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Impact of Merger & Acquisition ACTIVITY ON RETIREMENT

A Discussion of Options Available to Plan Sponsors

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INTRODUCTION

In a vibrant economy, merger and acquisition activity is more the norm, than the exception. Companies understand the economies of scale by acquiring competitors (sometimes larger, or much larger companies are the targets) and the efficiencies gained by entering new businesses through acquisition, rather than through development. As a result, M&A activity over the last few years has been frenetic.[1]

Unfortunately, the business decision-makers that plan and execute a merger or acquisition are not always those primarily concerned with company benefits. Consequently, the impact of M&A activity on a company's benefit structure is usually left to be dealt with as an afterthought in the M&A process, or even is ignored until after the merger or acquisition has been accomplished.

This document is intended to identify those major benefit issues that *should* be of concern to management, and to provide general guidance for implementing an analysis, evaluation, and project plan for dealing with those issues. Every benefit plan is different. Every company is different. Each M&A scenario is different. Understanding the differences is the key to successfully implementing a long-term benefit solution for the company.

What is necessary to accomplish this is to ensure that the right people are included at the right times in order to undertake a thorough analysis and smooth transition of employees and benefits. All of your advisors need to be apprised of the details of the proposed transaction, *and should be involved in determining what those details are,* in order to develop the right solutions. As is always the case in M&A activity, confidentiality is of key concern. Many times benefit service providers and consultants are not apprised of proposed, or even pending transactions because of concerns of confidentiality. These people *need* to be involved in the planning stages of the merger or acquisition — at least to the extent of its impact on benefit plans. Indeed, they may be able to assist you in performing due diligence reviews of benefit plans, and be able to spot operational and compliance issues that may not be readily apparent to other advisors or consultants. Your service providers

[1] According to the Federal Trade Commission, M&A activity has increased every year since 1991, increasing on average at a 20% rate each year.

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should be able to give assurances of confidentiality — if they cannot, then perhaps you need to find another service provider.[2]

In analyzing, evaluating, and implementing a benefits merger strategy, four stages of the processes will be discussed: (a) pre-merger planning and due diligence[3]; (b) employee impacts and communications; (c) plan design; and (d) the merger process.

PRE-MERGER PLANNING AND DUE DILIGENCE

The most important phase of the process is the pre-merger due diligence. It is during this phase that an acquirer can understand the implications of various course of action (plan merger, plan termination, or leaving the plan with the seller), and makes some preliminary decisions which can be incorporated into the corporate merger or acquisition transaction.

In order to understand the criticality of evaluating the benefit options at this stage, an employer must have a general understanding of the possible options, and the limitations on those options based on the structure of the underlying corporate transaction.

During the pre-merger planning phase, the acquirer may have not yet formulated an approach for the corporate transaction. There are two common approaches for corporate acquisitions. The first is a "stock acquisition," in which the acquirer purchases the outstanding stock of the target (or a subsidiary), acquiring the company "intact." The second is an "asset purchase," in which the acquirer purchases some or all of the assets of the target, without acquiring the "company." The advantages and disadvantages of each are beyond the scope of this discussion. Suffice it to say that with an asset purchase, the acquirer generally does not acquire any of the outstanding liabilities of the target (except those that are directly related to the assets acquired – such as purchase money mortgages and other asset liens). The benefit implications of each are also divergent. In a stock purchase, the acquired company continues to be the sponsor of any benefit plans it has in existence, and is responsible for continued maintenance and qualification. By virtue of now being the parent of the target, the acquirer would also have some responsibility for the plans.[4]

SUCCESSOR PLAN ISSUES:

In a stock purchase of a sponsor of a profit sharing plan with a "401(k)" feature, it also may be impossible to terminate the acquired company's plan. Internal Revenue Code

[2] Your legal advisors should be able to draft an appropriate confidentiality agreement that you and your service provider can enter into. If your service provider is also a fiduciary with respect to your plan(s), they may have a fiduciary obligation to maintain confidentiality with respect to the plan, and company activity that may impact the plan and its participants.

[3] Pre-merger planning refers to the period of time prior to the corporate transaction. It is during this period of time that crucial decisions concerning whether to merge plans or not will be made.

[4] In a purely legal sense, this may not be completely accurate — each ""corporate entity" would be responsible for its own obligations, including its own plans; however, the parent's responsibility is based on its economic interest in the subsidiary. The value of that subsidiary is directly related to the liabilities. Failure to appropriately maintain benefit plans (especially qualified retirement plans) may give rise to huge exposure.

§401(k)(10) essentially provides that if a sponsor of a 401(k) plan maintains another 401(k) plan (a "successor plan") at any time during the 12 months prior to the termination of the first 401(k) plan through 12 months following that termination, in which any of the participants in the terminated plan participate, then the termination of the first plan is not considered a distributable event — and distributions to participants in the first plan, as a result of the plan's termination, are disallowed. *If there is a successor plan, distributions of "401(k)" money from the terminated plan would jeopardize the qualification of both plans.*[5] The reason for this rule is to prevent an employer from terminating a plan in order to receive a distribution (for personal reasons) and then to reestablish a plan for future contributions. The first plan's termination is essentially a sham — designed to "create" a reason for distribution of assets from a plan prior to the time legitimately contemplated by law.

Theoretically, the IRS would treat the terminated plan and the successor plan as the same plan — with impermissible distributions — which is why the qualification of both plans is at risk. The rule is applied in a merger and acquisition scenario, because if the acquiring company at any time becomes the plan sponsor of a target's plan, the acquirer's existing plan may be deemed a successor plan, triggering the rules outcome.

There is no "successor plan" rule applicable to non-401(k) money. That is, any employer contributions (including matching contributions, profit sharing contributions, or money-purchase plan contributions) may be distributed upon termination of a plan, even if a successor plan exists. A plan with 401(k) money and employer contributions may terminate, merging the 401(k) money into a successor plan and distributing the employer contributions to participants. This part-termination distribution and part-merger of a plan may be useful if employer contribution sources are subject to unpalatable protected benefits, which the employer would not like to preserve in the surviving plan.[6]

This may not be a problem if the acquirer chooses to merge the plans; however, if there are reasons to not merge, the sponsor would be constrained to continued maintenance of the acquired plan.[7]

Asset Purchase Transactions:

Many companies (and their advisors) believe that if the acquisition is structured as an asset purchase, no plan level due diligence need be conducted. A better approach, however, is to always conduct a thorough review of plan features and benefits. This does several things for the acquirer. First, it allows for a glimpse at the approach the target has taken with respect to its employees. If the plans are well run, organized, documented, etc., then the company has understood the value of employee benefits to its human capital and the liabilities inherent in offering benefit plans. Second,

[5] The consequences of a plan disqualification are beyond the scope of this paper; however, generally a disqualified plan loses its tax-advantaged status, and all contributions plus earnings may be immediately taxed to the participants. In addition, deductions for contributions to the plan may be disallowed. Usually, the IRS will only recognize the tax consequences of a plan disqualification to the sponsoring company and the company's highly compensated employees, on the theory that the non-highly compensated employees are innocent bystanders in the operation and compliance activities of a plan.

[6] See discussion, infra note 15.

[7] The plan need not be active – that is, participants need not be able to continue to defer into the plan. However, the plan will have to remain in existence, with distributions processed as distributable events occur. Additionally, the plan document will have to be updated periodically for any changes in the tax code impacting qualified retirement plans.

a review of the benefit plans will allow the acquirer to understand the expectations of soon-to-be-acquired employees. Generous benefits from the target, which may not survive the acquisition, may cause employee relations problems for the acquirer. Third, the target's benefit plans may be a source of funding for acquired employees' retirement benefits. This may sound like a truism, but consider the ramifications of allowing acquired employees to receive distributions from their prior employer's plan. Historically, most of the distributed amounts will not be rolled over — either into the current employer's plan or an IRA vehicle.[8] That being the case, it can be assumed that the money is spent. Essentially, the bulk of the acquired employees will then be "starting over" in planning for their financial retirement. How many of them will be able to afford to retire at the time the employer thinks they should retire? Finally, a review of the operational and technical deficiencies should be undertaken. No matter what the other benefits of merging a plan exist, problems may be sufficiently severe to warrant a decision against merger.

Compliance Review:

This final review is typically what others term the due diligence aspect of the pre-merger planning stage. A systematic approach should be taken, concentrating on four areas: (a) review all documentation for compliance with legal requirements; (b) review all employee communications and educational material; (c) ascertain the nature of the corporate transaction and the impact of that structure on the employees and the benefit plans;[9] and (d) determine if the acquired, or potentially acquired, plans' records are up to date and accurate.

Employee Impact and Communications

Most employers will recognize the need to communicate with newly acquired employees. The old adage that you should "tell them what you're going to tell them, tell them, and then tell them what you told them" is appropriate. However, it should be modified so that your communications strategy is "tell them what is going to happen, *and why,* tell them what is happening, *and why,* and tell them what has happened, and *what they can now expect.*" It's the "why" part of the communications that is often missing. When employees are acquired, their lives are filled with a certain amount of uncertainty. They may not remain employed. They may change reporting structures. There may be different processes and procedures that govern their work. There may be new expectations and other changes that will cause anxiety levels to rise. Uncertainty about the future of their retirement plan money, especially if it was contributory, need not be added to the mix. In addition, improperly set expectations may increase the employee relations issues.[10] Trust for the safekeeping of their assets with a *former* employer may be lacking.

[8] Industry average for all rollovers is approximately 11% of total distributions.

[9] Consideration should be given to whether the employees' tenures will be continuous; whether the newly acquired employees need meet service requirements; vesting parameters; partial plan termination issues, and the like.

[10] One of the most frequent questions asked by employees is "when can I get my money from my former employer's plan?" Employees need to be reminded that retirement plan money is for retirement, and that it will remain safe, secure, and productive until their retirement or separation from service.

While implementation of a communication plan prior to the closing of a deal may be impracticable, a communications strategy should be developed, and appropriate communications with affected employees should commence as soon as the transaction is public. In addition to information about their jobs, information about options an employee may have with current plan balances will go a long way towards reducing future confusion.[11] As soon as the details of the transaction have been finalized, a transition or conversion plan detailing the process that will be undertaken to move assets from one plan to another should be distributed.[12]

Most acquirers don't realize that their existing employees have concerns that may be addressed through a communications program. Employees of the acquirer also have a certain level of uncertainty thrust into their lives. *They may not remain employed. They may change reporting structures. There may be different processes and procedures that govern their work. There may be new expectations and other changes that will cause anxiety levels to rise.* The acquirer's existing employees may well have identical concerns to the acquired employer's employees. This would be most clearly seen in the case of a "merger of equals" where management from both companies will remain in place. A transition plan or guide for these employees may be appropriate. This, of course, would be especially true if their plan features or investments were changing, as is often the case with plan mergers.

The approach a plan sponsor should take is to develop a *consistent communications program* that emphasizes five points of particular importance to participants: (1) Explain the plan and process changes that are going to impact the participants. Detail contribution levels, transaction processes, forms requests, telephone numbers, and the right people to get the right answers from for those questions that will crop up. (2) Highlight the enhancements to the plan as a result of the changes (or even as a result of the infusion of merged assets). Many times a larger plan can afford to offer more services for little or no additional cost. Lower cost "institutional" funds may be available. Technology enhancements may further the dissemination of information and educational material. Each change to a plan should be described in a positive light, as adding to the desirability of plan participation and asset accumulation for the participants. (3) Educate the participants about investment funds and the investment mapping process. Simply providing information is insufficient — a thorough campaign to maximize understanding is essential to a smooth transition, few(er) complaints, and reduced liability.[13] (4) Reassure the participants that their assets are protected, held in trust, are productive, and will be continuously invested pursuant to their elections (as mapped into new funds). (5) Participants should be aware of, and have reinforced,

[11] Many times employees are misinformed about the options they may have — including rights of distribution. If the retained employees will not be able to receive a distribution at the time of the transaction, they should be informed of that *as soon as possible.*

[12] A transition plan need not go into the gory details; however, at a minimum the communication should include: (1) investments, including new funds, mapping, where assets will be during transition, and where to get more information; (2) timing, including when can investment changes be made prior to transfer to effect mapping, last dates for loans, hardships, or other transactions; (3) expected end of the quiet period; and, (4) new features and access instructions.

[13] First Union Bank is finding this out the hard way. See: Franklin, et al. v. First Union Corporation, et al., Civ. No. 3:99 cv 344 (E.D.Va., Williams, J.). In that litigation, plaintiffs, participants in a plan sponsored by Signet Bank, which was acquired by First Union, are alleging that the mapping strategy used by First Union (which caused a non-employer stock fund to be mapped into a stable value fund) was a breach of a fiduciary duty, and gives rise to liability for the difference in the investment performance of the stock fund (approx. 160% in the first year) and the performance of the stable value fund (approx. 7% over the same period).

the general provisions of the company's benefits philosophy. Underlying the offering of every benefit plan is a corporate benefit philosophy, which governs the terms and implementation of the plan. Most defined contribution plans are designed to provide a supplemental retirement benefit (in addition to any foundation provided by a defined benefit plan), or provide a mechanism for participants to obtain tax-advantaged savings for retirement or other legitimate purposes. If the philosophy is constant for current employees, then the changes in store for them need to be put in light of furtherance of the goals established by that philosophy. If the philosophy is changing as a result of the merger activity, reasons for the change (including cost cutting, if appropriate) need to be communicated in a credible manner. Newly acquired employees need to be indoctrinated in the philosophy, understand how it will guide their retirement savings and investments, and achieve their personal retirement goals.

Suffice it to say that communications is one of the most vital aspects of plan management in an M&A scenario. Keep in mind that you cannot over-communicate change. Say it early, say it clearly, and say it often for best results long term.

Plan Design

Generally:

In most cases, assuming there are no legal impediments discovered in the due diligence phase, it is advisable to merge plans together.[14] Many practitioners take the approach that the acquired plan should be merged into, and conformed with, the acquirer's plan. The better approach is to review the two plans, identifying the best features of both, *as they relate to the new, larger, more diverse organization,* and then design a plan that meets the needs *going forward* of that organization. In an M&A situation, the company is changing. The retirement plans of the company should be expected to change, as well.

Benefits, Rights and Features:

The first step in determining what the resulting plan will look like should be accomplished in the due diligence phase of the process. It is during this phase that the acquirer should become familiar with the "benefits, rights, and features" of the target's plan, and a determination can be made of which benefits must be preserved as "protected benefits."[15]

[14] This is, of course, subject to dispute. Many lawyers take the position that a plan is a liability, and one that need not be undertaken by the acquirer. This ignores the fact that a plan is an asset to the employees, and its preservation has value. To that extent, it also has value to the employer. Keep in mind that employers sponsor retirement plans for a reason. One of the preeminent reasons for maintaining a plan is to provide retirement income to employees. This is a benefit to the employer, in that it allows the employer to be competitive in recruiting labor, and allows employers a way to allow older employees to leave the company, making room for younger, more energetic employees, with new ideas.

[15] Internal Revenue Code §411(d)(6) requires that certain benefits that have accrued to a participant be preserved. The most basic of these is that the dollar value of accrued benefits may not be reduced (except for investment experience losses) going forward. Other protected benefits include optional forms of benefit distribution (installments, annuities, and the like), and distribution timing. Features that are not protected benefits include the right to take loans, investment choices, the right to direct the investment of balances, and the right to receive hardships. Those features that are protected need only be protected with respect to benefits already accrued and may be curtailed, or eliminated, with respect to future benefit accruals.

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