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Top Labor and Employee Benefits Issues to Think About in M&A Deals

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An overview of labor and employee benefits considerations in M&A transactions, which can implicate financial liabilities and impact the value and long-term viability of a business.

As M&A transactions are negotiated, parties often focus on the business and revenue drivers of the target during the due diligence process and leave labor and employee benefit plan considerations as a secondary thought. However, employees are often the backbone of a business - employee and benefit plan matters can implicate serious financial liabilities and employee relations issues can impact the value and long-term viability of a business. Below, we highlight several labor and employee benefits considerations in M&A transactions.

1. **Impact of Deal Structure on Employees and Benefit Plans**

In a transaction structured as an acquisition of equity, the buyer acquires the target company's (or a parent entity's) equity interests, and typically inherits the target's existing employees and employee benefit plans. Similarly, in a merger, the target becomes part of the buyer (or a subsidiary of the buyer). The continuity of the existing structure means target employees will generally automatically transfer employment to the buyer group while often remaining employed by their current employing entity, without any offer and acceptance process. This structure offers simplicity for the buyer from an on-boarding perspective, but demands a more thorough review of existing labor practices and benefit plans because the buyer will assume any legacy programs and historical liabilities. The scope of due diligence will include identifying (i) any potential employment practices or benefit plan concerns or non-compliance with applicable laws, and (ii) evaluating labor practices and benefit plans for post-closing integration with buyer practices and plans. In addition, a strategic buyer will need to determine how to handle duplicative benefit plans post-closing and may wish to require a seller to terminate certain plans pre-closing (or need to consider benefit plan mergers post-closing). In contrast, in a transaction structured as an acquisition of assets, the buyer generally has more control and flexibility over which employees to hire and which benefit plans (if any) the buyer would like to assume. However, even if the buyer does not assume any benefit plans, the concept of successor liability for certain labor practices and benefit plans may still result in liability for the buyer. An asset structure also means the buyer will have to on-board target employees with an offer and acceptance process and employment agreements may need to be renegotiated. As part of this process, the buyer will also have to consider any employee relations issues as target employees face potential changes to their work environment and compensation and benefit structures. Notably, in some mergers or equity deals, employees may be employed and benefit plans may be maintained at a parent level (rather than at the subsidiary being acquired). Such transactions are more akin to an "asset purchase" from a labor and benefits perspective as parent-level employees and benefit plans would not transfer automatically with the subsidiary target in the deal.

2. **Potentially Costly Benefit Plan Liabilities**

Thorough due diligence of benefit plans generally involves an examination of the target's retirement plans and health and welfare benefits. Employee benefit plans are subject to a number of complex regulatory requirements, including the tax code, ERISA and the Affordable Care Act, which carry significant taxes and penalties in the event of

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noncompliance. Many of these laws also operate on a “controlled group basis,” meaning that benefit plan obligations at a parent or brother-sister entity can create exposure for the target. The due diligence process can help identify any potential legal risks and design strategies to mitigate such legal risks. One area of particular concern is identifying whether the target (or any target employee) participates in any defined benefit pension plans or union (multiemployer) pension plans, or whether the target provides (or has promised to provide) any retiree health or other welfare benefits. Defined benefit pension plans are subject to strict funding requirements, and maintaining an under-funded plan may result in increased costs for the buyer post-acquisition due to unexpected increases in required contributions. Withdrawals (including partial withdrawals) from a union pension plan may also implicate significant withdrawal liabilities for an employer contributing to such a plan. In addition, if the target provides (or has promised to provide) any retiree welfare benefits, the buyer should take into account the future financial costs of such obligations, which can be quite significant depending on the covered population and the type of benefit. Thus, attention should be given during due diligence to the funding status of pension plans, any outstanding or potential withdrawal liability, and the extent of any retiree benefit commitments. Once such items are identified, the buyer can develop strategies for addressing these liabilities, including negotiating purchase price deductions or special indemnities.

3. **Impact of Executive Compensation Arrangements and Code Section 280G**

Due diligence should also cover the target’s executive compensation arrangements, including any equity arrangements, severance benefits, or other payments that might be triggered in connection with the transaction, to understand the potential future financial obligations and assess the compliance of such arrangements with regulatory requirements. Section 280G of the Internal Revenue Code (“Section 280G”) applies to certain payments (“parachute payments”) made to certain service providers of a corporation (“disqualified individuals”) in connection with a change in control. If parachute payments exceed three times the disqualified individual’s “base amount” (generally the average of the individual’s prior five-year compensation), Section 280G imposes a 20% excise tax on a portion of such payments and also prohibits the employer entity from taking a tax deduction for such payments. Transaction or retention bonuses, equity acceleration, and severance compensation and benefits are common payments that could be considered parachute payments. ***Private Company Targets***. There are several notable exceptions to Section 280G. One of the most commonly used exceptions for private corporations is to obtain shareholder approval of parachute payments. This process generally involves: (i) obtaining a waiver from each of the disqualified individuals waiving their right to excess parachute payments if such are not approved by the target’s shareholders, (ii) disclosing the details of such payments to all of the company’s shareholders, and (iii) obtaining the approval of at least 75% of the voting power of the target’s shareholders, excluding those receiving parachute payments. Depending on the number of disqualified individuals and shareholders involved, this process can be lengthy and involve additional negotiations. Thus, the parties should identify Section 280G payments early in due diligence so that any shareholder approval process is completed before closing. Where a transaction has a staggered sign and close, a covenant is also often included in the purchase agreement requiring sellers to solicit waivers and shareholder approval in accordance with 280G’s regulatory requirements (under Section 280G the consummation of the transaction cannot be contingent on actually obtaining such shareholder approval). ***Public Company Targets***. The shareholder approval exception is not available to public company targets. Thus, the parties should identify potential Section 280G payments early in the due diligence process to explore mitigation strategies. Common mitigation strategies involve: (i) using “cutback” provisions to reduce parachute payments to the maximum amount that avoids excise taxes or that results in a better net after-tax benefit for the individual, (ii) for transactions that will sign in one calendar year and close in a later calendar year, increasing the disqualified individuals’ “base amount” by accelerating certain compensation (such as annual bonuses and potentially equity vesting) to the year prior to the year of closing so that such amounts will be included in calculating the “base amount,” and (iii) obtaining valuations of any

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applicable restrictive covenants which can help to offset the value of excess parachute payments in certain circumstances.

4. **Potential Exposure to Worker Misclassification Liability**

Due diligence should also include a review of the target's worker classification practices. Two primary worker misclassification issues can arise in the context of an M&A transaction: (1) misclassification of workers as exempt under the minimum wage and overtime requirements of the Fair Labor Standards Act ("FLSA") and similar state laws; and (2) misclassification of workers as independent contractors. Claims brought by employees who have been improperly classified can result in significant liability—including liability for unpaid wages and benefits, liquidated damages, unpaid taxes, and attorney's fees. These claims are often asserted as collective actions seeking damages on behalf of all affected employees. ***Exempt or Non-Exempt Status***. In order to comply with the FLSA and similar state laws, exempt employees often must meet separate salary level, salary basis, and job duties tests. To complete a fulsome analysis of these tests, the buyer should ensure that the target provides an employee census early in the diligence process that lists all of the target's employees, their locations, job titles, compensation rate, compensation type (hourly, salaried, or commission), and classification under the FLSA (exempt or non-exempt). A complete employee census is the first step for identifying potential "red flags." For any job titles that raise FLSA classification concerns, the buyer should request a job description and additional details to assess whether job duties align with requirements of an applicable exemption under the FLSA. ***Independent Contractors***. Although true independent contractors are not subject to the FLSA, an employee improperly classified as an independent contractor may have a viable claim for minimum wage, overtime pay, employee benefits coverages and other benefits typically reserved for employees. For this reason, an analysis of the target's worker classification practices should include review of the use of independent contractors, including an independent contractor census reflecting the scope of work and the length of engagement of independent contractors, as well as an analysis of sample contracts between the target and its independent contractors. The Department of Labor ("DOL") released a final rule on January 10, 2024, tightening the standard for evaluating the classification of workers. The rule, effective March 11, 2024, suggests that employers use a "totality of the circumstances test" made up of six equally-weighted factors: (1) the opportunity for profit or loss depending on managerial skill; (2) the investments by the worker and potential employer; (3) the degree of permanence of the work relationship; (4) the nature and degree of control over performance of the work and the work relationship; (5) the extent to which the work performed is integral to the potential employer's business; and (6) the skill and initiative of the worker. No one factor controls; instead, an analysis of all six factors is needed in order to effectively evaluate a worker's classification. The greater a target's use of independent contractors, the more fact-intensive a due diligence inquiry into the nature of the parties' working relationship must be. While the DOL's new rule is likely to be the subject of legal challenges, it reflects a general trend subjecting independent contractor arrangements to closer scrutiny, increasing the need to carefully assess such arrangements in deal diligence.

5. **Collective Bargaining Issues**

If the target company or any of its employees are parties or subject to collective bargaining agreements ("CBAs"), work councils, or any other similar labor obligations with representative bodies, due diligence requires a careful analysis of the agreement's terms to evaluate its potential impact on the transaction both pre- and post-closing. Examples of such terms include, but are not limited to: (1) provisions that require notice to and consent from the union prior to a sale or transfer of the business; (2) provisions that require recognition of the union; and (3) provisions that require the transferee or purchaser to continue providing certain benefits to the covered union members (such as pension plans). In addition, the buyer should note the status and term of any agreements. If a CBA has recently expired or its expiration is imminent, union negotiations and bargaining for a new CBA could impact the timeline of the transaction and thereby the date of closing, as well

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as give rise to other considerations. In addition to examining any union agreements themselves, buyers must be aware of the practical considerations of purchasing a company with union labor obligations, including the scope of any union recognition on employees covered by the transaction. A buyer should also be aware of extra-contractual duties that could arise under federal labor law. For example, the National Labor Relations Board ("NLRB") recently expanded its test for finding the existence of "joint-employer" status under a final rule to become effective on February 26, 2024. Under the new standard, two or more entities may be found to be joint employers of a group of employees (and, thus, jointly obligated to recognize a union as the representative of such employees) if two conditions are met: (1) each entity has an "employment relationship" with the employees; and (2) the entities "share or codetermine one or more of the employees' essential terms and conditions of employment." This new standard can be important to consider in transactions involving parent/subsidiary arrangements, joint ventures, and outsourced management (including between property owners and managers and between portfolio companies and private equity managers). Another consideration—albeit less common—is that of a double-breasted operation (a practice often—but not exclusively—seen in the construction industry). Such an arrangement can occur when one parent company (or a common owner) operates both union and non-union businesses in the same market. Although permitted by federal labor law, these types of arrangements can be subject to additional scrutiny by the NLRB to ensure that the entities are truly separate and not alter egos of each other created to circumvent the CBA's coverage of all employees. In the absence of adequate separation, the parent or common owner can be exposed to substantial liability flowing from application of collective bargaining obligations to its erstwhile non-union business operations.

6. **Review of Pay and Payroll Practices**

Due diligence should also include a review of the target's pay and payroll practices, including the company's policies on employee pay and timekeeping practices. The target should have a system to accurately record time worked and track other employee time, such as meal and break times (the specific requirements for which can vary based on state laws). In reviewing the target's pay and timekeeping practices, a buyer should keep in mind any distinctions that could be susceptible to challenge. For example, does the target "round" reported time or require non-exempt employees to "clock in" for work electronically in a manner that arguably does not account for the time it takes for the individual to log in to a computer or otherwise perform "clocking in" tasks. Another issue to consider is the target's practices and recordkeeping related to employee bonuses. For example, if a bonus that is offered to a non-exempt employee qualifies as a "non-discretionary" bonus under DOL rules, the bonus should be included in the employee's regular rate of pay for purposes of overtime pay calculation under the FLSA. Proper recordkeeping should allow the buyer's counsel to confirm the target's compliance with overtime rules where nuances exist.

7. **Pre-Employment and Hiring Practice Compliance**

Many companies require certain pre-employment screenings and testing, such as drug tests, background checks, or physical exams, to help screen and select job applicants. Aside from immigration compliance and anti-discrimination laws, most hiring practices are governed primarily by state law. Buyers must carefully assess potential liability stemming from the target's pre-employment practices, paying particular attention to the laws of states where the target employs a sizeable number of workers. Improper administration or application of these tests may give rise to a variety of legal claims. Testing should be uniformly applied and comply with the Americans with Disabilities Act ("ADA"), and reasonable accommodations for disabled individuals must be provided. Finally, consideration of any privacy concerns or recordkeeping requirements related to the target's pre-employment and hiring practices should also be a part of the due diligence process. ***Employment Eligibility and Immigration Law Compliance.*** Due diligence should cover the target's practices for ensuring immigration compliance, including Form I-9 completion and potential use of E-Verify to confirm a prospective employee's eligibility

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to work in the United States, which may be required or restricted under applicable state and federal laws. If the target employs foreign workers and the buyer intends to hire or retain these workers, due diligence should also take into consideration the work status of each of these workers, including the existence or availability of applicable visas or other immigration-related approvals. ***Background Checks***. Because of the patchwork of state laws governing these subjects, a target's use of criminal background checks, consumer or credit reports, or social media screening are all cause for additional scrutiny. For example, many states restrict an employer's ability to inquire into an applicant's criminal record or limit the employer's ability to make hiring decisions solely based on an applicant's criminal record. Additionally, obtaining information about an applicant from a company that compiles background information as a business may require the disclosure of specific information to the applicant in writing. ***Medical Exams; Drug Tests***. A target's practices in conducting any pre-employment medical screenings should be closely examined. Under the ADA, job applicants cannot be required to submit to medical or physical examinations or alcohol tests prior to receiving (at least) a conditional job offer. Note, however, that according to EEOC guidance, employers may ask applicants to submit to drug tests before making a conditional job offer.

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