but there would most likely need to be a provision regarding sharing of information in order for the successor to know what compensation has been paid by the predecessor.

Section 410(b)(6)(C)

- Generally each plan must satisfy certain minimum coverage rules by taking into account all employees in the controlled group. These rules are set forth in Section 410(b) of the Code.
- Section 410(b)(6)(C) of the Code provides a special rule that is helpful in integration matters after closing of a transaction and should be taken into account if benefit plan integration is an issue in the transaction.
- This rule provides that if a person becomes or ceases to be a member of a controlled group, the requirements of Section 410(b) will be treated as satisfied during a transition period if:
  - the requirements were met immediately before the change in the controlled group; and
  - the coverage under the plan is not significantly changed during the transition period.
- The transition period begins on the date of the transaction and ends on the last day of the first plan year beginning after the date of the transaction.

COBRA

- In the event of a corporate transaction, IRS regulations apportion COBRA liability between the selling group and the buying group with respect to "M&A Qualified Beneficiaries":
  - In a stock sale, an M&A Qualified Beneficiary is a qualified beneficiary whose qualifying event arose <u>prior to or in connection with</u> the sale and who is (or whose qualifying event occurred in connection with) a covered employee whose last employment prior to the qualifying event was with the acquired organization.
  - In an asset sale, an M&A Qualified Beneficiary is a qualified beneficiary whose qualifying event occurred <u>prior to or in connection with</u> the sale and who is (or whose qualifying event occurred in connection with) a covered employee whose last employment prior to the qualifying event was associated with the assets being sold.

COBRA

- The regulations apportion the COBRA liability between the selling group and the buying group as follows (with the "groups" being aggregated based on 80% common ownership):
  - So long as the selling group maintains a group health plan after the sale, the selling group has the COBRA obligation with respect to M&A Qualified Beneficiaries with respect to the sale.
  - If the selling group ceases to provide group health coverage to all employees in connection with the sale (determined based on the relevant facts and circumstances and determined on a controlled group basis), the COBRA obligation shifts to the buying group with respect to M&A Qualified Beneficiaries with respect to the sale.

COBRA

- What this means is that if a selling group ceases to provide COBRA coverage to any person, the buying group is responsible for COBRA obligations for all M&A Qualified Beneficiaries, even if those individuals never went to work for the buying group.
- The parties to a transaction may agree to allocate the liabilities other than in accordance with the general rules BUT the group that is allocated the liabilities under the regulations remains liable for providing the coverage as a legal matter; recourse would be to pursue contractual remedies for a default under the agreement or to obtain some other security for the obligation.

4204 Assumption—Asset Sales Only

- When an employer "withdraws" from a multiemployer plan (that is, ceases to contribute or reduces its contributions by a significant amount, the employer incurs withdrawal liability. In an asset sale, the selling employer will almost always have a withdrawal due to the fact that the level of contributions will be reduced or eliminated.
- Section 4204 of ERISA provides that if a withdrawal would occur as the result of a bona fide arm's length sale of assets to a third party, the seller will not incur withdrawal liability as a result of a cessation of covered operations or an obligation to contribute to the plan if the following requirements are met:

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4204 Assumption—Asset Sales Only

- the purchaser has an obligation to contribution to the plan for substantially the same number of units;
- the purchaser provides to the plan for a period of five plan years commencing with the first plan year beginning after the sale, a bond in an amount specified under Section 4204; and
- **the contract for sale provides** that if the purchaser withdraws from the plan during the first five plan years, the seller is secondarily liable for the withdrawal liability that it would have had to the plan but for the assumption by the purchaser.

- If the contract does not include the 4204 language, it is **FATAL** to a 4204 assumption.

Indemnities

- Indemnification provisions:
  - General
  - Special
  - Are benefits reps "fundamental" reps?
- Survival period:
  - Specific period of months/years post closing
  - Statute of limitations

Benefits & Compensation University: Upcoming Events

- October 13, 2021: Hot Topics in Executive Compensation
- October 20, 2021: Recent Legislative and Regulatory Developments Regarding the Use of Non-Compete and Non-Solicitation Agreements
- October 27, 2021: Latest ERISA Developments and Trends

CLE credit is available for the programs (pending approval).

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