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401(K) PLAN ERRORS COST SELLERS OF COMPANY NEARLY $200,000

A recent Court of Appeals decision provides a tangible example of the costs of ignoring employee benefit compliance requirements. In *Tatum v. SFN Group, Inc.* (No. 16-11966, 6/23/17), the 11th Circuit affirmed that the purchase price paid for a CFO-outsourcing firm was properly reduced in light of compliance errors in the operation of the company's 401(k) Plan.

In February 2010, Tatum, LLC (Seller) and staffing company SFN Group (Buyer), entered into a merger agreement (Agreement) under which the Buyer agreed to acquire Seller's company for payment of several million dollars, which included payments in cash and stock, as well as the assumption of debt and liabilities. The Seller's 401(k) plan was assumed by the Buyer. Under the terms of the Agreement, part of the purchase price was held back for eighteen months after the closing in the form of an indemnification holdback fund. The purpose of the holdback fund was to compensate the Buyer in the event it incurred certain defined damages, including damages resulting from the Seller's breach of any representation or warranty contained in the Agreement.

After the closing, but just before the end of the eighteen-month holdback period, the Buyer notified the Seller of its discovery that the Agreement had misrepresented the Seller's 401(k) plan. Specifically, the Seller had represented and warranted in the Agreement that its 401(k) plan was operated in compliance with applicable law. The Buyer had learned, however, that the 401(k) plan was not in compliance, and was therefore subject to potential tax-disqualification by the IRS.

The 401(k) plan's significant compliance errors were ultimately resolved through the IRS's Voluntary Correction Program (VCP), under which a 401(k) plan sponsor may self-report a compliance issue to the IRS and receive approval for its proposed solution, thereby avoiding tax-disqualification. By the time the compliance errors were rectified, the total 401(k)-related legal expenses and VCP fees incurred by the Buyer totaled $192,000. As a result, the indemnification holdback fund, minus the $192,000 amount, was disbursed to the Seller.

While the Seller asserted claims including breach of contract and conversion in an attempt to recover the withheld funds, the Court found that the Seller had breached its duties to the Buyer under the Agreement and that the Buyer was entitled to withhold the amount at issue.

Had the 401(k) plan errors been previously resolved by the Seller, or discovered by the Buyer before the transaction closing, the costs to the Seller (and burdensome correction process by the Buyer) may have been reduced or avoided. The ruling serves as a reminder of the importance of adherence to compliance with benefits requirements, as well as the need for performing careful due diligence and strategically drafting the purchase agreement in merger and acquisition transactions.