

## What's New in M&A:

### Scrambled EGTRRA with a Side of Enron

The past several months have seen yet another legislative shake-up of benefits law, albeit one that produced many positive changes for employers and employees. The Economic Growth and Tax Relief Reconciliation Act (“EGTRRA”), signed into law by President Bush on June 7, 2001, resolved some thorny problems for 401(k) plans, but created some others. In addition, no one can talk these days about 401(k) plans without somehow mentioning Enron. Who am I to buck the tide?

#### Repeal of the Same Desk Rule . . . Well, Sort Of

Probably one of the most despised items of benefits law prior to EGTRRA was the same desk rule and its labyrinthine effect on 401(k) distributions in an M&A context. Pre-EGTRRA, unless a transaction fell within certain very narrow exceptions, a 401(k) plan was prevented from making distributions to employees of the seller who went to work for the buyer. Sometimes, the selling plan sponsor could take action to permit distributions, but this action generally had to take place prior to the closing of the transaction. Getting the seller and buyer to discuss this in the middle of heated and often high-speed negotiations was a true challenge. Even if you accomplished that task, asset sales often created a situation simply by their structure in which there was no way to effect distributions to employees who were hired by the buyer.

The same desk rule's impact on ongoing administration of the seller's plan, as well as the morale of the acquired employees of the buyer, was significant. The seller's plan had to continue to account for the funds belonging to people who no longer worked for it (and continue to pay the administrative costs in relation to that accounting).

Employees were distressed because they were put in the position of leaving their pre-tax savings in the hands of a company that literally sold them to someone else. The buyer and the seller, who may have become antagonistic toward each other during the transaction, were forced to stay in contact in order to communicate about employment status and current mailing addresses of the acquired employees.

All in all, it was a “no-win” proposition. Everyone, including Congress, knew it. As a result, elimination of the same desk rule made it into one or another piece of legislation for years before EGTRRA. It took until last year for the repeal of the same desk rule to be attached to a bill that became law.

Prior to EGTRRA, section 401(k)(2) permitted distributions only on “separation from service” (a phrase with a checkered past that was not deemed to include the movement of an employee from the seller’s payroll to the buyer’s, if the job was substantially the same). EGTRRA changed this phrase to “severance from employment,” and that change made the same desk rule problem obsolete. Now, an employee’s termination of employment with a seller and rehire by a buyer constitutes a severance from employment. Distributions to the departing employees are permitted. The buyer may, at its option, permit rollovers from the seller’s plan to its plan. The employers are happy, the employees are happy, plan advisors are ecstatic.

There was a nervous moment, however, when the law passed. Along with the repeal of the same desk rule, Congress eliminated what it perceived to be now superfluous exceptions to the rule. One of the exceptions, the disposition of subsidiary rule of the old section 401(k)(10)(A)(iii), permitted distributions to employees of a

subsidiary that participated in the parent's 401(k) plan when the subsidiary's stock was sold to an unrelated buyer.

For example, employees of a sold subsidiary are still working after the transaction for the same company as before the transaction. Therefore, it is clear that they have experienced neither separation from service nor severance from employment. As a result, the elimination of the disposition of subsidiary exception created a new problem: distributions that *were* permitted prior to EGTRRA were suddenly impermissible. Yikes!

IRS guidance on this issue came in the form of General Counsel Memorandum 39824, which predated the codified disposition of subsidiary exception. Under the GCM, distributions were permitted to employees of a sold subsidiary if certain rules were met. Nonetheless, a GCM is fairly far down the IRS guidance food-chain, and practitioners were a little nervous about these distributions.

Enter the Treasury, in the role of the hero of the story, which issued Notice 2002-4 earlier this year. [2002-2 I.R.B. 798] That notice clarified (for anyone who wondered) that distributions from a 401(k) plan to participants of a sold subsidiary are permissible so long as the subsidiary does not sponsor the plan after the sale (which was one of the requirements of GCM 39824, as well). Neither the Notice nor the GCM says how rapidly the subsidiary must take action to cease its participation in the parent plan. The safest route is to make sure that the subsidiary does not participate in the parent's plan at all after the transaction is complete. As a result, pre-transaction planning by the employers is likely still needed to ensure that the subsidiary's participation terminates concurrently with the closing of the transaction. The plan document should be consulted to confirm

what is needed – sometimes an amendment, sometimes simply an action by the subsidiary’s board of directors.

And we all live happily ever after ....

#### Catching Up with Catch-Up Contributions

EGTRRA authorized 401(k) plans (and 403(b) plans, 457 plans, and IRAs) to add a new benefit for participants who are age 50 or older. If the plan permits, these older participants may elect to contribute amounts in excess of their normal deferral limitations. The maximum amount of these “catch-up contributions” is \$1,000 for 2002, and will increase at the rate of \$1,000 per year until it reaches \$5,000 in 2006. [IRC §414(v)]

Hidden deep within this new law is a “universality” requirement. [IRC §414(v)(4)] The proposed regulations issued by Treasury make it clear that the IRS will take this requirement seriously. [Prop. Treas. Reg. §1.414(v)-1(e)] Specifically, the requirement says that, if a company permits some participants in a plan that accepts deferrals to make catch-up contributions, that availability must be extended to all participants in all deferral-accepting plans of the employer (except 457 plans [*see* Prop. Treas. Reg. §1.414(v)-1(e)(2)]). For this purpose, “employer” includes all IRC §414 companies – that is, all members of the controlled or affiliated service group. [IRC §414(v)(4)(B), Prop. Treas. Reg. §1.414(v)-1(a)(5)(i)]

In an M&A context, this means that, if a buyer acquires the stock of a target and the target sponsors a 401(k) or 403(b) plan, the buyer’s and seller’s plan must both either provide for catch-up contributions or not provide for them. This rule is particularly problematic in 2002, as service providers scramble (at different rates) to enable

employers to add this provision to their plans. So, what should be done for the buyer whose plan institutes catch-up contributions effective May 1, 2002, if the target's recordkeeper won't have the systems needed to deal with catch-ups until August? Not incidentally, some states have not adopted legislation to permit the exclusion of these additional deferrals from state income taxes. If one of the companies in the group resides in a non-comforming state, it may be hesitant to add catch-up contributions at a time when the local tax impact of these contributions is unknown. This also contributes to the desire of companies within a controlled group to institute catch-up contributions at different times.

What to do? The Treasury came to the rescue yet again. Under the proposed regulations, the buyer's and seller's plans must be updated as soon as administratively feasible, but not later than the end of the transition period under Code Section 410(b)(6)(C). This transition period begins on the date of transaction closes and ends on the last day of the plan year following the plan year in which the transaction occurred.

Example. A stock purchase happens on May 1, 2002, and the buyer and target both sponsor 401(k) plans with calendar plan years. The plans do not absolutely need to be brought into compliance with the universality requirement until December 31, 2003. Furthermore, sympathizing with the fact that 2002 is a transition year, Notice 2002-4 provides that plans do not have to be in compliance with the universality requirement in any event until October 1, 2002. [Notice 2002-4, Section V]

#### Enron and M&A: Thoughts and Observations

For those of us who practiced in the benefits area before 1990, it has been amazing to see the American public become conscious and even conversant in retirement

planning. Everyone knows about 401(k) plans, and it seems like just about everyone has the opportunity to participate in one. (I knew that I'd entered the world of 'N Sync and Britney Spears when my 15-year-old son's girlfriend asked me to explain what a 401(k) plan is. Well, maybe not, but it was nice to be asked nonetheless.)

The positive public image of 401(k) plans took a huge plunge with the Enron debacle. Suddenly, having money in an employer plan – your own money, no less – doesn't seem to people as the safest thing in the world. And, if the money is invested in employer stock, conventional wisdom is that you may as well take it to Vegas.

Stripping off the hyperbole with which the press and Congress have surrounded Enron, we are left with a few naked truths that deserve mention. First, people are more conscious now of the potential for litigation in the 401(k) arena, giving all the concerns that we have had over the years with fiduciary responsibility more credence. Decisions that surround 401(k) investments – from the selection of funds that are made available to participants to the timing of a blackout period necessitated by a change in recordkeeper – must be looked at thoroughly. There is always a possibility that these decisions will be scrutinized by plaintiff's counsel, a judge, and a jury, not to mention the Department of Labor. (A word to the wise HR manager or vice president: notice how prominently the Enron class action complaint names the members of the Plan Administration Committee as individual defendants. And, remember that fiduciaries are *personally* liable for losses occasioned by their breach of duty.)

All of this concern is exacerbated in an M&A context, when employees are already nervous. Delays in making permissible distributions from the seller's plan or changes to the target's plan following the transaction, for example, can increase

participant concern. In the wake of Enron, participants are even more scared than they are customarily when their company is purchased, and they are more cognizant than ever before that some legal action is possible to protect their interests. In this environment, it is reasonable to expect the amount of ERISA litigation, as well as the threats of such litigation, to increase.

*Changing Investment Fund Choices After a Plan Merger.* A good example of a fiduciary decision made in an M&A situation that gave rise to a lawsuit actually pre-dates the Enron scandal. Signet Banking Corporation (“Signet”) was acquired by First Union Corporation (“First Union”) in 1997. Signet sponsored a 401(k) plan, in which its employees were permitted to invest their accounts in a selection of options, including several of Signet’s proprietary mutual and collective trust funds. In 1998, First Union merged Signet’s 401(k) plan into its own plan, and modified the investment options available for the former Signet accounts to those offered in the First Union Plan. Those options included First Union proprietary funds.

Former Signet employees sued, saying that this was done for First Union’s benefit, and that the Signet funds performed better than did the First Union funds. Therefore, the plaintiffs argued, the change in funds was a breach of First Union’s fiduciary duties. [Franklin v. First Union Corp., 84 F.Supp.2d 720 (E.D. Va. 2000)]

The case was settled with the fiduciary questions left undecided by the court. Nonetheless, this case highlights how a decision made by buyers all the time – to convert the target’s plan to the same recordkeeper as the buyer’s plan, often in connection with a merger of the plans – needs to be examined more carefully than originally thought. The mere decision to do this can give rise to a lawsuit for fiduciary breach.

Would the former Signet employees have won the lawsuit? Who knows? Regardless, being the target of a fiduciary breach lawsuit has its own unpleasantness.

But, perhaps, First Union was not acting in a fiduciary capacity at all when it changed the funds available for the 401(k) plan. The Department of Labor has said in a different context that the decision to adopt, amend, or terminate a plan is a settlor function – that is, it is an action by the employer in its capacity as the employer, and not as a fiduciary of the plan. [See, e.g., DOL General Information Letter to Kirk Maldonado, dated March 2, 1987] This would lead one to believe that the decision to terminate the plan of an acquired subsidiary or to merge the plan into the buyer’s plan would not be a fiduciary action, and First Union would not be liable in a lawsuit.

Nonetheless, a buyer should be conscious that someone might claim that the participants were harmed by this decision, that it was done only to benefit the buyer, and that it constitutes a fiduciary breach. Furthermore, implementation of the decision is also a fiduciary action, so that delay or ineffectiveness in that process can produce a fiduciary breach. The plan administrator and employer should both be careful to make sure that decisions are implemented properly. Last, the choice of funds to offer participants in a self-directed plan is also a fiduciary decision, and that selection should be made in compliance with ERISA’s fiduciary requirements.

*Talking about Plan Investments.* Another aspect of Enron highlights an additional M&A-related issue. The Enron participants claim in their lawsuit that various corporate officials (including Plan Administrative Committee members) encouraged the investment in employer stock. The Enron plaintiffs claim that this was misrepresentation of the value of the stock as a good retirement plan investment. Under Varity v. Howe, a

plan sponsor that make misrepresentations about benefit plans can be found liable for breach of fiduciary duty. [516 U.S. 489, 116 S.Ct. 1065 (1996)]

In today's environment, a buyer must be very careful about how it characterizes plan changes. While it is normal for a buyer to try to convince acquired employees that its benefits are as good or better than they were before the transaction, it is important that comments made in employee meetings or communications be truthful.

*Legislative Changes and Employee Communication.* As a result of the Enron events, Congress has begun attempting to enact legislation that will permit better investment education for participants. In addition, the proposed legislation requires advance notice of blackout periods (which common sense likely encouraged employers to give in most cases anyway). There is a new premium on truthful communication with employees, and this communication may be the best thing that an employer can do to minimize the possibility of litigation. It's also good practice for employers in an acquisition setting, with nervous employees watching every move for signs of what will happen to them next. So, the lesson of Enron may be one of common sense and good business in the benefits and M&A contexts.