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Employee Benefits

ACA Considerations in M&A Transactions

Mark E. Bokert and Alan Hahn

This column highlights some of the unique issues raised by the Patient Protection and Affordable Care Act in the context of corporate transactions.

One of the most difficult aspects of any corporate transaction is determining how the seller's employees should be treated as part of the deal, including the appropriate transition from the seller's employee benefit plans to the buyer's plans. The treatment of employees and employee benefit plans has historically been influenced by a number of factors, including the form of the transaction and an evaluation by the buyer of any liabilities associated with the employees and plans. Prior to the passage of the Patient Protection and Affordable Care Act (the ACA), there were a set of risks recognized by buyers in regard to health and welfare benefits that needed to be considered as part of the buyer's "due diligence" process, and in many cases both buyers and sellers understood the risk attendant to these sorts of plans. For example, buyers would need to evaluate whether the seller complied with the terms of the policies and applicable law, including COBRA. In addition, buyers needed to evaluate the impact of the transition to the buyer's plans, including cost considerations and the appropriate time to transition employees from the seller's plan. In short, buyers and sellers have been accustomed to the notion that employee benefits in corporate transactions, and particularly health and welfare plans, are critically important. Despite this appreciation, it is less clear that buyers and sellers fully appreciate the changes wrought by the ACA. A cautious buyer will recognize that the due diligence process associated with health and welfare plans has become even more complex with the passage of the ACA

Mark E. Bokert is a partner and co-chairs the Benefits & Compensation Practice Group of Davis & Gilbert LLP. His practice encompasses nearly all aspects of executive compensation and employee benefits, including matters related to equity plans, deferred compensation plans, phantom equity plans, qualified retirement plans, and welfare plans. Mr. Bokert may be contacted at *mbokert@dglaw.com.*

Alan Hahn is a partner and co-chairs the Benefits & Compensation Practice Group of Davis & Gilbert LLP. His practice is devoted to advising clients of all sizes, including in the design and implementation of a wide variety of creative, unique, and tax-effective employee benefit plans and programs. Mr. Hahn may be contacted at *ahahn@dglaw.com*.

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and its implementing regulations. Now, with the ACA employer mandate being fully implemented, buyers and their counsel would be well advised to consider unique issues raised by the ACA in the context of a corporate transaction. This article will highlight some of the attendant issues.

ACA Implementation and Overview

The ACA is a complex statute, with its various provisions being rolled out over time. Recently, the pace of the rollout has increased, and by now, most of the ACA's major requirements have become effective (there is, of course, more to come, including the Cadillac Tax and an update to the Internal Revenue Service (IRS) nondiscrimination rules). Failure to comply with the ACA can subject companies (and individuals) to significant penalties. While most companies subject to the ACA have (hopefully) consulted with their legal advisors about how best to comply, the ACA may nevertheless create headaches for otherwise compliant companies in the context of corporate transactions. Unfortunately, the IRS has released only limited guidance with respect to the ACA in corporate transactions, leaving companies to infer how best to comply.

The provisions of the ACA impacting employees include certain market reforms that govern the terms and conditions of group health plans, including prohibitions on pre-existing conditions exclusions and lifetime and annual limits, the provision of preventive care benefits without cost sharing, and coverage of dependent children to age 26. If a group health plan fails to comply with the market reforms, it is subject to a $100 per person per day excise tax for each day that the failure exists.[1]

Additionally, under the ACA, employers with 50 or more full-time employees ("applicable large employers") must offer health care coverage to at least 95 percent of their full-time employees (70 percent for 2015), and such coverage must be "affordable" to the employee; this is commonly called the "employer mandate." If a large employer fails to offer health coverage to at least 95 percent of its full-time employees and their dependents and even one employee receives subsidized health coverage on a public exchange, the employer will be subject to a penalty equal to the number of all full-time employees, less 30, multiplied by one-twelfth of $2,000 (indexed) for each calendar month in which such failure occurs (this is sometimes referred to as the "(a) tax").[2] Even if an employer offers health coverage to at least 95 percent of its full-time employees and their dependents, an employer will nevertheless be subject to a penalty if the employer-offered coverage is not affordable or does not provide minimum value. This penalty is equal to the number of full-time employees who actually obtain subsidized coverage multiplied by one-twelfth of $3,000 (indexed) for each such failure (this is sometimes referred to as the "(b) tax").[3] Actual liability under the (b) tax is capped at the maximum potential (a) tax.[4] These taxes accrue on a legal entity by legal entity basis.

Beginning with the 2015 calendar year, large employers must report their compliance with the employer mandate to employees and the IRS. In order to comply with the reporting requirements, employers (and their insurance providers if the plan is fully-insured) must complete the applicable forms indicating, for each full-time employee, among other information, (i) whether an offer of coverage was made for each month of the calendar year, (ii) the lowest cost option of coverage offered for each month of the calendar year, (iii) whether the employee enrolled in the offered coverage or, if no offer was made, why no offer was made, and (iv) information about any dependents who enrolled in the offered coverage. For 2015, failure to comply with the reporting requirements may result in a penalty of $260 per form.[5] If the IRS determines that there was an intentional disregard of the reporting requirements, it may impose additional penalties.

The ACA provides that any reference to an employer includes a reference to any predecessor of such employer.[6] Unfortunately, the final regulations do not define predecessor employer and instead reserve it for future definition.[7] However, the preamble to the final regulations provides that taxpayers should rely on a reasonable good faith interpretation in determining whether an employer is a predecessor employer, and may consider the rules developed for purposes of determining whether wages paid by a predecessor employer may be considered as having been paid by the successor employer.[8] In a stock deal, the buyer will presumably be deemed to be a successor employer. It is unclear, however, what position the IRS will take with respect to asset deals. It may be that parties in an asset deal can apportion responsibility as they do for COBRA continuation coverage, but the IRS has not yet issued additional guidance. In the meantime, buyers will likely generally want to assume that they will be deemed to be a successor employer and will therefore be liable for any failures of the seller. Additional analysis may be warranted in the event of an asset deal in which substantially all of the seller's assets will *not* be acquired, and/or where the seller will otherwise continue as a going concern post-transaction.

Initial M&A Considerations

As an initial matter when contemplating a corporate transaction, buyers should determine whether the seller company is subject to the ACA. For larger transactions this may be obvious, but more careful consideration may be warranted for smaller sellers. In determining whether a company has 50 full-time equivalent employees, employees of all companies in the controlled group of corporations pursuant to Section 414 of the Internal Revenue Code of 1986, as amended, are included. Buyers should consider whether there are any other companies that would be considered to be in a controlled group of companies with the seller and, if so, whether their existence means that the seller is subject to the ACA.

Even if the seller and all other members of its control group do not have 50 or more full-time equivalent employees, there may nevertheless be a concern if any individuals have been misclassified. Because misclassification of independent contractors is a concern for other reasons, most buyers already review employee classifications. Now buyers must conduct an additional level of analysis and consider whether any misclassifications would cause the seller to become subject to the ACA (*i.e.*, if the independent contractors are in fact employees, does the seller actually have 50 or more full-time employees?). If the seller is subject to the ACA, then they likely failed to make an offer of coverage to the misclassified employees, meaning that the seller may be subject to ACA penalties. Buyers should analyze whether the extent of the misclassifications means that offers of coverage were made to fewer than 95 percent of the seller's full-time employees, making the seller potentially subject to the (a) tax.

Buyers should also keep an eye out for any indication that a seller has deliberately reduced an employee's hours below the 30-hour per week requirement or has otherwise managed employee hours to avoid making an offer of health coverage. Although the ACA may not expressly prohibit employers from reducing an employee's working hours in the ordinary course, doing so may open companies up to liability in the form of class action lawsuits. In May 2015, a class action lawsuit was filed against Dave & Buster's, Inc. alleging that employees' hours were involuntarily reduced beginning in June 2013 because ACA compliance would have been too expensive.[9] The Dave & Buster's case may involve unique facts, in particular that the store's general manager told employees during a staff meeting that to avoid the cost of complying with the ACA, Dave & Buster's planned to reduce most employees' hours below the ACA's 30-hour per week threshold. Nevertheless, buyers should be aware of the risk of class action lawsuits if it appears that a seller may have deliberately prevented employees from working 30 hours per week.

Other Due Diligence Considerations

Buyers typically already ask for all plan documents and review them in the course of conducting due diligence. In addition to the documents on most diligence request lists, buyers should also be sure to request the summary of benefits and coverage, required by the ACA, for each group health plan in which the seller's employees can participate. Buyers should also ensure that they understand how the seller makes the offers of coverage and that the offers are compliant. For example, are offers made in languages other than English? Buyers should request copies of open enrollment and initial enrollment packets provided to employees. Buyers should also request examples of the seller's IRS reporting forms.

Buyers also should review the plans with a different eye. Below are a few items to consider. Failure to comply with the below may subject the plan sponsor (or its successor) to significant excise taxes.

- Do any plans purport to be grandfathered under the ACA? As we move further away from the ACA's initial effective date this becomes less likely, but nevertheless, some plans have tried to maintain grandfathered status. Grandfathered plans are exempt from certain aspects of the ACA, but strict requirements must be met in order for the exemptions to apply. Buyers should carefully review whether those requirements have been satisfied.

- Does the seller maintain any premium reimbursement arrangements? Under the ACA, premium reimbursement arrangements are treated as group health plans and are therefore required to comply with the ACA. However, they typically violate the ACA (*e.g.*, they usually do not pay for preventive care).

- Does the seller maintain any health reimbursement arrangements (HRAs)? HRAs are also considered group health plans under the ACA. Generally, in order not to run afoul of the ACA, an HRA must be an "integrated HRA," meaning that they are only used in connection with another group health plan that satisfies the ACA. Buyers should consider whether the requirements for an integrated HRA are satisfied.

Document Considerations

In addition to the standard representations and warranties, buyers should consider adding the following to address specific ACA issues.

- A specific representation that summaries of benefits and coverage have been timely provided to all participants.

- If due diligence uncovered any grandfathered plans, or if there is otherwise concern that there may be a grandfathered plan, a representation should be included indicating that any group health plan intended to be a grandfathered plan has satisfied the requirements since March 23, 2010.

- A specific representation that the seller has complied with the reporting requirements under the ACA.

- If not already addressed elsewhere, a representation that all service providers have been properly classified.

Because there may be a significant period of time between the ACA compliance failure and the imposition of excise taxes, buyers should also ensure that the representations with respect to the ACA are fundamental representations that survive closing.

Buyers will also want to ensure that they have adequate information to accurately report offers of coverage post-transaction. If the seller will continue post-closing, the transaction document should specify who bears responsibility for satisfying the reporting requirements for the year of the transaction for any months prior to closing. A covenant should obligate the seller to provide the buyer with any information necessary to meet these obligations. If the seller company uses the lookback method to determine full-time status, this information will also be important for properly applying the lookback measurement method post-transaction, as discussed below.

If significant issues are uncovered during due diligence with respect to the ACA, buyers should consider how to address them in the deal documents. For example, in an asset deal, buyers may wish to specify that neither the health plans nor their associated liabilities will be assumed to the extent this is possible. However, in that case, the buyer must be in a position to bring the acquired employees onto its plans immediately as of closing. Because in a stock deal all plans and liabilities are typically assumed, buyers may instead wish to consider including a covenant requiring that the seller's health plans be terminated effective as of closing. Again though, this means that the acquired employees must be brought onto the buyer's plans immediately as of closing. Furthermore, although this means that the plans post-closing should be compliant, the buyer may nevertheless be liable for the seller's noncompliance as a successor employer.

Integration Considerations

If the seller's plans are assumed and continued, the buyer will want to consider whether and how to bring the seller's employees onto its health plans. Buyers must also ensure that they are able to satisfy the ACA's reporting requirements for the assumed plans.

Buyers will also need to determine to whom offers of coverage should be made. The ACA defines a full-time employee as any employee regularly scheduled to work at least 30 hours per week. However, in many industries, employee hours fluctuate based on various factors. The IRS therefore provided two methods for determining full-time status: the monthly measurement method and the lookback method. Employers must determine which method applies to its employees and are required to use the same method for similarly situated employees. Companies will need to consider how to integrate seller companies that use a different measurement method.

The final regulations address situations where an employee transfers from a category of employment in which one method applies to another. Although the rules are complicated, generally they are intended to protect an employee's status as full-time during any transition period.[10] However, the final regulations do not address whether and how an

employer that uses a method for a specific group of employees may subsequently change that method, instead indicating that guidance would be forthcoming. In 2014, the IRS released IRS Notice 2014-49 addressing some of these issues. Although IRS Notice 2014-49 does not apply specifically to mergers and acquisitions, the IRS indicated that "[u]ntil further guidance is issued, and in any case through the end of calendar year 2016, taxpayers involved in a corporate transaction in which employers use different measurement methods may rely on the approach described in [IRS Notice 2014-49] in determining an employee's status as a full-time employee" for purposes of the ACA.

Because IRS Notice 2014-49 provides different rules for different scenarios, buyers should consult with legal counsel to determine whether any of the safe harbors provided therein apply. However, generally speaking, IRS Notice 2014-49 provides that for purposes of the lookback method, an employee in a stability period (or an employee who is in an administrative period immediately following the end of the initial measurement period) at the time of the transaction must retain his or her status as a full-time or nonfull-time employee until the end of that stability period, although the buyer can always elect to offer coverage to nonfull-time employees. At the end of the stability period, the employee would assume the full-time or nonfull-time status that the employee would have under the lookback measurement method applied by the buyer. For employees who are not in a stability period at the time of the transaction, the buyer will determine their full-time or nonfull-time status using the buyer's lookback measurement method as of the date of transfer, including all hours of service with the seller.

Conclusion

Now that many important provisions of the ACA have taken effect, it is crucial that companies consider its impact in the context of corporate transactions. As we have seen, there are a number of issues buyers should consider with their counsel, from due diligence concerns through integration considerations. Failure to appropriately consider these issues may result in unexpected liabilities, and companies should work with legal counsel to ensure that they are protected.

Notes

1. I.R.C. § 4980D(b)(1).
2. *See* Treas. Reg. § 54.4980H-4.
3. *See* Treas. Reg. § 54.4980H-5.
4. Treas. Reg. § 54.4980H-5(a).

5. *See* 2015 Instructions for 1094-C and 1095-C and 2015 Instructions for 1094-B and 1095-B.

6. I.R.C. § 4980H(c)(2)(C)(iii).

7. Treas. Reg. § 54.4980H-1(a)(36).

8. 79 Fed. Reg. 8543, 8549.

9. Marin v. Dave & Buster's, Inc. and Dave & Buster's Entertainment, Inc., No. 15 Civ. 3608 (S.D.N.Y., filed May 8, 2015).

10. *See* Treas. Reg. § 54.4980H-3(f).