Considerations for 401(k) Plan Sponsors during Mergers and Acquisitions

By Sheldon M. Geller

Corporate mergers and acquisitions create practical and legal considerations as to whether to terminate, merge, or maintain the 401(k) plan of an acquired entity. A decision to terminate, merge, or maintain an acquired company's 401(k) plan affects employees requiring a buyer and seller to stipulate and then communicate with parties charged with governance.

Critical and timely messaging is necessary to provide clarity for employees whose employers and 401(k) plans are the subject of a transaction, and thus hopefully improve employee retention.

Pre-transaction Determination

Buyers often ask how to handle the target company's 401(k) plan in a stock purchase transaction—that is, whether to terminate the target company's 401(k) plan prior to closing or to maintain the target company's plan through closing and then merge it with and into the buyer's existing plan.

401(k) plans can create liabilities and benefits for acquirers; therefore, it is advisable to engage plan sponsors, legal counsel, and investment advisors in advance of the transaction date to determine whether to terminate, merge, or maintain an acquired company's plan as well as to manage the process to avoid gaps in 401(k) plan coverage for acquired employees and to avoid other unintended consequences.

Although the structure of a transaction can dictate the acquirer's approach, the acquiring company and the acquired company can agree and thus stipulate whether to terminate, merge, or maintain an acquired company's 401(k) plan based upon a review of both parties' plans and stated objectives.

Plan Termination versus Plan Merger

Many buyers require sellers to terminate their 401(k) plan prior to closing if they do not wish to merge the seller's plan into their plan, to avoid the successor plan rule that prohibits termination distributions. In this event, the buyer would cover the acquired employees in their plan as of the transaction date (or soon thereafter) in order to avoid a gap in 401(k) plan coverage for the seller's employees.

It may be difficult to terminate the seller's plan immediately preceding the transaction's closing date because the closing date might change, and a plan termination requires a plan termination date.

Accordingly, the author has used language in board resolutions to terminate the seller's plan as of the day immediately preceding the date of the closing of the sale of the seller's company by name to the buyer's company by name, such immediately preceding day defined as the *plan termination date*. This is the date at which the seller ceases making contributions to its plan, fully and immediately vests all employer contribution accounts, and adopts amendments to effect same.

In the alternative, a buyer would merge the seller's plan into and with their existing plan post-merger to avoid the successor plan rule, preserve plan assets for retirement, and retain forfeitures to reduce future employer contributions.

Transactional lawyers generally recommend terminating a target's plan prior to closing to avoid having buyers assume operational risk. If so, the buyer would amend their plan to count prior service with the seller for eligibility and vesting purposes to enable their plan to immediately cover acquired employees the day following the transaction date, thus avoiding a gap in 401(k) plan coverage.

A seller's board would resolve to terminate its plan, establish a termination date, amend its plan to cease employee deferrals and employer contributions, fully and immediately vest employer contribution accounts, and take into account legislation requiring an amendment before the transaction closing date.

The termination of the acquired company's plan prior to closing avoids having the acquired company's plan qualification issues (if any) affect the acquirer's plan, and permits acquired employees to take a distribution upon plan termination.

Nevertheless, a plan merger would preserve the acquired company's plan assets for the benefit of acquired employees, enable the acquirer to reduce the recordkeeping fee for their plan by leveraging an enhanced plan profile post–plan merger, and provide the acquiring company with forfeitures with which to offset future employer contributions.

The acquiring company's advisors would review the documentary and operational compliance of the acquired company's plan to ensure that there are no qualification issues that would affect the buyer's plan upon merger, and to quantify the monetary exposure for any noncompliance.

Parties charged with governance are responsible for operational compliance, as recordkeepers do not monitor and employee benefit plan auditors do not verify operational compliance.

A plan termination requires the full vesting of participant accounts, which eliminates the potential for forfeitures, that the acquirer could have transferred to its plan in connection with a plan merger and used to reduce future employer contributions made to the merged plan (e.g., a financial benefit).

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A plan termination also creates a distributable event pursuant to which acquired employees may take a distribution or elect to roll over their account balance, which creates many individual transactions for the acquired company's plan, adding an administrative burden and administrative and legal fees. On the other hand, a plan merger does not require the full and immediate vesting of account balances, elimination of forfeitures and additional cost of an amendment, termination distributions, and Form 1099 reporting.

A plan termination would require acquired employees to repay their outstanding participant loans, which may be burdensome because a defaulted loan represents phantom income reported for the year of receipt.

In a *stock purchase*, the acquirer assumes the liabilities and thus sponsorship of the acquired company's 401(k) plan; therefore, it can determine whether to terminate or merge the acquired company's 401(k) plan with and into the acquirer's 401(k) plan. In an asset purchase, the acquirer and acquired company can agree and thus stipulate in the acquisition agreement to merge the acquired company's plan into and with the acquirer's plan.

The acquirer would amend its plan to count service with the acquired company for purposes of its plan to avoid a gap in 401(k) plan coverage for acquired employees. The buyer may permit the seller to adopt the buyer's plan as a participating employer thereunder for the benefit of its eligible employees if the seller's employees continue to be on the seller's payroll after the closing date. The acquirer would also amend its plan to preserve any protected benefits (e.g., form of distribution, accrued benefits) made available under the acquired company's plan to comply with the anti-cutback rule. Most 401(k) plans do not offer annuities or other provisions that would complicate plan administration.

Sellers may automatically invest their plan assets in the buyer's plan pursuant to a plan merger in like (e.g., same asset category) funds in accordance with a mapping strategy, provided advance notice is given to participants. A safe harbor protects a seller who maps to like funds with advance notice as plan assets continue to be participant-directed upon transfer and reinvestment.

Plan Merger

A plan merger is not a distributable event; thus, there is no processing of participant distributions—which would include participant notices, participant elections, participant distributions, participant rollovers, and IRS reporting—that would otherwise be required in a plan termination. Rather, the acquirer resolves to merge, distributes a notice of plan merger to acquired employees, and directs a bulk wire transfer of plan assets, including participant loans, from the acquired company's plan service provider to the seller's plan service provider for reinvestment in the seller's plan.

Accordingly, a plan merger would avoid plan distributions and rollovers, repayment of outstanding participant loans, processing of participant distributions, full and immediate vesting of employer contribution accounts (absent a partial plan termination), and distribution of multiple employee notices.

It is advisable to determine whether the acquired employer's plan is operationally compliant; that is, whether the acquired company administered its plan in accordance with its terms and applicable law—and, if not, whether any operational errors can be self-corrected prior to the plan merger.

There is a transition period extending from the transaction date to the last day of the plan year following the plan year in which the transaction took place, to terminate or merge without having to aggregate the acquired company's plan with the acquirer's plan for compliance, coverage, and benefit purposes.

The operational risk associated with a plan merger can be determined in pre-closing due diligence. Action can be agreed upon and taken in connection with the seller's plan in advance of closing to protect the buyer, if a merger of plans is the intended course of action.

Plan administrators may take corrective action, adopt retroactive amendments, and use prescribed IRS self-correction procedures to cure any defect, if they are eligible to do so. If not, then plan administrators can correct by applying under the IRS Employee Plans Compliance Resolution Program.

Self-correction is not available for plan administrators once they receive written or verbal notification of an IRS audit examination; hence the benefit of effective plan governance.

Pre-transaction Planning

It is important to engage plan sponsors, legal counsel, and investment advisors in advance of the transaction date to determine whether to terminate, merge, or maintain an acquired company's plan and to manage the process to avoid gaps in 401(k) plan coverage for the seller's employees.

The advisor's role has become increasingly important, as plan sponsors are acquisitive in a vibrant economy with little fear of recession, resilient corporate profits, enthusiasm around artificial intelligence, and expectation of interest rate cuts.

Advisors need to help plan sponsors implement strong plan governance practices in order to maintain the fiduciary and operational compliance that enable plans sponsors to transact without 401(k) fiduciary, reporting, or compliance issues. Plan sponsors need to perform triennial plan compliance reviews (as contemplated by case law) to make certain their organizations do not engage in fiduciary breaches and to ascertain whether their plans are operationally compliant.

The best performing advisors and plan administrators engage with their retirement plan committees at least annually to report on reasonable fees, fund performance, monitoring, Form 5500 reporting, and operational compliance to reduce organizational risk and be prepared for an unanticipated transaction. ■

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