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Health and Welfare and 401(k) Plan Integration Issues in Strategic M&A Transactions: Important Diligence Topics and Best Practices

Henrik Patel and Samantha Rozell

In this article, the authors provide an overview of common integration-related issues that arise with respect to 401(k) and health and welfare plans in strategic mergers and acquisitions transactions.

Strategic corporate transactions (i.e., transactions where the buyer is an existing company or business with its own operations, corporate payroll and human resources ("HR") structure and benefit plans) pose a host of unique challenges for buyers, sellers, and/or targets, and their advisors. Among those are questions regarding how to approach health and welfare and 401(k) plan coverage for employees

Henrik Patel, global head of White & Case's Employment, Compensation and Benefits practice, advises a range of U.S. and international clients, including public and private companies, boards of directors, and executives, on the full spectrum of executive compensation and employee benefits issues. Based in New York, he may be contacted at henrik.patel@whitecase.com. Samantha Rozell, counsel in the firm's Employment, Compensation and Benefits practice, focuses her practice on executive compensation and employee benefits matters, principally in connection with mergers and acquisitions and other corporate transactions. Based in Chicago, she may be contacted at samantha.rozell@whitecase.com. Tyrone Crawford, an associate in the firm's office in Washington, D.C., assisted with the research for this article.

of the target business in a manner that protects buyers from assuming unwanted liabilities while preserving the benefit entitlements of the target's employees with minimal disruption.

The structure of the transaction itself can introduce an additional layer of complexity. If an entity that sponsors the relevant 401(k) and health and welfare plans and programs is being acquired in a stock purchase or merger, these plans and programs will be assumed by operation of law, and as such, the default treatment is clear. If the buyer in such a stock sale or merger wishes to amend or terminate any target plan or program, it must take affirmative action to do so in a timely manner as required by various regulations and guidance (as discussed further in this article). However, in the case of a carve out transaction (whether structured as an asset sale, or a stock sale or merger wherein the assets and liabilities of a specific business line are poured into an entity, and that entity is sold to the buyer), the parties must clearly contemplate the treatment of these plans and programs, and the assumption and retention of assets and liabilities, at the time of the transaction, including whether transition services may be needed for a period of time post-closing for either or both parties.

This article provides an overview of common integration-related issues that arise with respect to 401(k) and health and welfare plans in strategic mergers and acquisitions ("M&A") transactions, and will discuss:

- The areas on which buyers their advisors should focus during diligence in order to best integrate a target's health and welfare plans;

- Similar issues that arise with respect to 401(k) plans; and

- Some of the unique concerns surrounding health and welfare and 401(k) plans sponsored by professional employer organizations ("PEOs").

Our hope is that this article will provide buyers, sellers, targets, and their respective advisors with a general framework within which to begin considering the appropriate approach to integrating 401(k) and health and welfare plans in future strategic transactions. The reader should note that the key diligence topics we identify below are likely important to any buyer in any acquisition, whether or not it is the type of strategic acquisition on which this article focuses. However, because buyers in strategic acquisitions often have their own internal HR functions and administrators who will need to understand any issues with a target's plans, it is critical for a buyer's legal advisors to thoroughly diligence these issues with a view toward key areas of

concern for their client's HR functional experts, and providing these HR experts with clear advice on next steps approaching, and integration following, the transaction closing.

HEALTH AND WELFARE PLANS – KEY DILIGENCE AND INTEGRATION ISSUES

Diligence in General

Compliance Matters

As with all benefit plan diligence exercises, buyer's advisors should review for compliance with relevant laws and regulations.

- *Form 5500 Filings*. Under the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), with limited exceptions,[1] the sponsor of any "employee welfare benefit plan"[2] that either (i) has 100 or more participants (excluding spouses and dependents and active employees who decline coverage) as of the beginning of the plan year, or (ii) is funded through a trust, regardless of the number of participants, must file a Form 5500 with the U.S. Department of Labor (the "DOL") for each plan year.[3] This requirement picks up medical, dental, and vision plans, accidental death and dismemberment plans, life insurance plans, scholarship funds, severance pay plans, disability plans, supplemental unemployment insurance coverage, and certain other plans. Forms 5500 and all required appendices and schedules must be filed with the DOL by the end of the seventh month following the end of the plan year in respect of which the form is being filed (which means that Forms 5500 are due by the end of the following July for calendar year plans). Because of this, practitioners should be sure to ask the target for more current information regarding its health and welfare plans, as information in Forms 5500, while helpful, can be relatively stale depending on when in the year diligence is taking place. Note that even if a plan has fewer than 100 participants for a given plan year, it may still be required to file a Form 5500-SF, or a "Short-Form Annual Report/Report of Small Employee Benefit Plan."[4] As the name suggests, this is an abbreviated version of the standard Form 5500, and requires less disclosure. Forms 5500-SF must also be filed with the DOL no later than the end of the seventh month following the conclusion of the applicable plan year.

Step one in diligencing this point is confirming that all required Forms 5500 have been filed for the target's health and welfare plans. If filings are delinquent or not made at all, the DOL can assess a daily penalty of up to $2,259 (with no maximum), and the Internal Revenue Service (the "IRS") can assess a daily penalty of $250, up to a maximum of $150,000, for each day following the applicable deadline for which a Form 5500 filing is not made. In the event such a delinquency is uncovered, the buyer should request that the target resolve the noncompliance and appurtenant exposure through the DOL's Delinquent Filer Voluntary Compliance Program (the "DFVCP"), which will require the target to belatedly file its Form 5500 for each year that relief is requested, and determine the amount owed to the DOL under the DFVCP Penalty Calculator, available online. The DFVCP has the benefit of capping the DOL penalties on delinquent filings at $10 per day, with maximum penalties for single late annual reports of $750 for small plans (less than 100 participants) and $2,000 for larger plans (100 or more participants), and maximum "per plan" penalties of $1,500 for small plans and $4,000 per large plans, regardless of how many late reports are being filed in connection with the DFVCP correction (although it does not cap or otherwise impact any owed IRS penalties or any other penalties imposed under ERISA with respect to the late filings).[5] Note that if the target has been contacted in writing by the DOL about its filing delinquency, it cannot correct the issue via the DFVCP, and the penalties owed to the DOL in such case will likely be significantly higher than those owed under the DFVCP.

- *Documentary Requirements*. When conducting diligence on health and welfare plans, the next step is confirming documentary compliance with all requirements under ERISA and DOL regulations and guidance, the most material of which are as follows:

    - *Summary Plan Descriptions*. Plan administrators are required to maintain summary plan descriptions (or "SPDs") for each of their health and welfare plans that is subject to ERISA. The SPD must contain a comprehensive description of the plan and be clear enough so that the average participant can understand the benefits to which he or she is entitled. SPDs must be distributed to participants within 120 days of the plan's effective date, or, for existing plans, within 90 days of the date a

participant begins to be covered (and new SPDs must be provided to all participants every 10 years if the plan has not changed, or every five years if it has).[6] If a plan is materially modified, the administrator must also provide participants with a Summary of Material Modifications (a "SMM") within 210 days after the end of the plan year in which the material modification occurred.[7] Note that failure to provide an SPD or SMM within 30 days of a participant's written request will expose the plan's administrator to DOL penalties of up to $110 per day, and failure to furnish any plan-related information to the DOL when requested (including an SPD or SMM, as well as any of the other materials described below) carries a penalty of up to $161 per day, not to exceed $1,613 per request.

- *ERISA Wrap Plan Document*. The target can also satisfy the ERISA disclosure[8] and SPD requirements by assembling a "wrap plan" document that details all the terms and includes all required disclosures (including allocations of duties and responsibilities between employers and insurers and participant rights) with respect to all of the target's health and welfare plans in one document. If the target has a wrap document in place, this will impact its Form 5500 filing requirements, as only one Form 5500 for all plans covered under the wrap document will be required, rather than one Form 5500 for each individual welfare plan.[9]

- *Section 125 Cafeteria Plan Document*. If the target provides employees with health and welfare benefits on a pre-tax basis, it must have a written Section 125 "cafeteria plan" document in place.[10] Note that a flexible spending account is a form of cafeteria plan, but health savings accounts are specifically carved out of the definition of "cafeteria plan" in the Internal Revenue Code of 1986, as amended (the "Code"). Forms 5500 are not required to be filed for cafeteria plans, but because cafeteria plans are subject to ERISA, they must comply with their aforementioned SPD and disclosure requirements thereunder. The lack of a cafeteria plan document can cause all pre-tax benefits thereunder to be included in the employee's gross income.[11]

- *Summary Annual Report*. DOL regulations provide that the administrator of any welfare plan for which a Form

5500 filing is required must furnish a Summary Annual Report to all plan participants, summarizing the information set forth on the Form 5500 and informing participants of how they can obtain a copy of this report. The Summary Annual Report must be provided to participants within nine months following the end of the applicable plan year.[12]

- *Affordable Care Act*. All U.S. employers with 50 or more full-time employees[13] must file Forms 1094 and 1095 with the IRS for each plan year, and must comply with all other requirements of the Patient Protection & Affordable Care Act of 2010, as amended (the "ACA"). The ACA imposes various penalties and excise taxes on employers for filing and compliance failures. Although the particulars of the ACA are beyond the scope of this article, we advise buyer's counsel to vet the target's health and welfare plans for material compliance with the ACA to the extent the buyer intends to assume any of the target's health and welfare plans or liabilities thereunder.

Fully-Insured versus Self-Insured Plans

As part of the diligence process, it is important to confirm whether the target's health and welfare programs are fully insured (i.e., claims are the responsibility of an insurance carrier) or self-insured (i.e., claims are the responsibility of the target and paid from its general reserves). If a target self-insures its plans, it likely maintains a "stop-loss" insurance policy, which caps the amount of individual and/or aggregate claims that the target must pay out before the insurance policy kicks in to cover higher claim exposure. If a plan is self-insured, the target could be on the hook to pay out a large claim that arises if it does not hit the stop-loss threshold or if the stop-loss insurer does not cover the claim for some reason.

Further, if the buyer maintains fully-insured programs, it may not make sense for the buyer to continue the self-insured plan. Another thing to keep in mind is that fully insured plans are generally subject to state insurance laws, while ERISA generally preempts state laws with respect to self-insured plans (unless they are considered "MEWAs," as discussed below).

MEWAs

In most situations that arise in diligence, a target's health and welfare plans will be "single-employer plans," meaning that they are

sponsored by the target for the benefit of the target's employees alone, or they are sponsored by either target or another entity that, together with the target, are members of the same ERISA "controlled group" (meaning that, the target and the other entity or entities, together, are considered to be a "single employer" under Section 414 of the Code), and only employees (and their dependents) of the target or such other entity or entities are eligible to participate in these plans. There are four types of controlled groups:

- *Parent-subsidiary*: Where all entities are connected through an unbroken chain of at least 80 percent common ownership by a parent.[14]

- *Brother-sister*: Where five or fewer persons own 80 percent or more of the vote or value of each entity (a "controlling interest"), and the same group, together, owns more than 50 percent of the vote or value of each entity, taking into account each person's ownership in an entity only to the extent that it is identical with respect to each entity ("effective control").[15]

- *Combined group*: Can be established by a combination of parent-subsidiary and brother-sister controlled groups, when three or more entities are each a member of a parent-subsidiary or a brother-sister group, and at least one entity is the common parent of a parent-subsidiary group, an also a member of a brother-sister group.[16]

- *Affiliated service group*: Groups of entities that do not fit into the ordinary parent-subsidiary or brother-sister controlled group paradigm, but are nonetheless related and should be treated as such. There are three types of affiliated service groups – "A org" and "B org" groups,[17] and "management organizations."[18]

However, depending on the target's structure, its health and welfare plans may, in fact, cover employees who are not employed by the target or another member of its controlled group. In these circumstances, the plans will be considered "multiple employer welfare arrangements," or a "MEWAs."[19] MEWAs are subject to both ERISA and state insurance laws, meaning that they are subject to all of the aforementioned ERISA-mandated disclosure and filing requirements, and they are also required to file a Form M-1 with the DOL,[20] plus they are subject to states laws regulating insurance for each state in which the MEWA has participants.[21] These laws vary widely between states, and

in some places require various registrations and filings, which, if not made, can also result in daily penalties.

This is not, in and of itself, problematic (although it certainly can be a high maintenance exercise for the target to ensure continued compliance with both ERISA and state insurance laws). However, in some cases, a target or its HR team might not properly understand the "controlled group" rules and inadvertently create a MEWA by allowing employees of entities outside of its controlled group to participate in its plans, or by allowing its employees to participate in the plans of entities outside of its controlled group. Because, in these situations, the target is not aware that it has created a MEWA, it will not have taken steps to comply with the applicable federal and state rules, and the noncompliance penalties may have been racking up for years prior to buyer's counsel uncovering this in diligence.

As such, it is key to understand the target's corporate structure and the extent of its controlled group when conducting diligence on who is entitled to participate in its health and welfare plans. In particular, if the target is a bank or in the medical or veterinary business, buyers should be sensitive to this issue, as the structures of those businesses often include a web of joint ventures and other atypical ownership structures that might foul up the controlled group analysis unless structured properly and carefully considered. If an "accidental MEWA" is uncovered in diligence, steps should be taken prior to the transaction closing to ensure that the target pays any penalties and takes any other actions with respect to historical noncompliance with ERISA and applicable state law, and to the extent appropriate, to ensure that the target's employees are covered by a single-employer plan going forward.

Key Integration Issues and Best Practices

Now that we have touched on the major areas of focus for a diligence review of health and welfare plans in a strategic transaction, we must consider how this information can be of use when advising buyers and their HR teams. The crux of this rests on whether the buyer intends to assume all or some of the target's health and welfare plans, or if the buyer will leave the plans behind. We explore some of the key considerations that arise in each of these situations below.

Buyer Will Assume Target Plans

In many strategic transactions, the buyer will assume the target business's health and welfare plans. Sometimes this happens by

operation of law, because the buyer is acquiring the sponsoring entity in a stock sale or merger, and other times, for whatever reason, the buyer and seller negotiate for the buyer to assume certain plans. In these situations, the main focus of the buyer's HR team will be either integrating these plans into the existing HR systems if the target is to be combined into the existing structure, or, if the target is to be run as a standalone business, establishing lines of communication and processes with the existing target HR team to ensure that any pre-closing areas of concern are addressed, and any problematic processes or practices that led to plan non-compliance pre-closing are corrected and eliminated.

Because much of this integration work will be business-driven and by necessity administrative, often legal advisors do not get involved in the details. However, there are a couple of important areas that buyer's advisors can make sure to flag to the client for resolution prior to, or shortly following, closing:

- *Addressing Non-Compliance*. As previously discussed, health and welfare plans are subject to various requirements under federal and state law and regulations. If buyer has uncovered evidence of historical non-compliance (e.g., Forms 5500s have not been filed, or employees receive health benefits on a pre-tax basis, but the plan sponsor has not prepared a Section 125 plan document), that non-compliance should ideally be resolved in full prior to closing so that the costs are borne by the target/seller and there remains no exposure to penalties or other liabilities that will be inherited by buyer.

  However, health and welfare issues are often considered immaterial in the broader context of a transaction, and resolving these issues may therefore be put off until post-closing in favor of focusing on points with more deal value (even if the cure, such as correcting a filing delinquency under the DFVCP, is relatively easy and straightforward). In transactions where buyer is assuming a plan by operation of law, consider getting estimates of the costs of addressing any compliance issues, and treating those amounts as purchase price deductions. To the extent there is a concern about exposure, buyer can work with its HR and benefits consultants to quantify the amount, and either seek an indemnity for specific concerns, or increase a purchase price deduction to address the risk. In carve out situations where there is an ability to leave liabilities behind with a seller, the transaction documentation may provide that all

pre-closing health and welfare plan-related liabilities remain with the seller, and include a provision by which the seller indemnifies buyer for any claims or exposure related to anything that occurred prior to closing, regardless of when the claim or exposure arises. In either case, buyer and its HR team should be apprised of these areas of concern, and any non-compliance should be cured as soon as possible following closing to reduce the risk of additional exposure to the buyer.

- *Addressing MEWAs*. If a target's employees participate in a MEWA, the cleanest and most buyer-favorable approach would be to avoid assuming the plan. Even if the MEWA was thoughtfully constructed as such, the patchwork rules at the state level will be difficult to manage on an ongoing basis, and will likely create headaches for the buyer's HR team, which may regard the extra compliance requirements as onerous and draconian. If taking this approach, buyer's counsel should specify in the transaction documents that the plans and related liabilities will remain with seller, and include a seller indemnity of buyer with respect to these liabilities. Buyer will need to ensure that its plans can accommodate immediate enrollment of the target employee population at closing for this option to be workable.

  However, if the strategic transaction is a stock sale or merger, leaving the MEWA behind will not be possible. Compliance issues should be addressed as suggested above, and the target employee population's participation in the MEWA should be terminated as soon as the buyer is able to seamlessly onboard target's employee population onto its own plans. If the buyer intends to run the target business as a standalone operation, buyer should consider whether it can start up new plans with its existing insurance vendors (or possibly with a PEO) to cover this population.

- *IBNR Allocation*. If a health and welfare plan being assumed is self-insured, the parties should consider how the financial responsibility for claims that have been incurred but not yet reported ("IBNR") as of closing will be allocated. The market position is that the buyer should be responsible only for claims incurred from closing and on. Where the target's plans are being assumed by operation of law and related liabilities cannot be carved out of the transaction, buyer should push

for these amounts to be treated as debt-like items so that it is not paying for claims that occurred prior to its ownership of the business. Where liabilities can be left with seller, the transaction documents should clearly contemplate that seller will be responsible for all claims incurred on or prior to closing, regardless of when they arise, and make clear that a claim is deemed "incurred" for these purposes when the event giving rise to the claim took place.

Buyer Will Not Assume Target Plans

Notwithstanding the foregoing, in carve out acquisitions, whether structured as a stock or asset sale, it often does not make sense for a buyer to assume the health and welfare plans covering the target's employee population. This point is often not contentious, as strategic buyers are often organizations with existing employee populations with robust HR, payroll and benefits infrastructures that they wish to keep uniform within the organization. From the seller's perspective, the plans covering the target's employee population often cover other seller employees, and seller therefore needs to retain these plans for the benefit of its remaining workforce. Although this division of liabilities may seem straightforward, it presents unique challenges from both a legal and an employee relations standpoint.

- *Providing Credit under Buyer Plans*. One important, but often overlooked consideration is ensuring that target employees who will enroll in buyer plans in connection with the transaction receive credit for their service with the target/seller and its predecessors and out-of-pocket costs already incurred for the plan year in which the transaction closes. We say that it is oft-overlooked because this requirement is viewed by practitioners as a standard covenant in the post-closing comparability section in most purchase agreements. However, in the context of a strategic deal, achieving this result may require amendments to existing buyer plans and, if the buyer's plans are fully-insured, having the HR teams work through paperwork and notification requirements with the benefit plan vendors in advance of closing to ensure there are no coverage disruptions.

- *FSA Balance Transfers*. On a similar note, if target employees have money in flexible spending accounts ("FSAs") sponsored by seller, and the transaction will close in the middle

of a calendar year (meaning that the employees likely have significant unused balances in their plans that they should retain access to, as they will be lost if not used by the end of the year), the parties should consider how to handle those balances. If the buyer has its own FSA plan (or is open to putting one in place), one common approach is to provide in the transaction agreement that target employee's FSA balances will be transferred into buyer's FSA plan, and the target employees will begin participating in that buyer FSA plan, with immediate access to their existing balances for the year, at closing. Another, less common, approach is for the target employees to remain participants in the seller's FSA plan for the year of closing; in this situation, balances will remain in the seller plan, and the buyer deducts amounts through payroll for the purposes of making FSA contributions, and transmits them to seller.[22] The latter approach is less popular because it requires the buyer and seller to remain entangled for a period of time post-closing, and it opens the door for confusion and possible interruptions in access to balances for target employees who are now employed by buyer, but still need to access plans with their former employer to take advantage of FSA benefits. To the extent both buyer and seller have FSAs and there are target employees with balances under seller's plan, the first approach may ultimately be the more efficient one.

- *COBRA "M&A Qualified Beneficiaries."* IRS regulations[23] dictate who is responsible for providing COBRA coverage to "M&A qualified beneficiaries" in connection with a transaction. The IRS regulations define an "M&A qualified beneficiary" as someone who experiences an event qualifying them for COBA coverage prior to or in connection with a sale transaction. This means that M&A qualified beneficiaries can be former target employees (but not former seller employees unaffiliated with target) who left the company prior to buyer engaging with seller and are currently receiving or eligible to receive COBRA coverage from the seller, or employees who experience a qualifying termination in connection with the transaction.

  Whether someone in the latter group of individuals is an M&A qualified beneficiary depends on transaction structure. If the deal is a stock sale, the employee must lose their job at closing to be an M&A qualified beneficiary. If the deal is

an asset sale, the employee must lose coverage under the group health plan of the seller after closing, and the buyer must not be considered a "successor employer" (which it will be if it continues to employ the individual and is continuing the operations associated with the purchased assets without interruption or substantial change).

Once the parties determine the scope of the "M&A qualified beneficiaries" implicated, the aforementioned IRS regulations allocate default responsibility between the parties, as follows: (i) in a stock sale, if the seller ceases to provide group healthcare coverage to any employee in connection with the sale, a group health plan maintained by buyer must make COBRA available to M&A qualified beneficiaries, (ii) in an asset sale, if the seller ceases to provide group healthcare coverage to any employee in connection with the sale, and the buyer qualifies as a successor employer, a group health plan maintained by buyer must make COBRA available to M&A qualified beneficiaries, and (iii) in either a stock or asset sale, if the buyer continues to maintain a group healthcare plan, the buyer's obligations begin on the later of (x) the date that the seller ceases to provide any group healthcare coverage to an employee, or (y) the closing date of the transaction. The flip side of this is that (A) if the seller continues to maintain a group health plan post-closing, the seller must offer COBRA to qualifying beneficiaries, and (B) if the seller no longer operates its group health plan post-closing, and if buyer does not have a group health plan, neither party is obligated to provide COBRA coverage.

Note that, if desired, the parties in a transaction can agree between themselves who will be responsible for COBRA coverage for M&A qualified beneficiaries and deviate from the described default rules (although if the party that contractually assumed the obligation fails to provide COBRA coverage as required, the obligation defaults back to the responsible party as set forth in the IRS regulations). However, what typically happens is that the parties either remain silent on the point (meaning they agree to abide by default rules), or they specify in the transaction document that they will follow the default rules, as the default rules are viewed as equitable.

- *Temporary MEWAs*. Our discussion thus far has assumed that when buyer is not assuming seller plans covering target

employees, it is because buyer has its own plans in which this population can participate. But what happens when that is not the case? In those scenarios (which happen not infrequently with these types of transactions), in order to ensure that target employees do not lose health insurance coverage due simply to the occurrence of the transaction, the parties will often agree to a limited transition services period, during which target employees, although part of the business being sold to buyer, will remain participants in seller's health and welfare plans until the buyer can establish its own plans in which these individuals can participate. The terms of these transition services (including the nature of the benefits that will be provided, the length of the transition period, and the way that costs will be calculated and paid by buyer to seller, as seller is covering these employees for buyer's benefit) will typically be governed by a transition services agreement that the parties prepare and finalize between signing and closing.

If this formulation (a health and welfare plan maintained by one employer or the benefit of employees of another employer outside of its controlled group) sounds familiar, that is because we have described the creation of a MEWA. However, note that practitioners often regard these "temporary MEWAs" as though they are not true MEWAs, and look to the fact that they are entitled to rely on the "deal"-based exception from filing a Form M-1 as evidence. This filing exception applies to a MEWA so long as (i) the plan sponsor is providing benefits to employees of two or more unrelated employers due to a change in control of a business, (ii) the MEWA is temporary in nature, and (iii) the parties are not seeking to use this exception simply to avoid filing a Form M-1, and provided that the MEWA no longer exists after the end of the plan year following the plan year in which the change of control of the business occurred.[24] Furthermore, although this exemption from a federal filing has no bearing on the applicability of state insurance law to these arrangements, practitioners often view temporary MEWAs as very low risk in terms of exposure to penalties from states for noncompliance with state law.

To further bolster the argument that these arrangements should not be viewed as true MEWAs, the parties should specify in the transaction agreement that all pre-closing liabilities for the target employees will be retained by the seller,

and all liabilities from closing and on will be borne by buyer, regardless of the fact that the target employees (who are buyer's employees) will be participating in seller's plans.

While this is a tried and true approach, some buyers and/or sellers may be uncomfortable with entangling themselves with the other party in this way for business and legal exposure reasons. If one side views the temporary MEWA route as a non-starter, the buyer's counsel should explore establishing new plans as early as possible in the deal process so that they will be ready for participants by closing, or, if not possible, engaging a PEO to provide health and welfare benefits for the target population until buyer can accommodate these employees on its own plans.

401(k) PLANS – KEY DILIGENCE AND INTEGRATION ISSUES

Diligence In General

Compliance Matters

Like health and welfare plans, 401(k) defined contribution plans are subject to ERISA and various DOL requirements. They must also take steps to remain "tax-qualified" such that participants may defer amounts on a pre-tax basis thereunder as intended.

- *Form 5500 Filings*. Like health and welfare plans, plan sponsors are required to file Forms 5500 for their 401(k) plans for each plan year. In addition to the requirements described above, which also apply to 401(k) plans, one-participant 401(k) plans[25] and certain foreign 401(k) plans[26] are required to file a Form 5500-EZ. Similar to the Form 5500-SF, the Form 5500-EZ is an abbreviated version of the standard Form 5500, and have the same filing deadline as the Forms 5500 and 5500-SF.

- *Documentary Requirements*. 401(k) plans are subject to the same SPD/SMM requirements as health and welfare plans, described above.

- *IRS Determination/Opinion Letters*. In order to be considered "tax-qualified," a 401(k) plan must be entitled to rely

on a determination (for individually-designed plans) or opinion (for prototype plans) letter from the IRS confirming its tax-qualified status. The current IRS rules require that 401(k) plans receive determination letters only in connection with their initial qualification or termination,[27] as well as in certain other limited circumstances, including plan mergers.[28] A key diligence point is confirming that any target 401(k) plan is the subject of a favorable determination or opinion letter. To the extent a plan has been recently adopted and has not yet received a determination letter, confirm that an application has been submitted.

- *Non-Discrimination Testing*. The IRS requires that all 401(k) plans pass certain annual tests (called "non-discrimination tests") to ensure that the plan does not disproportionately benefit "highly compensated employees" or "HCEs" (for 2022, anyone who owns more than five percent of the plan sponsor during 2022 or 2021 (either directly or by attribution), or anyone who received more than $135,000 in compensation from the plan sponsor during 2021)[29] and that amounts have not been deferred in excess of statutory limitations (for 2022, the IRS is permitting employee pre-tax deferrals of up to $20,500).[30] These tests include the Code Section 410(b) "coverage test" (to ensure that the plan's participants in a given year include the appropriate amount of non-HCEs), the "actual deferral" or "ADP" test (to ensure that the rate of salary deferrals made by HCEs does not exceed those made by non-HCEs by more than a permitted amount), the "actual contribution" or "ACP" test (to ensure that company matching and voluntary after-tax contributions made to HCEs does not exceed those made by non-HCEs by more than a permitted amount), and the Code Section 416 "top-heavy" test, to determine whether plan is "top heavy" for a given year (meaning that the account balances of "Key Employees"[31] exceed 60 percent of the plan's total assets as of the last day of the plan year). In addition, plans must run tests to be sure that neither the annual contribution[32] nor elective deferral limits[33] for the plan year have been exceeded.

  401(k) plans frequently fail one or more of the aforementioned tests. However, this failure is also frequently immaterial because there are no penalties for employees or employers if the failure is corrected in a timely manner

(for calendar year plans, the deadline is March 15th of the year following the end of the applicable calendar year). Depending on which test was failed, complying is simply a matter of refunding an excess contribution or making a "QNEC" (qualified non-elective contribution) or other contribution to resolve the issue. If the company has missed the correction deadline of March 15th, the company can still resolve non-compliance through the IRS's voluntary self-correction program so long as it does so by December 31st of that year.

Companies will have documentation evidencing their non-discrimination testing for each year, so buyer's counsel should ask to review such documentation, and, if applicable, documentation evidencing timely correction.

Loan Balances

Diligence as to the magnitude of outstanding loans under a target's 401(k) plan can be a key issue in strategic transactions. If buyer intends to merge the target's 401(k) plan into its own, buyer must determine whether there are loans outstanding under the target plan, and if they can ultimately be absorbed into buyer's plan (and, if they can be absorbed, whether the buyer has an appetite to keep the loans outstanding). If buyer decides not to assume the target's 401(k) plan (either because the plan will be terminated at closing, or because the plan is remaining behind with a selling entity), target 401(k) plan participants will no longer be eligible to participate in the target 401(k) plan, which may cause the loan balances to come due in full upon the closing of the transaction.

Even if these loan balances are small, loan holders may have difficulty repaying them quickly, so the obligation to repay even relatively small balances might put employees in a difficult situation, and cause friction during the integration process. If there are loan balances outstanding, usually the parties work to ensure that loan holders are not penalized. If the target 401(k) plan is remaining behind with a seller, one possible solution would be for the seller to amend its plan to permit loans to stay outstanding following a participant's termination; another approach would be for buyer to permit loanholders to roll their loans over into the buyer's plan if permitted by its terms.

MEPs

As with health and welfare plans, most 401(k) plans that one will encounter in a diligence process are single-employer plans. However,

if a 401(k) plan permits participation by employees of any entity that is not within the plan sponsor's controlled group, it will be considered a "multiple employer plan" (or "MEP"), which is defined in Section 413(c) of the Code as a single plan maintained by more than one unrelated employer. If a target's 401(k) plan is a MEP, whether by design or by accident, the buyer's counsel should review and confirm whether there has been any material noncompliance in the plan's operation. Note that each unrelated employer participating in a multiple employer 401(k) plan is treated as a separate employer for nondiscrimination testing purposes, and depending on how the plan's assets are allocated, multiple Forms 5500 filings might be required for the same plan (if all plan assets are available for the benefit of all employees, only one Form 5500 is needed, but if an individual employer's assets are available only to that employer's employee's each participating employer may need to file its own Form 5500). As with MEWAs, if a target's 401(k) plan is a MEP, steps should be taken prior to the transaction closing to ensure that all noncompliance is resolved and penalties are paid, and to the extent appropriate, a new plan should be stood up or provided for target employees.

Key Integration Issues and Best Practices

Buyer Will Assume Target Plans

As noted in the context of health and welfare plans, there are myriad business reasons why a buyer might want to assume a seller's 401(k) plan. If the buyer has decided to go this route, there are a few things that buyer's counsel should discuss with the client:

- *Addressing Noncompliance.* As discussed in the health and welfare plan section, above, to the extent 401(k) noncompliance (whether with respect to non-discrimination testing failures, which is relatively common, or the absence of a 401(k) determination letter, which is rare) is uncovered during the diligence process, the seller/target should be encouraged or required to resolve it prior to closing. However, as with health and welfare plans, unless a potentially material issue has been uncovered, such noncompliance will often be left to be handled following closing. In these circumstances, the buyer should work with the target's HR team to resolve the noncompliance, and to the extent it is nondiscrimination testing failure that can be resolved within the windows described above, there will be limited to no costs to buyer if this is addressed post-closing. To reiterate, the most frequent

compliance issues that come up in diligence are non-discrimination testing failures that can be cured with no penalty to either party.

- *Maintaining Multiple 401(k) Plans*. If the buyer intends to operate the target business as its own standalone organization within the buyer's broader structure, the buyer may view keeping the target's 401(k) plan in place unchanged for the benefit of target employees as desirable. So long as buyer's counsel has not identified a massive risk with inheriting the plan, this approach is workable and may, in fact, impose the lowest burden on the buyer's existing HR experts (in the event that target's HR team is coming over in the deal). However, the most important thing to flag to the buyer in this scenario is that, ultimately, future non-discrimination testing for its existing 401(k) plan(s), together with target's 401(k) plan, will need to be done on a controlled group-wide basis, and not a plan by plan basis. Because there are differing employee populations covered by the different plans, plans that passed non-discrimination testing alone may fail when combined with other plans. Buyer's counsel should encourage the buyer to work with a third party advisor to anticipate these issues and cure any noncompliance after the first year of testing. Note that the buyer will be able to take advantage of a limited "M&A transition rule" relief window (which endures until the end of the plan year following the one in which the transaction closes),[34] during which it can continue to conduct non-discrimination testing on a plan-by-plan basis.

- *Merging the Target Plan into Buyer's Plan*. The buyer may also wish to maintain flexibility to either continue to operate the target's 401(k) plan or merge the target's 401(k) plan into its own. If the buyer avails itself of this approach, it can also take advantage of the M&A transition rule relief window to decide when and whether to merge the plans, but note that if the plans have not been merged by the end of the plan year following the plan year of closing, the buyer will not be permitted to merge them.[35] Note further that plan mergers can be a thorny process if the buyer's existing 401(k) plan and the target's plan are not relatively similar, both because the plan merger rules prohibit the buyer from reducing certain benefits under the target's 401(k) plan,[36] and the buyer will not evade penalties (if any) for historic noncompliance by virtue of the plan merger. For this reason, practitioners will

often advise buyers against plan mergers, and suggest either operating both plans, or, where possible, terminating or not assuming the target's plan (as discussed below).

Buyer Will Not Assume Target Plans

Notwithstanding the foregoing, absent a compelling business reason to keep the target 401(k) plan going, the choice is either to have the seller's 401(k) plan terminated prior to closing (if the transaction is a stock deal where the 401(k) plan and all of its participants are being acquired by operation of law), or provide for a direct rollover or trust-to-trust transfer of outstanding balances into the buyer's 401(k) plan (if the transaction is a carve out where the seller needs to retain the 401(k) plan because non-target employees participate). These approaches will help mitigate risks of (i) inheriting known or potentially unknown historic liabilities under the seller plan, and (ii) potential complications or confusion with ensuring that non-discrimination testing is performed on a controlled group-wide basis.

- *Terminating a 401(k) Plan*. Where the target employees constitute the full universe of participants in the target 401(k) plan, the buyer can request that the seller/target terminate the target 401(k) plan in connection with the transaction closing, and provide that participants will be eligible to directly roll their balances into buyer's plan or another tax-efficient retirement vehicle. If the buyer opts for this approach, keep in mind that the plan must be terminated at or prior to closing, or not at all. This is because 401(k) plan termination constitutes a permissible distribution event,[37] but the "successor plan rule" will prohibit the distribution of elective deferrals under a 401(k) plan if the employer maintains another 401(k) plan within the 12 month period following the plan termination date.[38] By terminating the plan at or prior to closing, the 401(k) plan never becomes a buyer plan, and therefore does not count as "another 401(k) plan" for purposes of the successor plan rule.

  In practice, this is the most typical approach taken by buyers when presented with this fact pattern where the buyer already maintains a 401(k) plan in which target employees will be eligible to participate on or shortly following closing. Usually, there will be a covenant into the transaction document that requires the seller to take all necessary action to terminate the plan no later than one day prior to closing, and

to provide the buyer with written documentation (usually board resolutions or other resolutions of the plan administrator) showing that formal action has been taken to terminate the plan. Note that because the 401(k) plan wind-down process takes months, buyer will be responsible for supervising the process and ensuring it is completed properly, but buyer will avoid inheriting any liabilities associated with the plan. In connection with the plan termination, balances generally vest in full and company contributions are required to be made through closing, which may require target or seller to accelerate vesting or contributions if any balances are unvested, and/or if contributions are made at year-end, rather than a payroll period basis. This approach is also viewed as employee-favorable, because it gives employees flexibility choose where to roll their balances. In connection with this approach, best practice suggests that the buyer should amend its plan to provide target employees with service credit for purposes of buyer's 401(k) plan.

- *When the Plan Cannot Be Terminated*. In situations where terminating the 401(k) plan is not feasible (because the seller sponsors the plan and wants to continue operating it), there are two options for how to handle target employee balances in the plan, discussed below. However, note that in both situations, the transfer of balances from the target plan to buyer's plan will "taint" buyer's plan to the extent there are any administrative or compliance issues with the target 401(k) plan, so buyer's should be aware of, and attempt to address, all compliance issues.[39]

    - *Optional Direct Rollover*. The closing of the deal will still constitute a distribution event for plan participants, because their employment with the seller group will be terminated. As such, employees will be permitted to choose whether to keep their plan balances in the seller plan, or roll them over into buyer's plan (or another retirement vehicle).[40] This is a relatively simple, low maintenance option, and the advisable approach if the transaction presents buyer with this fact pattern. As with a plan termination, the buyer should amend its plan to provide target employees with service credit for purposes of eligibility and vesting under buyer's 401(k) plan.

    - *Trust-to-Trust Transfer*. Another option is to transfer the assets of the plan held by target employees to the buyer's

401(k) plan. This is referred to as a "trust-to-trust transfer," as assets from the target 401(k) plan trust are directly transferred into the buyer 401(k) plan trust).[41] However, this approach requires a lot of heavy lifting by both buyer and seller and their respective 401(k) plan providers and HR teams, and may be viewed less favorably by employees, as it does not give them the same flexibility as a direct rollover. For these reasons, this approach is less frequently taken than the optional direct rollover approach.

- *Treatment of Loans*. Another important area of consideration is the impact of the transaction closing on outstanding 401(k) plan loan balances held by target employees, as many situations could cause loan balances to become due and payable in full at closing, which could result in significant financial hardship to the loanholder. If a 401(k) plan is being terminated and there are outstanding loans, buyer should confirm they are comfortable assuming these loans, and if so, whether the buyer's plan will permit it, or if it has to be amended to provide for the loan rollover at the same time as the direct account rollover. As noted elsewhere in this article, buyer may not want to assume loans in a plan termination scenario.

  Where the target 401(k) plan will remain outstanding, the buyer's counsel should review the plan's adoption agreement to confirm whether the plan permits former participants to continue to pay down loans pursuant to their existing schedule, or if upon cessation of participation in the target 401(k) plan, the loan comes due in full. In the latter scenario, the parties should discuss the appropriate approaches, which are similar to the approaches available in the case of a plan termination. Whatever approach is taken should be memorialized by the parties in the post-closing compensation and benefit covenant section of the transaction agreement.

- *Temporary MEP*. Last, but not least, we must consider a situation where the seller is retaining the target 401(k) plan, but for whatever reason, the buyer does not have a 401(k) plan available in which target employees can participate. In these circumstances, similar to the temporary MEWA discussed above, the seller can temporarily turn the target 401(k) plan into a "multiple employer plan," and permit target employees to remain in the plan for a brief post-closing transition period until the buyer can adopt its own plan. This works from a

successor rule perspective because the buyer can establish its own 401(k) plan while target employees remain in the seller plan. As with the temporary MEWA approach, liability and cost allocation would be governed by a transition services agreement. This is a tried and true method, and something that buyer's counsel should discuss with the client as a possible approach if buyer does not have a 401(k) plan. However, this approach is not without risk (e.g., if any one employer in the MEP fails to comply with the tax qualification requirements applicable to the 401(k) plan, it results in the tax disqualification of the entire plan for all employers, commonly called the "one bad apple" rule).[42] Therefore, as with the temporary MEWA, some buyers and sellers are put off by the idea of engaging in the operation of a multiple employer plan, even if for a very brief window. If this is a non-starter for a buyer, buyer's counsel should suggest establishing its own plan as soon as possible or exploring a PEO (although withdrawing employees from a PEO-sponsored 401(k) plan has its own complications, as discussed below).

PEO PLANS – SPECIAL CONSIDERATIONS

The assumption for the foregoing discussion is that the target's 401(k) and health and welfare plans are "company-sponsored," i.e., plans that the seller or the target entity self-maintain, or contract with outside vendors, insurers, and plan administrators to maintain. However, where target employees participate in PEO-sponsored plans, buyer and its advisors must think critically about whether the PEO arrangement should be continued post-closing, and if not, the steps that will need to be taken to disentangle the target employee population from the PEO plans.

As the reader is likely aware, where a company is unable or unwilling (due to its size, finances, or other reasons) to maintain its own health and welfare and/or 401(k) plans, it can contract with a third-party entity called a PEO. These PEOs provide payroll and benefits services, meaning that they will act as the co-legal employer of the employees, and as such, make available their own 401(k) and health and welfare plans to these individuals for participation. The company is required to pay fees to the PEO, and provide them with all funds and information necessary to run payroll and make pre-tax benefits deductions and 401(k) plan deferrals. This arrangement is typically governed by a boilerplate services agreement, which can usually be terminated by either party with a certain amount of notice (typically between 30 and 90 days).

A complete analysis of potential joint employment issues that arise in the context of PEO relationships, as well as the risks and benefits PEO-sponsored plans more generally, is outside of the scope of this article. However, we wanted to flag a few material issues that could arise in strategic transactions specifically where the target population participates in PEO-sponsored health and welfare plans.

PEO Health and Welfare Plans

The most important thing for practitioners to keep in mind when encountering PEO health and welfare plans in a diligence exercise is that these plans are MEWAs, because the companies are viewed as the common law employers of the participant employees, even though the PEO legally employs them.[43] While the PEO industry has pushed back against the propriety of this characterization given their business model (the whole point of a PEO is that it is providing coverage to employees who provide services to a wide range of unrelated employers, and they should not be discouraged from doing so by being subjected to the more onerous federal and state requirements for MEWAs), and experts are constantly forecasting that a change is coming, for now, this is still the case. Note that, because the MEWA is the PEO's plan, and not the seller's or target's, the MEWA compliance requirements fall squarely on the PEO's shoulders. While this is positive in that complying with applicable federal and state law is the PEO's responsibility, it means that the seller and target have no visibility into, or control over, whether the PEO is in fact complying. Working with well-known and trusted PEOs can allay this concern, but it is important to fully vet the PEO that a seller/target is using, and if they are not reputable, consider engaging a new PEO or having the seller or target, as applicable, terminate the health and welfare plan relationship prior to closing (with enough notice that it lapses at closing) and enrolling target employees into buyer plans or in the plans of a new PEO.

PEO 401(k) Plans

Similarly, the most important thing to keep in mind with respect to PEO-sponsored 401(k) plans is that they are MEPs, as the companies engaging the PEOs, rather than the PEOs, are viewed by the IRS as the common law employer of the participating employees, and therefore the 401(k) plans sponsored by the PEOs are plans in which multiple unrelated employers participate.[44] As such, there is a risk of tax disqualification under the "one bad apple" rule discussed above if one or more

of the other companies whose employees are covered by the PEO plan fails to comply with all 401(k) plan tax qualification requirements.

The fact that PEO 401(k) plans are MEPs creates an additional layer of complexity in carve-out transactions when the buyer in the strategic transaction wants to terminate the PEO relationship, or will not inherit the PEO relationship from the seller. This is because terminating the target employees' relationship with the PEO alone is not considered a distributable event for the purposes of the PEO's 401(k) plan. As such, the buyer's options are as follows:

- Tell employees that their balances are unfortunately stranded in the PEO's 401(k) plan unless they want to take a taxable distribution;

- Do a trust-to-trust transfer of the applicable balances from the PEO plan into the buyer's plan (which, as noted below, comes with the risk that noncompliance in the PEO plan, which it is nearly impossible to diligence, will taint the buyer's plan); or

- Spin off the target employee plan balances into a new single-employer seller plan prior to closing and terminate that plan, which would be a distributable event in connection with which employees can rollover (this can be onerous for HR teams and plan administrators, and therefore seem like an unattractive option).

For this reason, where possible, it may make sense to advise the buyer to keep the PEO relationship in place for the target employee population through and following closing (at least temporarily) to give the HR team time to consider its options and, if needed, take the required steps to terminate the relationship and enable 401(k) plan participants to bring their balances over to the buyer's 401(k) plan.

CONCLUSION

It is clear that, among the myriad issues that can arise in strategic transactions, the topic of how to deal with the 401(k) and health and welfare plans in which the target business's employees participate is key. As with many employee- and compensation-related topics, buyers and their advisors must maintain a twin focus on minimizing exposure to legal risk, and ensuring employee satisfaction with the integration and continuous benefits during this time.

After all, if the target employee experience is not top of mind when working on a strategic M&A transaction, all of the legal diligence and business negotiations will be for naught, as the employees who generate value for the business will not be incentivized to remain with the post-closing business.

NOTES

1. *See* the section of the DOL's Form 5500 filing instructions entitled "Welfare Benefit Plan – Do Not File a Form 5500 for a Welfare Benefit Plan that is Any of the Following" for the types of welfare benefit plans with respect to which Forms 5500 are not required.

2. *See* ERISA Section 3(1), which provides "[t]he terms "employee welfare benefit plan" and "welfare plan" mean "any plan, fund, or program which was heretofore or is hereafter established or maintained by an employer or by an employee organization, or by both, to the extent that such plan, fund, or program was established or is maintained for the purpose of providing for its participants or their beneficiaries, through the purchase of insurance or otherwise, (A) medical, surgical, or hospital care or benefits, or benefits in the event of sickness, accident, disability, death or unemployment, or vacation benefits, apprenticeship or other training programs, or day care centers, scholarship funds, or prepaid legal services, or (B) any benefit described in section 186(c) of this title (other than pensions on retirement or death, and insurance to provide such pensions)."

3. *See* ERISA Section 104.

4. *See* the DOL's Form 5500-SF filing instructions for guidance on the types of welfare plans for which Forms 5500-SF are required.

5. *See* IRS Notice 2014-35.

6. *See* 29 CFR § 2520.104b-2-3.

7. *See* 29 CFR § 2520.104b-3.

8. *See* 29 CFR § 2520.104b-1.

9. *See* the DOL's Form 5500 filing instructions.

10. *See* Code Section 125.

11. *See* Prop. Reg. § 1.125-1(c)(6)-(7).

12. *See* 29 CFR § 2520.104b-10.

13. *See* IRS Notice 2014-49.

14. *See* 26 CFR § 1.414(c)-2(b).

15. *See* 26 CFR § 1.414(c)-2(c).

16. *See* 26 CFR § 1.414(c)-2(d).

17. *See* 26 CFR § 414(m)(2).

18. *See* 26 CFR § 414(m)(5).

19. *See* Section 3(40) of ERISA, which defines a MEWA as "an employee welfare benefit plan, or any other arrangement (other than an employee welfare benefit plan), which is established or maintained for the purpose of offering or providing any benefit described in Section 3(1) of ERISA to the employees of two or more employers (including one or more self-employed individuals), or to their beneficiaries," other than plans maintained pursuant to collective bargaining agreements.

20. Note that failure to timely file an M-1 will subject the plan sponsors to DOL penalties of up to $1,746 per day.

21. *See* ERISA Section 514(b).

22. *See* IRS Rev. Rul. 2002-32.

23. *See* 26 CFR § 54.4980B-9.

24. *See* Instructions for Form M-1, provided by the DOL.

25. Defined as any plan, other than an Employee Stock Ownership Plan, that (i) covers only one person, or that person and their spouse, and that person (alone or together with their spouse) owns the entire business, (ii) covers only one or more partners, or partners and their spouses, in a business partnership, or (iii) does not provide benefits for anyone other than one person, or that person and their spouse, or one or more partners, or partners and their spouses. *See* Instructions for Form 5500-EZ, provided by the Internal Revenue Service.

26. Defined as any "plan [that] is maintained outside of the United States primarily for the benefit of persons substantially all of whom are nonresident aliens" (*See* ERISA Section 4(a)(4)). Forms 5500 are required for these plans if they are sponsored by either (i) a U.S. employer, or (ii) a non-U.S. employer with income derived from sources within the U.S. (including foreign subsidiaries of U.S. employers) if contributions to the plan are deducted on its U.S. tax return. *See* Instructions for Form 5500-EZ, provided by the DOL.

27. *See* IRS Rev. Proc. 2016-37.

28. *See* IRS Rev. Proc. 2019-20.

29. *See* Code Section 414(q) and the regulations promulgated thereunder.

30. *See* Code Section 402(g)(1) and the regulations promulgated thereunder.

31. *See* Code Section 416(i)(1)(A)(i), defining a "Key Employee" as someone who, at any time during the plan year, is (i) an officer making over $185,000, (ii) a five percent owner of the business, or (iii) an employee owning more than one percent of the business and making over $150,000 per year (indexed for inflation in $5,000 increments).

32. *See* Code Section 415, setting forth the sum of employee and company contributions that can be made during a plan year. For 2022, the limit is the lesser of 100 percent of the participant's compensation, and $61,000 ($67,500 including catch up contributions).

33. *See* Code Section 402(g), which sets for the plan year limits on pre-tax and Roth salary deferrals. For 2022, the limit is $30,500 ($27,000 for catch-up eligible participants).

34. *See* Code Section 410(b)(6)(C).

35. *See* Code Section 411(l).

36. *See* the "anti-cutback rule" regulations promulgated under Code Section 411(d)(6).

37. *See* Code Section 411(d)(3) and the regulations promulgated thereunder.

38. *See* Code Section 401(k)(10)(A) and the regulations promulgated thereunder.

39. *See* Code Section 411(d)(6).

40. *See* 26 CFR § 1.401(a)(31)-1.

41. *See* 26 CFR § 1.414(l)-1.

42. This is often referred to as the "unified plan rule," or the "one bad apple rule." *See* 26 CFR § 1.413-2(a)(3)(iv), although certain proposed regulations (published July 3, 2019) would scale back the harsh application of this rule in certain circumstances. Hearings on these proposed regulations are schedule for June 2022.

43. *See* Information Letter to George J. Chanos, Attorney General, Nevada Department of Justice, May 8, 2006.

44. *See* Rev. Procs. 2002-21 and 2003-86. The exception to this rule is Insperity's 401(k) plan, which is the subject of an IRS determination letter stating that it is a single-employer plan.