

Due Diligence Review of Health and Welfare Benefit Arrangements: Two Perspectives on One Process

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Many individuals who become involved in a corporate transaction are not familiar with what is known as the “due diligence process.” The due diligence process is an important part of many corporate transactions and involves a buyer’s review of the business being purchased, including the seller’s employee benefit plans. One of the many types of employee benefit plans that should be considered by the buyer during its review is the seller’s health and welfare benefit arrangements. This article focuses on this small, but important, piece of the due diligence process from both the buyer’s and the seller’s perspectives.

BACKGROUND

Before beginning the process, it is essential that the individuals involved in the due diligence process understand the structure of the transaction at issue. The structure of the transaction and the terms of its related agreement drive the entire due diligence process, and, in many cases, will determine who has certain obligations and liabilities under the seller’s various health and welfare benefit arrangements.

Many due diligence scenarios arise out of a corporate transaction in which the stock or assets of a corporate entity are acquired by another corporate entity. This analysis focuses on transactions in which a buyer purchases the stock of a seller (*i.e.*, a stock purchase transaction), but can be applied similarly to a corporate merger between a buyer and a seller. In an ordinary stock purchase transaction, the buyer will essentially take on the seller’s legal obligations under its health and welfare employee benefit arrangements.

In addition to the structure of the transaction and the terms of the agreement, other factors may play a role in how the due diligence process is completed. For example, one party may have more bargaining power than the other in a particular transaction. In those cases, the due diligence process is likely to be driven

by the party with more power. If that party is the seller, it may be able to limit the scope of the due diligence review. If that party is the buyer, it may be able to scrutinize the seller’s arrangements with a keener eye. Other factors that may have an impact on the process include the nature of any past or current relationship between the parties, the time allotted and resources available to complete the due diligence process, and the expertise of those playing a prominent role in the process.

GENERAL PURPOSE AND GOALS

The purpose and goals of the due diligence process for the buyer and the seller are, often times, very different. For example, as a result of a stock purchase transaction, the buyer will likely assume the health and welfare benefit obligations of the seller as of the closing date. In order to prepare for this undertaking, the buyer is likely to use the due diligence process to review each of the benefit arrangements maintained by the seller, and, subsequently, determine what actions it will take with respect to those arrangements after the closing (*e.g.*, terminate the arrangements, continue the arrangements unchanged, or continue the arrangements with certain modifications). The due diligence process simply provides the underlying information necessary for the buyer to make the decisions that best suit its business objectives.

Additionally, the buyer may partake in the due diligence process to uncover and quantify any legal compliance issues that may or will cause exposure to undesirable liability or create administrative burdens. This process is very important in a stock purchase transaction because the seller’s liability with respect to its benefit arrangements will become the buyer’s liability upon closing, regardless of whether or not the arrangements are continued, modified, or terminated. The buyer can use the due diligence process to assess the potential liabilities, determine the cost of necessary

corrective action needed for compliance purposes, and negotiate the overall purchase price (or require an escrow of funds) if necessary.

From the seller's perspective, the due diligence process is a means to limit its future liability by fully disclosing the particulars of its health and welfare benefit arrangements to the buyer. The stock purchase agreement between the buyer and the seller is likely to require the seller to disclose each of its health and welfare benefit arrangements, as well as represent and warrant that certain facts about those arrangements are true. During the due diligence process, the seller will deliver the documents related to the arrangements and fully disclose the particulars of those arrangements to the buyer.

Additionally, many sellers (and buyers in some cases) may want to ensure that the seller's soon-to-be former employees experience a seamless transition of benefit coverages. If each of the benefit arrangements is not fully disclosed to the buyer, the buyer may not be able to properly plan for the continuation of benefits after the closing or properly notify affected employees of coverage changes. This can lead to, among other things, disgruntled employees, disputes over coverage obligations, and potential contract breaches with respect to collective bargaining agreements. Accordingly, as a general matter, the seller will want to disclose as much information as possible to the buyer throughout this process.

INITIAL REVIEW

To put this discussion into context, the legal compliance issues related to health and welfare benefit arrangements that may be discovered as a result of the due diligence process will not typically have a significant impact on the key features of the transaction (*e.g.*, the purchase price) because (i) many compliance issues can be remedied by simple corporate action without governmental intervention, and (ii) many common compliance issues

requiring governmental intervention can be remedied at a relatively low cost and in a short period of time. This relative ease of compliance is, in part, due to the fact that health and welfare benefit arrangements are often exempt from the strict eligibility, vesting, and funding requirements applicable to other types of plans (*e.g.*, tax-qualified pension and 401(k) plans). However, for the reasons explained above, the due diligence review of the seller's health and welfare benefit arrangements has many valuable and important purposes and should not be taken lightly by either party.

In most cases, the buyer will ask to review documents and other information relating to the seller's health and welfare benefit arrangements. Most commonly, these arrangements provide for one or more of the following benefit coverages: medical, dental, vision, prescription drug, short-term disability, long-term disability, life and accidental death and dismemberment, pretax premium contributions, medical expense reimbursement, dependent care assistance, and severance.

While each transaction may have a different set of documents depending upon its structure and the entities involved, the following is a list of documents the buyer is likely to request from the seller:

- Employee handbook(s)
- Plan documents and amendments
- Summary plan descriptions
- Evidence of HIPAA compliance
- Service agreements
- Administrative forms
- Insurance and annuity contracts/stop-loss policies
- IRS Forms 5500 for the last three years
- Funding vehicles
- COBRA reports
- Short-term disability reports
- Long-term disability reports
- FAS 106 reports (retiree health and life)
- Individual arrangements (such as any individual life insurance

policies, individual severance agreements, etc.)

- Evidence of other welfare arrangements, such as severance policies

There are situations in which the buyer will not have the time, resources, or desire to undertake an exhaustive review of the relevant documents. The extent of the buyer's due diligence review is a business decision. There is no legal obligation, *per se*, to partake in the due diligence process, but it provides the buyer with an opportunity to discover actual or potential problems (that it may inherit after closing) during the initial stages of the transaction.

The seller should attempt to timely provide the buyer with current documentation that fully satisfies the buyer's requests. Transfer of these documents early in the due diligence process can serve many purposes, including strengthening the buyer's confidence in the seller's business and level of competency, keeping the communication between the parties positive, and avoiding any closing delays due to a failure to complete the due diligence process.

SPECIFIC ISSUES TO CONSIDER

While every issue that may arise throughout the due diligence process cannot easily be enumerated in a comprehensive listing, there are certain issues that deserve focused review. Some examples are described below.

AMENDMENT AND TERMINATION PROVISIONS

As mentioned above, one of the goals of the due diligence process is to provide the buyer with information to determine what it will do with the seller's benefit plans after the transaction is complete. The buyer should assess the plans' and insurance contracts' amendment and termination provisions to determine under what circumstances and through what processes the plans can be amended and/or terminated. If the

plans include restrictive amendment and termination provisions (or the same is effectuated through a collective bargaining agreement), the buyer's flexibility as to the provision of benefits decreases.

RETIREE MEDICAL BENEFITS

Retiree medical plans typically provide health insurance to retired employees who have worked a minimum number of years with a company. These arrangements are of particular concern during the due diligence process because their maintenance can result in substantial future costs due to longer life expectancies of plan participants and the increased cost of prescription drugs and medical technology. Many of these retiree medical plans were established decades ago. And, in many cases, the funding (if any) of these plans has not kept pace with the rising cost of health care. Of particular importance, in addition to the amendment and termination provisions providing the buyer with a right to discontinue or change benefits, described above, is the existence of any employee communications that deem to preserve retiree medical benefits for current retirees. Accordingly, individuals evaluating retiree medical plans should review the future costs and/or liabilities related to these arrangements, including the existence and status of any funding vehicles, and any supplemental documentation about the plans. A plan that provides prescription drug coverage for Medicare-eligible participants should also be reviewed for compliance with applicable requirements mandated by the Center for Medicare and Medicaid Services.

SELF-INSURED BENEFIT ARRANGEMENTS

Although many companies contract with a third-party insurer to control medical care costs and limit risk, some companies choose to self-insure (*i.e.*, act as their own insurer by maintaining premium rates and

paying the entire cost of the health care services utilized by employees, subject to cost sharing by the employee). Self-insured plans that wish to cap their potential risk can purchase stop-loss insurance coverage, which limits liability in the case of catastrophic events or other rare but highly expensive treatments. During due diligence, self-insured plans require extra attention because they inherently carry greater risk and an increased chance of potential liability compared with traditional insurance under which a company has transferred most or all of that risk to a third-party insurer.

Additionally, self-insured plans must be examined to make sure that they do not discriminate in favor of highly compensated individuals (HCIs) as to participation or benefits pursuant to Internal Revenue Code Section 105(h). If a self-insured plan is found to be discriminatory, the benefits of HCIs will be considered taxable to them. For example, if a plan pays out \$100,000 on behalf of an HCI for a heart surgery and the plan is found to be discriminatory in favor of HCIs, that \$100,000 benefit will be considered taxable income for the HCI. The buyer may want to assess any impact on such employees.

VESTED BENEFITS

While most health and welfare benefits are not intended to vest, the terms of the relevant plan documents may inadvertently create a vested benefit. Because accrued vested benefits cannot be reduced or eliminated at the will of the plan sponsor, during a due diligence review, the buyer should assess the existence and potential future costs of any accrued vested benefits and determine if future vested benefits can be curtailed.

MEWA

A multiple employer welfare arrangement (MEWA) is an employee welfare benefit plan that is established or maintained for the purpose of offering or providing benefits to the employees of two or more unre-

lated employers. MEWAs are typically agreements between smaller companies that are able to negotiate better terms by joining together. In general, these plans should be reviewed to determine if any provisions restrict an employer's ability to cease or change participation in the plan. Many MEWAs set up multiple employer trusts (METs) to fund related health benefits. During the due diligence process, METs should be examined to determine if they are self-funded, funded through insurance, or a combination thereof, in addition to assessing any future liabilities and potential tax consequences.

LIFE INSURANCE

A buyer should also pay close attention to the myriad of tax consequences involved with group life insurance plans and individual policies to ensure the plan does not unexpectedly increase the buyer's tax liability. This review includes looking at the type(s) of life insurance provided to employees, ownership of the insurance policies, the amount of the benefits, the designated beneficiaries, and, for group plans, compliance with nondiscrimination in favor of highly compensated individuals and the regulatory ADEA safe harbor (or cost-justified rates for older employees).

DEATH BENEFITS

In addition to life insurance, an employer may provide a direct payment to the survivors of an employee following the employee's death, normally out of the employer's general assets. The tax treatment of these plans depends largely on how they are structured, whether the employer pays for all or part of the benefit, and the amount of the benefit. These plans must be evaluated to determine potential future liability in terms of premium payments, payment of benefits, and possible tax consequences.

DISABILITY

The seller may maintain one or more disability plans to compensate its employees for income lost due

to periods when they are unable to work because of injury or illness. Like other insurance policies, tax consequences vary depending on how they are structured. For example, if an employee contributes after-tax dollars to a long-term disability (LTD) plan, LTD benefits paid to the employee will not be subject to income tax. If the employer contributes to the LTD plan, those contributions are exempt from income tax for the employee and tax deductible for the employer, but the benefits paid to the employee are subject to income tax. In conducting due diligence, the buyer should assess these possible adverse tax consequences on employees.

In addition, with respect to short-term disability (STD) plans, the buyer may want to determine whether the STD plan is structured as a "payroll practice" rather than an ERISA plan, because a payroll practice must be in compliance with applicable state law.

FLEXIBLE SPENDING ACCOUNT (FSA)

Flexible spending accounts (FSAs) are typically part of an Internal Revenue Code Section 125 cafeteria plan that allows an employee to defer a portion of his income on a pretax basis. These pretax dollars can be used by the employee to reimburse medical expenses or pay for dependent care expenses. One disadvantage to an FSA is that it operates on a "use it or lose it" basis, meaning that money within an FSA not spent during the tax year (with possible limited extensions) is surrendered. If

the buyer does not continue the seller's plan, employees can use deferred income only to reimburse expenses incurred before closing, and may be forced to forfeit some of these dollars. The buyer may want to assess any such impact on employees.

VEBAS

A Voluntary Employees' Beneficiary Association (VEBA) is a funding vehicle through which benefits such as life insurance, disability payments, and health benefits are provided. VEBAs can be set up in a number of ways, through trusts, corporations, or associations, and can be structured so that the income earned will not be taxed. Nondiscrimination requirements apply to VEBAs, as well as restrictions on who can and must be entitled to voluntary membership, the level of funding, and the type of benefits provided. VEBAs should be reviewed to assess potential liabilities, future costs, and options the employer has with respect to the VEBA.

SEVERANCE

Severance plans and arrangements provide compensation to employees whose employment terminates, normally due to an involuntary termination by their employer. In a stock purchase transaction, the parties should determine the extent of the benefits offered and ensure that the benefits will not be triggered for any employees offered comparable employment with the buyer. Special consideration needs to be given to

severance plans and arrangements due to the impact of new Internal Revenue Code Section 409A, which may limit distribution options under certain plans and arrangements.

CONCLUSION

The buyer's and seller's perspectives as they relate to the due diligence review of health and welfare benefit arrangements within the context of an ordinary stock purchase transaction can be drastically different. However, it is imperative that both the buyer and the seller have a common understanding of the process and what each party hopes to achieve as a result of its completion. The issues that can arise are vast and varied but are typically a small part of a much larger whole. That said, the health and welfare benefit plan issues that may arise can be significant and costly and, therefore, should be reviewed thoughtfully. ☉

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