

Administrative Issues Relating to Mergers and Acquisitions Involving an ESOP Company

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THIS CHAPTER EXAMINES some of the administrative issues that arise when an ESOP company acquires a non-ESOP company, is acquired by a non-ESOP company, or acquires another ESOP company. A precautionary note: this chapter deals only with administrative issues and does not discuss the multitude of legal and fiduciary issues that must also be addressed in a merger or acquisition.

Communication

When an ESOP company acquires a non-ESOP company, assuming the participants of the non-ESOP company will participate in the ESOP, there are several communications-related issues to deal with. Current ESOP participants will be very concerned about how the acquisition will affect their future benefits now that the pieces of the pie have been cut smaller. Furthermore, they will want to understand the impact of the acquisition on valuation, vesting, and distributions. New ESOP participants, on the other hand, will be at ground level, needing to understand what the ESOP is. It is important to treat this group of participants in the same manner in which the original ESOP participants were treated when the plan was first implemented, gradually getting them to the same level of understanding enjoyed by current plan participants. When a non-ESOP company acquires an ESOP company, more often than not, the ESOP will be discontinued. In this case, the ESOP participants need

to understand what this means to them and what their choices are with respect to the benefits they will receive. It is important to communicate that these benefits are, in fact, retirement benefits, and participants should be factoring this into their decision-making process. Individual projections of what their benefit would be worth at some point in the future, using reasonable growth assumptions and calculations as to the after-tax proceeds today, are usually helpful.

When two ESOP companies merge, all plan participants will want to know how the new ESOP compares with their ESOP: what the similarities and differences are in areas such as vesting, distributions, and the like. In addition, assuming the two companies handled ESOP communications differently, one of the participant groups may need to receive special attention for a period of time.

Minimum Coverage Requirements

Internal Revenue Code (“Code”) Section 410(b) provides that a qualified plan must cover a minimum number of a company’s participants who cannot be statutorily excluded. Therefore, when one company acquires another company, decisions have to be made with respect to whether or not the participants of one company will participate in the retirement plan of the other company. In many instances, because of the afore-mentioned law, there is not a choice. Fortunately, there is a provision in the law that provides at least some time to deal with this issue. Code Section 410(b)(6)(C) provides that the plans are deemed to meet the coverage requirements until the first day of the second plan year following the acquisition as long as the plans met the coverage requirements before the acquisition and the coverage under the plans has not significantly changed during the transition period. In most cases, plans are merged or participants are brought in to the successor plan much sooner than this, but it is worth noting that immediate action is not required.

After the transition period, all of the qualified plans maintained by the company must be able to satisfy the minimum coverage requirements. When different plan years are involved, the first plan year to occur will control the timing, as both plans are currently being maintained by the same company.

Crediting of Past Service

If a company maintains a plan previously sponsored by the company it acquired, it must credit the participants in that plan with past years of service for vesting and eligibility purposes. In the case of a merger of two ESOP companies, and assuming the plans are merged as well, prior service must be counted, and the change in vesting schedule rules under Code Section 411(a)(10) would have to be adhered to.

From a practical standpoint, for situations in which counting of prior service is not required, this issue is typically treated in the same manner that the initial plan sponsor treated it with initial ESOP participants. If prior service was credited when the ESOP was adopted, it would typically be credited to the participants of the acquired company.

Communicating this sticky issue is one of the greatest challenges one can face when discussing with participants the plan provisions of a new ESOP. Long-term employees never understand why their prior service years are ignored, and more often than not, this single obstacle precludes them from ever embracing the ESOP. Our approach has been somewhat effective, and even more importantly, is based on honesty. What we ask is: “If you have been here for 20 years or so, isn’t it a pretty fair assumption that you will be here for another 5 or 7 years?” Typically, they agree. We go on to ask, “What about those who have been here a year or two? Aren’t their chances of staying less than yours? And if they choose to leave and are not vested because the company chose not to give credit for prior years of service, shouldn’t the amounts that were allocated to their accounts be reallocated to yours?” We have found this argument to be most helpful in illustrating the up side of this decision.

Dealing with Other Plans

When an ESOP company acquires another company, it is not uncommon for the company that is being acquired to have maintained a 401(k) plan or another type of qualified plan. If the ESOP company also maintains a 401(k) plan, it is likely that the other company’s plan will be merged with it. In this case, there are a number of issues that must be addressed. Some of the more important issues are as follows:

IRS Filing Requirements

If two or more defined contribution plans are being merged, an IRS form 5310-A filing may be required, but generally not if the merger satisfies the requirements of Treas. Reg. § 1.414(l)-1(d). These requirements are satisfied if the sum of the account balances in each plan before the merger equals the fair market value of the entire plan assets; the assets of each plan are combined to form the assets of the plan as merged; and immediately after the merger, each participant in the plan has an account balance equal to the sum of the account balances the participant had in the plans immediately before the merger. On the other hand, if one of the plans has an unallocated suspense account, such as a Section 415 excess suspense account or an ESOP suspense account, a Form 5310-A may be required and must be filed with the IRS at least 30 days before the merger.

Protected Benefit Rules

Whenever two defined contribution plans are merged, there are certain Code Section 411(d)(6) protected benefits that must be dealt with properly. The benefits that are protected include early retirement benefits (and subsidies) and other optional forms of benefits. An optional form of benefit is a distribution form that is available under the plan with respect to a participant's benefit and is defined in Treas. Reg. § 1.411(d)-4 Q&A-1b. It includes all features relating to the distribution form such as the timing, the payment schedule, the commencement date, and the form of distribution. There are some exceptions to these rules when plans are merged, which are beyond the scope of this chapter. However, it is important to review the terms of both plans to make sure that the successor plan preserves any required protected benefits from both plans.

Timing of the Merger

If at all possible, the merger should occur at the end of the plan year of the acquiring company's plan. This will avoid having to deal with difficult issues including the special 401(k) discrimination tests, the determination of highly compensated participants, allocation issues, and so on.

Investment Choices

It would be extremely uncommon for the two plans to have identical investment options. Therefore, a determination must be made regarding the investment vehicle that will be used on a going-forward basis. Once determined, the participants who are not familiar with these options need education and must be provided with the opportunity to make new elections.

Other Issues

There are many other issues that may also need to be addressed. As an example, one of the plans may have a loan provision while the other does not. Another may be the rate of the matching contribution and perhaps the maximum deferral amounts that are permissible, given the level of the contributions to the ESOP.

If the ESOP company does not maintain another defined contribution plan, and the company being acquired maintains a 401(k) plan, the acquiring company could either continue the purchased company's plan, freeze the plan, merge the plan into the ESOP, or terminate the plan. However, if the ESOP company does maintain another defined contribution plan and the intent is to terminate the acquired company's 401(k) plan, distributions to participants may be restricted because of the rules set forth in Code Section 401(k)(2)(B). This section provides that elective deferrals to a 401(k) plan may not be distributed earlier than: (1) severance from employment, death or disability; (2) plan termination described in Code Section 401(k)(10); (3) attainment of age 59½; or (4) hardship. While these rules allow for distributions upon plan termination, the acquiring company's non-ESOP defined contribution plan would be considered a successor plan, and elective deferrals would not be permitted to be distributed on account of plan termination. However, depending on the structure of the transaction, distributions of elective deferrals may still be allowed. In a stock acquisition, the change in ownership of the plan sponsor would not typically result in an employee experiencing a severance from employment. However, in an asset sale, as long as the buyer does not assume sponsorship of the seller's plans, the acquired company's employees may still be considered

as attaining a severance from employment, and distributions of elective deferrals would be allowed.

Code Section 415 Issues

If a company acquires a company that maintains an ESOP, it is not uncommon for the ESOP to be terminated in conjunction with the acquisition transaction. If the ESOP was leveraged, and there was still debt outstanding with respect to the ESOP loan, the proceeds of the sale would be used to repay the balance of the debt. In these situations, the proceeds are often greater than the remaining debt, and the balance must be allocated to the plan participants. The plan document should dictate the manner in which these excess amounts are allocated, with the alternatives usually being either based on compensation during the year of the allocation or based on the participant's account balance. The IRS issued a technical advice memorandum in 1997 in which (reversing its earlier position) it stated the allocation of these excess amounts will not be considered to be annual additions for purposes of the Code Section 415 limitations.

Plan Termination Vesting Issues

If an ESOP is terminated in conjunction with a merger or acquisition transaction, the law requires that all active participants, as well as all former participants who have not either received a complete distribution of their vested balance in the plan or incurred a five-year break in service, must be fully vested in conjunction with the termination event.

In some cases, it may be appropriate to amend the distribution provisions of the plan before termination. If the vested balances of former participants have not been distributed, and such participants have not incurred a five-year break in service, the plan could be amended to permit an earlier distribution, which would make it possible to avoid having to fully vest such former participants. In the case of former participants who terminated without vesting, the document should be amended to provide that non-vested former participants will be deemed to have received a distribution of their entire account, and the non-vested balance will be forfeited as of the date of the deemed distribution.

Prohibited Allocation Issues

In each of these merger and acquisition scenarios, it is important to determine what impact, if any, the merger or acquisition transaction will have in the context of the Code Section 409(n) prohibited allocation rules. Because of the change in ownership, new determinations as to who is a more-than-25% shareholder will need to be made.

If the acquiring company is an S corporation, it is extremely important to determine the effect the merger or acquisition will have in the context of the Code Section 409(p) prohibited allocation rules. Because of the change in ownership structure or the possible inclusion of synthetic equity in the transaction, the impact of the transaction on 409(p) testing should be reviewed before finalizing the transaction.

Repurchase Obligation Issues

A merger or acquisition transaction could also have an impact on the repurchase obligation the ESOP will give rise to, and perhaps on the funding strategies of the plan sponsor. Therefore, prior projections should be reviewed and updated as necessary, and the plan sponsor should reexamine existing distribution policies with the new facts in mind.

A Final Note

As noted above, there are many administrative and communication issues that a merger or acquisition can give rise to, especially when one or more of the companies has an existing ESOP. The importance of addressing the communication issues early on cannot be overemphasized. Despite these issues, it is important to understand the answer to the question most frequently asked by companies contemplating an ESOP: “Will the ESOP preclude us from going public, from selling the company at a later date, or from acquiring another company at some point?” The answer is “absolutely not.” In many cases, the ESOP may actually facilitate the deal.