

## **Employee Benefits Issues in Spin-Offs**

Article By:

Jeffrey M. Holdvogt

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In a corporate spin-off, both the existing company and the new company (spinco) must consider the implications for employees, employee benefit plans and executive compensation arrangements. Benefit plans and compensation arrangements can represent significant liabilities and responsibilities, and typically are expressly allocated in an employee matters agreement (EMA). This article provides a brief summary of some of the key employee benefit plans issues to consider in a spin-off.

### **Separating Employees and Management**

For most employees, it will be clear whether they are primarily related to the future profile of the parent company or of the spinco following the separation. The EMA should carefully delineate the status of each employee or employee group. For executives and management, particularly where existing managers have responsibilities that cover both the parent company and the spinco, the parent and the spinco should carefully consider their management personnel, including whether additional management may be necessary for the spinco's successful transition.

### ***Continuing Salary and Benefits; Transfers Post-Spin***

Once the parties are separate, will the spinco employees continue salary and benefits at the same levels? To reassure spinco employees, the parent company and the spinco may want to establish a transition period guaranteeing salary and benefit levels following the separation. Will employee transfers between the parent company and the spinco be anticipated (or perhaps prohibited) post-separation? If so, the parent company and the spinco should address this issue in the EMA.

### ***Transition Services***

The spinco (or the parent company, if key personnel leave it) may need support for payroll, tax, human resources and other functions immediately following the separation. A cost-sharing agreement may be necessary to cover costs related to benefits and administration for former employees. The parent company and the spinco also should consider establishing data sharing and privacy practices for the post-separation period.

### **Separating and Establishing New Employee Benefit Plans**

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The spinco may already maintain its own separate employee benefit plans, in which case the transition will be easier. However, if the spinco does not maintain separate plans, it must create its own plans prior to separation in order to assume the assets and liabilities from the parent company's plans related to spinco current employees (and perhaps former employees). If those new spinco plans cannot be set up prior to the spin-off, it may be necessary to structure arrangements to allow spinco employees to continue to participate in the parent company's plans for a limited period of time (and to implement appropriate plan documentation, administration and reporting/non-discrimination testing procedures).

### ***Retirement Plans***

If the former parent company has a defined benefit plan in which spinco employees participate, the parties should consider the following questions:

- Will the spinco create a new, active defined benefit plan for its employees?
- Even if the spinco will not have an active defined benefit plan for its employees, will assets and liabilities attributable to pension benefits accrued through the date of the spin-off be transferred from the parent company's pension plan to a frozen spinco plan?
- If there is such a transfer, will it be for only those spinco employees as of the date of the spin-off, or will it also relate to previously terminated or retired employees of the spinco business?
- How will the parties measure any unfunded benefit liabilities?

Employee accounts in the parent company's defined contributions plans typically are transferred to a spinco plan for employees who transfer to the spinco. The parent company and the spinco should work together to coordinate employee elections. If the parent company's defined contribution plans contain parent company stock as an investment fund, special considerations arise with respect to the valuation and split of the stock as a result of the separation, and fiduciary liability related to maintaining non-employer stock as an investment option post-separation in both the parent company and the spinco's defined contribution plans (*i.e.*, the parent company may have spinco stock in its plan, and the spinco may have parent company stock in its plan).

### ***Nonqualified Plans***

Because nonqualified benefits often are unfunded or only informally funded, there can be great sensitivity regarding whether spinco employees' nonqualified plan benefits should transfer to the spinco or remain with the parent company. If the desire is to *distribute* those nonqualified benefits rather than keep them with the parent company or transfer them to the spinco, it will be necessary to analyze whether a distribution is permissible. For nonqualified benefits that are subject to Section 409A of the Internal Revenue Code, the Internal Revenue Service takes the position that spin-offs generally do not constitute a "separation from service" that would permit distributions to employees; however, distributions may be possible if the transaction constitutes a change in control as defined in Section 409A.

### ***Health, Welfare and Fringe Benefit Plans***

In general, the parent company and the spinco each will be responsible for claims incurred against

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their own welfare plans post-spin. However, to the extent the parent company maintains or previously maintained a retiree medical program, the parties must determine how to measure and allocate those retiree medical liabilities (*i.e.*, should the spinco be responsible for retiree medical costs of all employees associated with its business—current, terminated vested and retired—or just future retirees, which would leave terminated vested and retired employees as an obligation of the parent company).

In addition, special attention may be necessary to allocate liabilities related to COBRA, long-term disability payments, spending account plans, accrued vacation/paid time off, workers' compensation, etc.

### ***Severance Plans/Employee Retention Agreements***

If the spin-off triggers a change in control or a separation from service, executives and/or employees with existing retention agreements can find themselves in possession of substantial payments earlier than anticipated, and the often unfunded nature of such plans and arrangements can result in significant payments required from general assets. The parent company and the spinco should determine whether severance obligations arise in connection with employee transfers to the spinco and, if so, how to allocate responsibility for such obligations.

In addition, it may be necessary or desirable to implement new retention or change in control agreements for key spinco employees.

### **Equity Awards/Incentive Plans**

Typically, parent company and spinco equity awards are equitably adjusted to preserve the aggregate spread and value of the awards in connection with the spin-off. However, care must be taken to determine what types of adjustments are permitted under the equity plan documents and whether the adjustments will trigger an accounting expense. Adjustments may be made both as to the number of shares underlying the awards and, in the case of options (including options under employee stock purchase plans), the exercise price.

In addition, the parent company and the spinco must determine whether awards will be based on parent company equity or spinco equity. One approach is to convert all awards for spinco employees to spinco awards and to convert parent company employees' awards into adjusted parent company awards. Another approach is to provide employees with both an adjusted parent company equity award and a new spinco equity award. For executives and management, particularly those with decision-making authority during the period prior to the separation, it may make sense to utilize the latter approach as a way of aligning incentives until the spin-off is complete.

For cash annual and long-term incentive plans, the parent company and the spinco must determine whether either entity will be responsible for the full-year liability or whether each will be responsible for its respective portion.

### **Other Issues**

Numerous other issues will arise depending on the nature and structure of the companies. For example:

- The parent company and the spinco must consider obligations under collective bargaining

agreements, including potential withdrawal liabilities related to multi-employer defined benefit pension plans (sponsored by unions and maintained pursuant to previous collective bargaining).

- The parent company and the spinco also must consider issues related to the treatment of foreign employees, including the transfer of non-U.S. retirement plans.
- Compensation arrangements must be established for the new outside directors of the spinco.

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