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Caveat Emptor - Employee Benefits Considerations in M&A Transactions (Part 2)

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Introduction

Typically, the employee benefits offered by a company include not only its retirement plans (discussed in Part 1 of this Practice Brief) but also its health and welfare plans. In addition to medical insurance and prescription drug coverage (together, often known as a "health plan"), companies also offer other health and welfare benefits including vision, dental, life, disability, retiree medical, long-term care and/or supplemental/employee pay-all (*i.e.*, critical illness) insurances, employee assistance programs, and pre-tax benefits such as dependent care and healthcare flexible spending accounts through cafeteria plans.

These health and welfare benefits may be subject to many laws and regulations, including the Employee Retirement Income Security Act ("ERISA"), the Internal Revenue Code (the "Code"), the Affordable Care Act (the "ACA"), the Consolidated Omnibus Budget Reconciliation Act ("COBRA"), and possibly state insurance laws. Failure to properly comply with any of these laws, or the many rules and regulations issued under these laws, can expose the sponsor of such health and welfare benefits to significant penalties and fees and can lead to negative tax consequences for certain employees receiving the benefits. For this reason, a critical part of the due diligence process in an M&A transaction involves identifying any liabilities associated with the target company's health and welfare benefit programs.

As described in Part 1, the depth of a buyer's due diligence will depend on the type of transaction. In an asset deal, the buyer typically does not assume the liabilities associated with the seller's employee benefit plans. However, the buyer may be subject to liability in certain situations even if it only purchases the seller's assets and does not assume the seller's employee benefit plan liabilities – for example, under the COBRA default rule, which is discussed below.

In a stock deal, unless the buyer requires the target to terminate its employee benefit plans prior to the closing, the buyer assumes the target's employee benefit plan liabilities as a matter of law. Therefore, due diligence is especially critical in a stock deal so the buyer may discover any issues or hidden liabilities that could result in Internal Revenue Service ("IRS") and/or Department of Labor penalties and fees due to the target's noncompliance with applicable reporting requirements, non-discrimination rules and the ACA.

Target's Health and Welfare Plans

A company's health plan can be fully insured or self-insured. A company that sponsors a fully insured health plan pays for its employees' medical claims through a contract with an insurance company that is not subject to the requirements of ERISA, but instead must comply with state insurance laws. Claims incurred in a self-insured health plan, on the other hand, are paid from the company's general assets, sometimes through a third-party administrator (which can be an insurance company). Self-insured plans usually include stop-loss coverage to mitigate the risk of large claims. Under current IRS rules, self-insured health plans also must comply with the nondiscrimination testing rules in Code Section 105 and, if the health plan offers employees the opportunity to pay premiums on a pre-tax basis, Code Section 125.

Retiree Welfare Benefits. If the transaction is a stock sale, the buyer will want to limit its liability with respect to retiree welfare benefits. Because retiree welfare benefits can represent a substantial unfunded liability, the buyer should negotiate the cost and funding of such liabilities with the seller.

COBRA Rights. The buyer also should examine COBRA rights for the target's employees and their covered dependents ("COBRA M&A Beneficiaries") who are terminated prior to, or in connection with, a transaction. Generally, parties to a transaction are free to contractually allocate COBRA liability in a purchase agreement, but if a party fails to satisfy its contractual obligation (or the contract is silent on the allocation of the liability), the COBRA default rule will apply. Under the COBRA default rule, regardless of whether the transaction is a stock deal or asset deal, if the target or any member of its controlled group continues to maintain a health plan after the sale, the target (or that related company) is responsible for providing COBRA continuation coverage to COBRA M&A Beneficiaries.

If, however, neither the target nor any related company will maintain a group health plan following the closing of a stock deal, the buyer must make COBRA coverage available to any COBRA M&A Beneficiaries. In addition, if neither the seller nor any related company continues to sponsor a group health plan following an asset deal, and the buyer continues the business operations of the seller as a "successor employer," the buyer is responsible for offering COBRA coverage to any COBRA M&A Beneficiaries.

Affordable Care Act. The ACA added some new issues and potential liabilities that must be considered in the due diligence process. In a stock deal, the buyer may be liable for the target's health plan Employer Shared Responsibility Assessments for prior plan years if the target's health plan did not make an offer of health insurance coverage that provided minimum value and was affordable to at least 95% of its full-time employees. Because the ACA imposes large penalties on an "applicable large employer" (defined in the ACA as an employer with 50 or more full-time employees and full-time equivalent employees) under its employer mandate, a buyer considering acquiring the stock of a target that is an applicable large employer should request information from the target regarding its offers of coverage and should review its ACA reporting forms.

How to Handle a Target's Health and Welfare Plans

Although a buyer does not have an abundance of options with respect to a target's health and welfare plans in an M&A transaction, it can take the following actions:

- continue the target's health and welfare plans and allow the target's acquired employees to continue to participate in those plans;
- require the target to terminate its health and welfare plans prior to the closing and allow acquired employees to participate in the buyer's own health and welfare plans (assuming the buyer has such plans in place);
- if the buyer does not have benefit plans to cover newly acquired employees at closing, provide for the buyer's newly acquired employees to remain on the seller's benefit plans and payroll for some period after closing through the use of a transition services agreement; or
- in certain cases, negotiate with the seller about which party will retain COBRA liability.

If a transaction occurs in the middle of the plan year, the buyer also will need to consider whether to provide credit to the seller's acquired employees for expenses already applied toward year-to-date deductibles and maximum out-of-pocket expenses.

Conclusion

A buyer in an M&A transaction should carefully consider the transaction structure and the health and welfare benefit plans the target sponsors to determine what requests to make during due diligence, as well as the depth of review. Any issues discovered during due diligence that could lead to significant post-closing liability for the buyer likely will require additional negotiations between the parties. As stated in Part 1 of this Practice Brief, benefits professionals should be engaged early to review the target's benefit plans and identify as many potential issues as possible to avoid costly delays later in the M&A process.

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