

# ABA JCEB M&A Webinar Series

## Part II: The Due Diligence Process

*Wednesday, June 14, 2017*

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<b>Date</b>	<b>Series</b>
May 24, 2017	Part I – Covenants and Post-Transaction Clean-up Issues
June 14, 2017	Part II – The Due Diligence Process
July 12, 2017	Part III – Last Minute Lessons for M&As: Tidbits Gleaned from Litigation and Other New Developments

# Today's Speakers

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# **ABA/JCEB M&A Webinar Series**

## **Part II – The Due Diligence Process**

# What We'll Look at Today....

- Overall Architecture of a “Deal”
  - What’s the goal of an M&A transaction?
  - Parties Involved
  - Internal and External Give and Take
  - All Important: Setting and Managing “Expectations”
- Basics of the “Deal”
  - Look at the overall process
  - What drives the deal structure
  - Where to get data
  - Reps & Warranties
  - Focus on specific areas, including pension, other retirement and executive benefits

# The Anatomy of a “Deal”

# Anatomy of a Deal

- Purpose of M&A – Make money
- Purpose of due diligence
  - Prove out the assets and liabilities assumed
  - Identify potential problems with the values
- In negotiating the deal, due diligence needs to flesh out:
  - What’s going to happen to the employees and benefit programs
  - Representation and warranties reflect this agreement
  - Transition issues are identified
- Closing and Post-Closing Issues

# M&A Deals: A Team Sport

- In-house Personnel
  - Executive Leadership
  - Line Leadership
  - Support Disciplines
    - Strategic Planning / M&A Group
    - Legal
    - Finance
    - HR/Labor
    - Environmental
- Outside Professionals
  - Investment Bankers
  - Legal Counsel (maybe more than one)
  - Accountants
  - Actuaries
  - Environmental
  - Valuation



# How do “deals” form?

- Buyer’s leadership sees the ‘deal’ or someone brings the ‘deal’ idea to them
  - Could be line managers, senior line managers, senior executives, board of directors
  - Basically, it’s someone high up enough to have influence
- Person with ‘influence’ starts / sells the idea (combination) to other internal parties
  - They boast of some advantage to acquisition or sale
  - In the final analysis, “timing” generally turns out to be paramount
    - Timing can even trump ‘price’

# Getting the Deal to Your Desk

- Typically, the Seller (working counsel) puts together an 'offering memorandum'
  - Usually an auction format
    - Investment banker accepts letters of intent with a price range showing an expression of interest
  - This process narrows the field to one or two potential buyers
  - Exclusive period – Typically, one potential buyer is given a limited period of time to negotiate the deal

# Deal Drivers: First “Money” then “Time”

- Initial “Deal” driver is “Financial” (i.e., money)
- However, “Timing” quickly takes over as the main driver
- Timing becomes important because:
  - Buying: Looking to add acquired company’s EPS
  - Selling: Looking to report cash generation/offset something

# Timing vs. Proper Due Diligence

- Due diligence can suffer – and suffer greatly due to timing
  - The corporate/client influencers begin to believe their own talk
- Pressure grows to surface only big issues
  - What constitutes “big” begins to increase
  - Experienced buyers have a higher threshold for what’s big
- Pressure to limit issues to strictly price issues
- No appetite for transition issues unless they could dramatically affect price

# Major Deal Components

- Strategic Fit – Business base
- Intellectual Property – How secure is it?
- Can you get it through HSR?
- Retention of ‘critical’ executives
- Liabilities assumed:
  - Taxes (structure to preserve tax attributes)
  - Environmental
  - Legacy Liabilities (asbestos)
  - Employee Benefit (pension / retiree medical)

# Price Negotiations

- Purchase price – generally determined at a very high organizational level (be careful – it's not your deal)
  
- All kinds of ways to handle:
  - All cash
  - All stock
  - Cash & Stock
  - Earn-out

# In the ERISA World – Price vs. Transition

- Constant tension between “price” issues and “transition” issues
- Reluctance by “corporate” lawyers to include benefits people because they view all the HR/benefits issues as “transition” issues – not due diligence
- BUT – there can be significant ‘price’ issues that need to be addressed

# Benefits vs. HR – What's the difference?

- Benefits
  - Actives & Retirees
  - Retirement
    - Pension
    - 401(k)
  - Welfare
    - Medical
    - Dental
    - Life Insurance
    - Disability
  - Executive Comp
- Human Resources
  - Employment Litigation
  - Collective bargaining
  - Security
  - Ethics
  - Service Center Issues
    - Payroll delivery
    - Benefits delivery
  - Government Compliance
    - OFCCP
    - EEOC



# In the ERISA World – Price vs. Transition

- Price Issues
  - Underfunding
    - Pension
    - Retiree Medical
    - Medical IBNR
  - Missing Corporate Flow-downs
  - Withdrawal Liability
  - 280G Liability
  - ESOP Issues
  - Pending Claims
    - Employment Discrimination
    - Benefits (Class Action or non-compliance)
  - Prior Incorrect COBRA Admin
  - Prior Incorrect WARN Admin
- Transition Issues
  - Payroll
  - Benefits Admin
  - 401(k) Admin
  - H&W Admin
  - Qualification Issues
  - Union CBA
  - Employee Relations Issues
    - Use of Job Titles
    - Comp levels

# HR/ERISA: To read-in or not to read-in

- HR/ERISA folks can often NOT get read into the deal
  - When they are read-in, it's usually at the end and there's not sufficient time to due anything other than ask a few pointed questions
- ERISA “price” issues are usually very factually intensive
  - Even legitimate price concerns can take a while to resolve
  - Complicating the matter, the seller often does not account for the organization being sold in the manner that allows for easy segregation of costs – this adds time to resolution
- As a result, HR/ERISA issues (and environmental) tend to be the last issues to close up

# Mitigating the Situation: Outside Counsel

- First, develop a close working relationship with the corporate lawyers
  - This is paramount – they’re the first to know
- Second, offer to do in-house educational sessions for the corporate lawyers on HR/ERISA issues
  - Helps to build a bridge
- Third, develop a close working relationship with the client’s HR/ERISA folks
  - Offer to develop an M&A protocol template
  - This eases the client’s resources constraints
    - HR hates nothing more than outside counsel who looks at each deal as a “new learning” experience
    - Clients have certain patterns/preferences – leverage those to your advantage

# Mitigating the Situation: Outside Counsel

- Fourth, develop a close working relationship with the client's other outside consultants
  - Actuaries and benefit consultants
  - Work out a process protocol with them as well
  - Look to understand and streamline the due diligence process
- Finally, understand and look for 'transition' issues that your HR/ERISA folks are going to have to struggle with AFTER the deal closes
  - Trapping the bear may be where the glory is
  - But, helping your client train the bear is where relationships are formed

# Best Practices

- A lot will happen quickly – time is a major pressure point
- Work out in advance how you (or your client) prefers to handle particular situations
- Consider developing an M&A Due ERISA Diligence Protocol

# **Getting Started: Doing the Deal**

# Types of M&A Transactions

- Stock purchase – same company (same liabilities), but ownership changes
- Asset purchases – buyer acquires specified assets and liabilities
- Merger – surviving entity has assets and liabilities of both companies
- Joint venture – partners may contribute assets, employees or both

# Deal Structure - **!IMPORTANT!**

- Stock – vs. – Asset – vs. – Merger
  - This is a major issue – threshold issue for everything
- Stock Deal
  - Positives:
    - Much simpler
  - Disadvantages:
    - Buyer picks up UNKNOWN liabilities
    - May involve running through an SEC process
    - Generally no step-up in tax basis



# Deal Structure - **!IMPORTANT!**

- Asset Purchase

- Positives:

- Liabilities are generally limited to those assumed
- Step-up in tax basis (more future deductions)

- Drawbacks:

- 3<sup>rd</sup> party consents may be needed
- Takes time to define/identify assets to 'sell' to buyer
- More legal work to 'transfer' legal title of stuff to buyer
- Usually a partial purchase results in 'splitting' services
- Some states impart liability on buyer who buys everything

# Deal Structure - **!IMPORTANT!**

- Merger
  - Defined: Results in the termination of one of the corporations to the transaction
  - Cash merger: shareholders of corporation going away receive 'cash'
  - Mergers can be affected in EITHER DIRECTION
    - Forward merger – The 'buyer' corporate survives
    - Reverse merger – The 'seller' corporate survives
  - Positives:
    - Relatively easy to accomplish
    - No need for title transfers
  - Drawbacks:
    - Some states impart liability on buyer who buys everything

# **Sources of information about U.S. plans and their assets and liabilities**

# Financial Statement Disclosures

- A company's financial statements and proxy provide information about:
  - Defined benefit plans
  - Other post-employment benefits (OPEB)
  - Multiemployer plans
  - Defined contribution plans
  - Executive benefits

# Public Sources of Information - 10-K

- Annual Report (10-K) Filing
  - Company website
  - FreeEdgar
- Footnote Info
  - Defined benefit plans (single-employer and multiemployer plans)
  - Defined contribution plans
  - Retiree medical plans
  - Executive/stock compensation plans
  - Major litigation

# Public Sources of Information – Proxy Statement (DEF 14A)

- Good supplemental source of benefit & compensation info for
  - Executive compensation arrangements
    - Supplemental retirement plans
    - Perquisites
    - Severance arrangements
  - Change in control agreements
  - Competitive peer group

# Public Sources of Information – Form 5500 Filings

- FreeErisa.com
  - Free info may be a bit outdated but more recent filings can be obtained at a small cost with all schedules included
- Plans that must file
  - Funded retirement plans
    - Some exceptions
  - Welfare benefit plans
    - Some exceptions

# Public Sources of Information - Other

- Multiemployer plans
- Litigation
- Retiree/alumni groups



# **A Review – Employee Benefits in Corporate Transactions**

# Identifying the Issues

- What plans does the company offer?
- Are the plans overfunded, underfunded or unfunded?
- What's going to happen to the plan in the transaction?
- Purchase price adjustments
- Controlled group liability
- Transition issues when the deal closes

# Identifying the Plans

- Identify plans from:
  - Footnotes to financial statements
  - Plan list provided in due diligence process
  - Plan documents provided in due diligence process
  - Interviews with seller's HR staff
- List of plans is usually a schedule to the M&A document

# Representations and Warranties

- Seller represents and warrants
  - Identity of plans covering employees, collective bargaining agreements, employment agreements, etc.
  - Compliance with ERISA, Code, other laws
  - Funded status of plans
  - No terminated DB plans or withdrawal liability

# Controlled Group Issues

# Controlled Group

§ 414(b), (c), (m) and (o)

- Parent-subsidiary controlled group
  - 80% or more of voting OR value
- Brother-Sister controlled group
  - 5 or fewer individuals own 80% or more
  - Using lowest %, same 5 own at least 50%
- Trades or businesses under common control

# Controlled Group Liabilities

- Defined benefit plan
  - Funding
  - Termination liability
- Multiemployer withdrawal liability
- COBRA health continuation
- Qualified plan nondiscrimination and coverage

# Defined Benefit Plans



# Is the DB plan overfunded or underfunded?

- Financial Accounting – FAS 87, 88, 132
  - Projected benefit obligation (PBO)
  - High grade corporate bond rate
  - Other assumptions specific to plan
- Funding – IRC § 412, §430
  - Accrued benefits
  - High grade corporate bond rates (yield curve)
  - Pension mortality table
- Termination-ERISA § 4001(a)(18)
  - PBGC assumptions ERISA § 4044

# Future Cost of a DB Plan

- What will be the future:
  - Impact on earnings
  - Cash contributions
- Changes in plan will impact future costs
  - Deal related
  - Collective bargaining
  - Changes in law, interest rates, etc.
- **ASK THE ACTUARY**

# What's going to happen to the DB plan?

- Seller keeps plan
  - Stand alone plan
  - Merged with another plan
- Buyer takes plan
  - Stand alone plan
  - Merged with another plan
- Plan is split between buyer and seller

# Merging a plan

Treas. Reg. 1.414(l)-1(e)-(g)

- Benefits and distribution options must be retained
- If one or both plans are underfunded, special schedule or data retention

# Dividing a DB Plan – “Spinoff”

Treas. Reg. 1.414(l)-1(n)

- If not fully funded, allocate assets as if plan terminated
  - PBGC priorities
  - PBGC assumption are safe harbor
- Surplus - no rules for dividing except within same controlled group
- Crediting interest or earnings after date of spinoff
- *De minimis* rule
  - Liabilities less than 3% of assets spun out
  - Assets transferred = value of accrued benefits

# PBGC Priority Categories

## ERISA § 4044(a):

- (1)-(2) Benefits attributable to employee contributions
- (3) Benefits of retired and eligible to retire 3 years prior to the date of the transfer, under the terms of the plan in effect 5 years prior to the transfer
- (4) Benefits that would be guaranteed by PBGC
- (5) Other nonforfeitable benefits
- (6) Any other benefits in the plan

# Purchase price adjustments

- Underfunding or overfunding at closing can impact purchase price
  - FAS assumptions
  - PBGC assumptions
  - Funding assumptions
- Adjustment of interest rate to reflect change in market conditions
- Actual values after division or transfer

# 401(k) Plan Issues



# 401 (k) Plan Issues

- Options:
  - Transfer entire plan to buyer
  - Transfer accounts of transferred employees to buyer's plan – Code § 414(l)
  - Distribute (“same desk rule” permits)
- Mapping investments
- Employer stock
- Participant loans

# Same Desk Rule

- Distributions permitted on “severance from employment”
    - If seller retains the plan, participants who transfer to buyer may receive distribution from the plan
    - If buyer takes the plan or a spinoff from the seller’s plan, no distributions permitted to transferred employees
    - Same rules for stock and asset sales
- General Counsel Memorandum 39824 (July 6, 1990)

# Mapping Investments

- Applies if participant originally selected investment option but does not make new election
- Can transfer to investment option with similar risk/return characteristics
  - If no similar investment options, can transfer to qualified default investment alternative
- Treated as if participant made the investment decision for purposes of § 404(c)

# Multiemployer Plans

# Multiemployer Plans

- Risks
  - Endangered or critical status-increased contributions
  - Withdrawal liability – not reflected on financials
  - Delinquent contributions
  - Controlled group liabilities – if other members had withdrawal
- Due Diligence
  - Estimates of funding status and withdrawal liability
  - Contribution information
  - Method used to calculate withdrawal liability
  - Required notices to/from plan

# Will Transaction Trigger Withdrawal?

- Stock sale – no, as long as contribution obligation continues unchanged
- Asset sale – ERISA § 4204
  - Buyer obligated to contribute for substantially same level of work
  - Buyer posts bond/escrow of exempt
  - Buyer inherits 5-year contribution history
  - Seller secondarily liable

# OPEB

# OPEB

- Other Post-Employment Benefits
  - Retiree benefits other than pension
- Retiree liabilities are almost always underfunded (or unfunded)
  - Coded § 419A discourages funding of retiree benefits unless collectively bargained
  - Can be funded while working



# Funding OPEB

- VEBA – voluntary employees beneficiary association – Code § 501 (c)(9)
- Grantor Trust
- Prepaid insurance
- Pension plan as a source of funding:
  - 401 (h) account
  - Section 420 transfers
    - Restrictions on employers' ability to alter retiree health benefits

# OPEB on the Financials

- Financial Accounting Standard 106 (FAS 106)
  - Requires companies to annually measure the increase (or decrease) in liability for benefits to be provided in the future over the working career of the workforce
  - Increase in the liability has to be expensed
- Liability includes benefits due to:
  - Current retirees and other inactives
  - Active employees (accruing while they work)
- Benefit obligation includes estimate of future health care inflation

# What's going to happen to the retiree liabilities?

- Seller keeps retiree liabilities
- Buyer takes retiree liabilities
  - Automatic in merger or stock sale
- Liabilities split between buyer and seller
  - Seller usually keeps retirees and inactives, sometimes those near retirement
  - Buyer usually takes only active liabilities
  - No rules on how (or whether) assets must be split

# Modifying Retiree Benefits

- No vesting under ERISA
- Employer can reserve right to modify or terminate
  - Issue is whether employer has done so
- Collective bargained benefits have been determined to survive expiration of agreement, particularly in 6<sup>th</sup> Circuit

# Other Health and Welfare Issues

# IBNR

- Incurred but not reported claims
- Seller should have accrued liability on balance sheet (often 25% of annual claims)
  - Who pays claims that come after closing?
  - Should be reflected in purchase price if buyer assumes

# Transitioning Health & Welfare Benefits

- Health benefits have to be in effect at closing
- Transition may have to be negotiated with seller or its service providers
- Issue whether seller plan becomes multiple employer welfare arrangement (MEWA) subject to state law
  - To avoid, buyer pays seller to provide COBRA coverage

# COBRA Liability in M&A

- Seller is liable for COBRA coverage for terminated employees who lose health coverage in M&A transaction
  - Applies to transferred employees in asset sale unless buyer provides same plan
  - Seller's controlled group liable as long as any member offers health coverage to employees
- Buyer becomes liable if seller controlled group stops medical coverage
  - In stock sale
  - In asset sale, only if “successor”



# Buyer as Successor for COBRA Continuation

- Buyer is successor in asset sale if business operations associated with assets purchased are continued without interruption or substantial change  
Treas. Reg. §54.4980 B-9 Q&A 8(c)
- Buyer only liable for M&A beneficiaries
  - Who lose coverage in connection with sale or
  - Who were associated with assets/entity being sold  
Treas. Reg. §54.4980 B-9 Q&A 4

# **Executive Compensation and Benefits**

# Identifying Executive Comp and Benefits

- Annual Report
- Proxy statement
- Equity programs must be filed with SEC
  - Look on the Edgar System
- Nonqualified Plans
- Employment agreements

# Golden Parachutes

- Parachute Payment defined:
  - A “disqualified individual” receives “payment” by reason of a “change in control” that in total equals or exceeds 3X of the individual’s average “base amount” (e.g., average of exec’s W-2 income from the prior 5 years)
  - Parachute payments not deductible (Code §280G)
  - Recipient has nondeductible 20% excise tax (plus income taxes) Code §4999

# Golden Parachute Issues

- Key issues for buyer:
  - Assess magnitude of change in control payments
  - Single trigger or double trigger?
    - Change of control alone (single trigger) or
    - Change of control plus termination or change in position or compensation (double trigger)
    - Are there tax ‘gross-up’ obligations?

# Severance

- Severance is covered by ERISA
- Is severance triggered by transaction even if buyer hires employees?
- Does plan give plan administrator right to interpret plan?
- Plan can be amended before closing to clarify that transaction doesn't trigger severance

# IRC Section 409A Issues

- Implications of IRC § 409A
  - Prohibited acceleration
- Review the executive agreements
  - Seller’s counsel: make sure the ducks are in a row
  - Buyer’s counsel: review the situation and make sure you understand the implications
    - Executives bear majority of the risk of failure
    - Don’t need unhappy people

# Other Qualified Plan Issues



# Minimum Coverage Transition Period

- Transition period until the end of the plan year after the year that the employer leaves or joins a controlled group  
If:
  - Coverage test passed before transaction
  - No significant change in coverageCode §410(b)(6)(c)
- Asset sales, stock sales, mergers or similar transactions  
- Treas. Reg. § 1.410(b)-2(f)
- Business acquired may be treated as qualifying separate line of business for nondiscrimination testing  
- Treas. Reg. § 1.414(r)-1(d)(4)

# Change in the Mix of Highly Compensated Employees

- Implications of population changes on IRS non-discrimination testing
  - Can have broad implications
- Definition:
  - 5% owner in prior or current year
  - In prior year
    - Had compensation of more than \$105,000 (in 2008, adjusted annually)
    - And, if employer elects, in top 20% of employees (“top paid group”)
- How to measure after transaction
  - IRS requested comments in Notice 2000-3
  - No rules yet issued

# Correcting Problems

- Seller represents that plan comply with ERISA and Code
- IRS and DOL have voluntary correction programs
  - IRS provides extended period for buyer to detect and correct defects
- Buyer may have indemnification from seller for undisclosed defects
- Survival of representations

# M&A – International Implications

# M&A Around the Global

- US Law does not apply everywhere
  - US management tends to think that it does
  - Representing a foreign company
    - Same concerns
- Benefit arrangements
  - US benefits primarily driven by US tax law
  - Foreign program (primarily in Europe) tend to be social program – may not be funded
- Employment agreements
  - Fairly rare in the US, while mandatory in many other countries
- European Works Councils
  - Not a trade union, but may have rights to consultation
  - Ultimately, can't stop the deal, but the process can slow it down

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# Questions?



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