M&A and 401(k): A Cautionary Tale

By Ary Rosenbaum, Esq.

Mergers and acquisitions (M&A) are transactions in which the ownership of companies, other business organizations or their operating units are transferred or combined. It was also the name of a really boring class I took at the American University Washington College of Law taught by a Professor who had zero personality and would bore me to sleep. I should know; I took him for three classes. That being said, M&A is extremely important in the world of retirement plans. Whether a business transaction is a merger, sale of stock, or sale of assets will have a tremendous effect on the retirement savings of plan participants if the acquired company and/or acquirer sponsor retirement plans. This article will bring up some important considerations as it pertains to M&A and 401(k) plans.

Any M&A deal must concern itself with any retirement plans involved in the transaction.

When you buy something, you need to make sure you identify any problems or issues that arise from purchasing a tangible asset. I would have loved to have known that my house was essentially built on sand. I might have foreseen the need to buy flood insurance. That being said, any transaction involving the stock and assets of more than one company whether it's a merger, stock sale or asset sale must deal with the fact that all retirement plans of the involved companies need to be identified and dealt with. There is no bigger buyer's remorse than a company that realized it bought another company with a defined benefit plan that is severely underfunded.

The players in the deal must identify the actual transaction

When you hear the term M&A, what you are really talking about is two possible acquisitions: a stock sale and an asset sale. The companies involved in the transaction need to determine whether the deal is an asset sale or a stock sale. It's important to identify the transaction because it will determine what course of action to take and whether the acquirer needs to even concern itself with the retirement plan of the acquired company. The asset sale is a transaction in which the assets of the target company are acquired. The asset sale could be everything that the target company has except the stock of the target company. The other type of sale is what we call a stock sale. A stock sale can include purchases of stock or partnership interests for cash, mergers in which the target company is absorbed by the acquirer and becomes a whole part of the acquirer, or various forms of reorganizations used to accomplish the absorption of the target company into the acquirer's structure.

The difference between asset sales and stock sales

Why do the players in the transactions need to identify whether the transaction is an asset sale or stock sale? There is a big difference. The big difference between an asset sale and a stock sale is that in the asset sale, the acquirer generally does not have to acquire any undesired assets or liabilities and that is going to include the retirement plans of the target company. From experience, a retirement plan is never going to be part of an asset sale if the acquirer doesn't have some sort of death wish. On the flip side, in a stock sale, the acquirer will be a successor to all the assets and liabilities of the target company, which is going to include the retirement plans

of the target company. So if the transaction involved is an asset sale, the acquirer really has no issues with the retirement plans of the target company. It's not their headache unless they decided to make it their headache by agreeing to assume the sponsorship of the plan and I always ask why anyone would want to assume someone else's headaches? If the deal involved was a stock sale, the acquirer needs to figure out what do with the target company's plan. They could do nothing and maintain two plans, merge the plans, or terminate the target company's 401(k) plan. There are concerns and issues with each path.

Maintaining two plans

Maintaining separate plans for the target company and the acquirer is the path for the ones who want to do the least amount of work. The problem is that it's a headache. Economies of scale would dictate that it would be less expensive to maintain one larger plan than to maintain two smaller plans. If the target company is still an active entity, then it still could maintain its own plan. The Internal Revenue Code has a rule that permits the acquirer to operate both plans — its own and the target company's — separately during a transition period. The period ends on the last day of the year following the year of the acquisition. What happens after the transition period is over? Well, compliance testing will need to be done where the target company and acquirer's plans are tested together. That could be a problem if the plans of the companies are handled by different providers because that would mean two different third party administrators (TPAs) may need to be involved. Keeping the status quo is the lazy person's option and so why would you deal with two problems (plans) when you only need to deal with one (one 401(k) plan where the acquirer sponsor and the target company participates as a participating employer)?

The Plan Merger Route

The merger of the target company's and acquirer's plans is often seen as the easiest path, but any path will have its own potholes. Merging the plans can be straightforward and simple as the two companies decide to merge the plans by a resolution. The merger is treated as an amendment to the plan that will survive at the end, which is usually the acquiring company's plan. Since one plan ends up disappearing after a merger, the plan document of the disappearing plan must go through an anti-cutback analysis to review any plan features and protected benefits that cannot be eliminated for benefits accrued up to the date of merger. These balances, features, and benefits must be tracked and preserved. Such features like vesting, normal retirement age, and an early retirement plan provision must be noted from the disappearing plan and preserved. While the disappearing plan is put out of existence, the Internal Revenue Service does reserve the right to audit the disappearing plan within the three years of the filing date of the final Form 5500. So that means that the records of the disappearing plan must be preserved and the disappearing plan actually needs to be reviewed before the plan merger to make sure that there are no compliance issues that may be discovered on a plan audit.

The Termination Route

The last potential route is to terminate one of the plans (again, likely the target company's plan). It's another route that has a pothole and we call that pothole "the successor plan rule". The successor plan rule is unique to 401(k) plans (and now 403(b) plans since the 403(b) regulations were implemented). It would be a great idea for the acquirer to simply terminate the target company's 401(k) plan and distribute plan assets to those participants and then have them enrolled in the acquirer's 401(k) plan. The problem is that the successor plan rule may impede that termination. The Successor Plan rule states that a 401(k) plan may not distribute amounts attributable to a participant's salary deferrals until either: (i) the employee's separation from service, or (ii) the termination of the plan without the establishment or maintenance of a "successor plan" by the employer within 12 months of termination. If the acquiring company terminated the target company's 401(k) plan and then tried to enroll the target company's employees under the acquiring company's plan, the successor plan rule would impede the termination. They say timing is everything in life and that would be true with the successor plan rule. So to avoid the successor plan rule is to have the termination before the acquiring company and target company become one employer. Even then, it could be an issue if the IRS doesn't recognize the target company and acquiring company as two different employers for purposes of the termination especially if the target company becomes a fully owned subsidiary of the acquiring company. So while the termination route looks great on paper, it's something that needs to be reviewed on whether the successor plan rule will be the stick in the wheels of termination.

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