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MERGERS AND ACQUISITIONS

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A broad discussion of the current state of the art, including:

- preliminary information gathering
- financial and accounting considerations
- determination of liability
- protection of participants
- design considerations
- interest of buyers and sellers
- plan design for successor plans

MR. ROBIN HOLLOWAY: I would like to begin by introducing the members of the panel. First we will hear from William J. McDonnell, Vice President of William Mercer, Inc., who will speak on the concerns of the plan participants and on plan design. Joseph R. Zatto, Vice President of Alexander and Alexander, will then speak on the financial considerations from an actuarial point of view. Then, Shaun F. O'Malley, a Partner with Price Waterhouse and Company, will speak on the financial considerations from an accounting point of view. After they have spoken, we will take questions from the floor.

First of all, I would like to give a little background on Mergers and Acquisitions.

Prior to ERISA, plan sponsors could transfer assets and/or liabilities from one pension plan to another with few restrictions (other than some concern for triggering a partial or complete plan termination or for retroactively disqualifying past tax deductible contributions). Consequently, it was common to merge two or more plans, to split a plan into two or more plans and to transfer liabilities (and, sometimes assets) from one plan to another when an employee or a group of employees were transferred.

ERISA placed severe restrictions on this practice. ERISA says that a trust which forms part of a pension plan will not be qualified under Section 401 of the IRS Code unless the plan provides that in the case of any merger or consolidation with, or transfer of assets or liabilities to any other plan, each

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participant in the plan would (if the plan then terminated) receive a benefit immediately after the merger, consolidation or transfer which is equal to or greater than the benefit he would have been entitled to receive immediately before the merger, consolidation or transfer (if the plan had then terminated). This determination was to be made without regard to the guarantees of the PBGC.

ERISA also provided that, if a pension plan terminated, the assets were to be allocated in accordance with an extremely complicated procedure (the so-called Section 4044 calculation). In order to demonstrate that an employee would receive the same benefit before and after a merger, consolidation or transfer of assets and liabilities, it was usually necessary to perform this calculation.

As a result of these ERISA provisions, plan mergers, spinoffs (the splitting of a plan into two or more plans) and transfers of assets or liabilities from one plan to another came to a standstill. Plan mergers were virtually impossible, unless the sum of the assets exceeded the sum of the liabilities. Spinoffs required complicated, time-consuming and costly calculations. Also the transfer of some of the assets or liabilities from one plan to another required that the first plan satisfy the spinoff test and the second the merger test.

Even the formerly common practice of transferring the liability (and, sometimes, the corresponding assets) of a single employee, who transferred from one unit to another (or from hourly to salaried), was made almost impossible (although many plan sponsors have continued this practice - apparently not realizing that it is contrary to ERISA).

Furthermore, many companies had been treating a single pension plan as if it were a series of plans and others had been treating a family of plans as if they were a single plan. Some had been doing both - acting as if they had a single plan when that suited their purpose and as a family of plans when that was preferable. ERISA had the effect of forcing such companies to recognize the legal facts, which were not always easy to determine and, if determinable, often contrary to the company's intent.

Recognizing that Congress had not intended to preclude mergers, spinoffs and transfers and, furthermore, that it was not always clear exactly what constituted a plan, the IRS issued proposed regulations in July 1977 which defined what a plan is and which made it easier to merge and split plans and to transfer assets and liabilities from one plan to another.

Because of the potential difficulty in reversing a merger or separation of plans which occurred in connection with the sale of a company's stock or assets, these proposed regulations may be relied on in such a situation if retroactive compliance with the final regulations would create undue hardship.

The proposed regulations permit companies to merge two or more plans if they establish a special schedule of benefits in the combined plan which has the effect of guaranteeing pre-merger benefits if the merged plan terminates within five years of the merger. But the construction of the special schedule requires the complicated plan termination calculations. In lieu of this schedule, therefore, the proposed regulation provides that plans can be merged <u>without</u> constructing a schedule if the actuary for the plan certifies that the data necessary to perform the calculations will be maintained for five years after the merger.

No relief for spinoffs has been provided (except for the de minimus rule described below). However, in recognition of the fact that it is often unclear as to whether a company has one or more plans, companies which have maintained asset allocations within a plan were permitted to establish separate plans, using the allocated, assets without satisfying the ERISA test, provided the legal separation was done by July 1, 1978.

A special de minimus rule is available in the event of the merger of a very small plan into a large plan or the spinoff of a very small piece from a larger plan. Because no significant dilution of the larger plan's funded status will result, a plan with accrued benefit liabilities which are less than 3% of the assets of a larger plan can be merged into the larger plan if a special benefit schedule is established for the smaller plan alone (or if data are maintained by the actuary). A piece can be spun off a large plan if it is less than 3% of the whole and assets equal to liabilities are transferred.

With that as background, I would like to turn to Mr. William McDonnell.

MR. WILLIAM J. MCDONNELL: One major problem that I have encountered in fulfilling the consulting actuary's role in a merger or acquisiton situation is being brought into the discussion at too late a stage to do my job in the most effective manner. In other words, being brought in after commitments have been made by one party or another without full knowledge of the consequences of those commitments.

Of necessity, proposed acquisitions and divestitures must be kept very confidential until the discussions have reached the point where a public disclosure can be made. A company trying to divest itself of all or part of its operations does not want to upset or alarm its employees, the local community and the business community while it goes through two, three or more exploratory talks with potential buyers. However, we should impress on our clients, whether potential buyers or sellers, the importance of bringing the actuary into the discussions before any agreements are signed which bear on the disposition of the pension plans of the acquired company.

As simple a statement in a preliminary purchase agreement as "the buyer agrees to assume all of the assets and liabilities of the seller..." can have a lot to say about what happens with the seller's pension plans.

So it is important, first of all, to have some kind of a checklist of the information to be gathered initially in order to point out to your client, whether he be buyer or seller, the different courses of action open to him and the implications of each.

This is not intended to be a complete checklist and many of the items of information needed may be discussed in detail by Joe and Shaun in their talks, but here are some of the things that should be discovered at the early stages of negotiation.

For the buyer:

- What pension plans does the seller have for its employees? What are the benefits provided under those plans? Are any of the plans covered under a collective bargaining agreement? When do agreements expire? Does the seller intend that the buyer assume all responsibility for any pension plan, including retired and terminated employees?

- What has been the treatment of retired and terminated employees under company practice or in collective bargaining? Have improvements to former employees' pensions been made in a consistent pattern when improvements are made for active employees?

- Do any pension plans have to be split? For what employees will the buyer have to assume responsibility in a split?

- What treatment will the seller insist on for the employees going over to the buyer? Will the purchase and sale agreement require that the same or comparable benefit levels be continued?

- What is the extent of funding under the seller's pension plans? Under what cost method, assumptions?

- What is the ongoing cost of pension plans included in the pro-forma income statement of the seller? Under what cost method, assumptions, past service funding period? Does this include all amendments, executed or otherwise promised?

- How would that income statement look if the buyer's benefit plans were extended to the acquired company? (I once had a client whose policy was to extend its fringe benefits to acquisitions. More than once they bought a company that was making money, extended their pension plan and other benefits to it, then, all of a sudden the black ink turned into red.)

For the seller, some questions might be:

- Why is the buyer buying this company or division? Is it to continue operating the company in much the same way as it has been operating in the past? Or is it to weed out some fat in the organization, pump up the earnings and then sell it off to someone else? Do they intend just to acquire the assets and liquidate the company?

  (Even if the intent of the buyer is to continue to operate as before, it does not always work out that way. I have heard an executive say, "they weren't making any money with it, but we thought we were smarter than they were, so we bought it. It turned out we were not as smart as we thought we were, so we sold it off.")

- Does the buyer intend to continue virtually all of the employees in his employment? If not, this could influence the seller to make provision for the protection of terminating employees in his pension plan or in the terms of the purchase and sale agreement.

- Does the buyer intend to continue the pension plans as is, terminate them,or integrate them into his existing plans?

- What is the buyer's policy on benefits for his own employees? Is he liberal or does he have a minimum type of benefit program?

Quite often, one party or the other has the upper hand in dictating the conditions of the sale that affect employee benefit plans. It will help the consulting actuary a good deal if he gets some kind of a reading on this situation early in the game so he can recommend practical alternatives to his client. If the seller is in the position of just dictating the terms of the sale with respect to benefit plans, this limits the alternatives that can be realistically explored.

How does the seller who wishes to protect his employees' pension rights do so? He can, of course, retain the responsibility for accrued pension rights for active and former employees and keep the assets that were accumulated to back up these accrued benefits. This may be the best way for the seller to be sure that the benefits earned by those employees while they worked for him are fully provided. He may want to provide for the accrued benefits for non-vested employees if they continue with the new employer,so that their combined service meets the vesting rules of his plan. This would require some arrangement with the successor employer to verify service records of employees who are not fully vested at the time of the sale.

The seller can also insist on a provision in the purchase and sale agreement that requires the buyer to continue the pension plans in effect,or provide comparable benefits to these employees under his own plans. How long a provision of this type can be enforceable is very much in doubt. Usually, this would require the new employer to set up a comparable plan, but not require him to continue it for any length of time. Knowledge of the buyer's treatment of his own employees in the past can be a big help in advising the seller about how much protection is needed after the sale.

If the pension plan is part of a collective bargaining agreement, the seller can usually depend on the union to make sure that pension rights are protected. The seller, from his knowledge of the buying company, should be able to assess how much strength the union will have in bargaining after the sale. Of course, depending on what the bargaining climate has been with that union in the past, he might not much care, and just let the union handle its own problems with the new owner.

The seller may want to discuss with the buyer beforehand what consolidations he intends to make and what employees are likely to be let go after the sale. The seller may want to retain or hire back these employees or make some special arrangement for them under his plan. If there are enough employees involved, he may consider a partial termination of his plan at the point of sale so these employees can be covered under special early retirement provisions.

Every once in a while, the acquiring company has a policy on fringe benefits which equates to virtually no such benefits, and it has no intention of continuing any pension plan for the acquired employees. Now the seller is forced into a decision on how he should treat these employees. Should he extend those benefits which would be payable if the plan terminated but employees were continuing to work or does he want to take a more liberal approach and extend retirement provisions under his plan to these employees,despite the fact that they will be keeping their jobs with a new employer? Remember also, that treatment of employees as retiring instead of terminating often involves liabilities under other benefit programs as well, such as life insurance and medical benefits and it becomes more costly to make improvements in benefits for retirees in the future.

A similar situation, but a lot more drastic, is the one where the acquiring company intends to liquidate virtually the entire acquired company or division within a short time after the sale. Then the employer might want to treat these employees as he would if he himself were closing down that operation.

What should the buyer be thinking about during the negotiations?

So much depends on the attitude of each company, the buyer and the seller, toward its employees. Even though we often would like to tell our clients how they should spend their money, it is after all their money and we are bound to advise them how to obtain their goals, as long as it does not compromise our integrity or ethics in any way or violate our rules of professional conduct.

The buyer should plan in advance the best way of operating his pension programs after he acquires the company, divisions, etc. Are their plans under labor agreements? If so, they will probably have to be absorbed as is and negotiated at the next bargaining date.

If he can do so, it might be to the buyer's advantage to accept only the liability for active employees and leave the responsibility for retired employees with the seller. If there has been a pattern of giving increases to retired employees, the buyer would be leaving this responsibility with the seller if he accepted no responsibility at all for the retired employees.

If there are collective bargaining agreements where increases have traditionally been negotiated for retired employees, the buyer probably would not escape the cost of future increases by not accepting the liability for employees retired before the sale. He might just as well absorb all the assets and liabilities attributable to present and former collective bargaining employees, assuming he gets a fair allowance for any unfunded liability in the purchase price.

As far as salaried and non-bargaining hourly employees are concerned, it is in the best interest of the seller to be able to assure these employees that they will be fairly treated after the sale -- no buyer wants to pay a lot of money for a disgruntled work force -- and it is in the best interest of the buyer to make the same kind of assurances after the sale, and as soon as possible after the sale, because this is a time when employees are feeling very apprehensive anyway, about keeping their jobs and about all kinds of working conditions they enjoyed before the sale.

The salaried employees of the acquired company or division usually create the most complex plan design problem. These are employees who are most likely to be "mixed up", one might say, with the salaried employees of the acquiring company, whether by transfers, or consolidation of certain operations such as accounting, sales offices and the like. Often an acquiring company may feel that the ongoing operations will stay quite separate for some time in the future, but this never quite works out. The best course of action might be to take a good look at the entire benefits program of the salaried employees in the acquiring company and the acquired company, and decide what kind of common program would be

best for all of them in the future, for a reasonable cost. Then take the necessary steps to put all employees on the same benefit program as soon as possible after the sale. This will undoubtedly involve some "swap-offs".

Company "A" may have a better pension plan, while company "B" may have a better life insurance program. Company "A" may have long term disability, while "B" has no LTD plan but has a dental plan - and on and on. I am talking here about a major acquisition, where the new group will make up a substantial part of the combination. You would not be likely to go through this exercise with a small acquisition.

Dealing with the pension plans specifically, suppose the acquiring company has a better pension plan in most respects than does the acquired company. If the cost is affordable, it should be fairly easy to absorb the new employees into the parent company plan, extending credit for all service with the predecessor company for all purposes of the plan, and offsetting the final pension by any pension which the employee will receive under the predecessor-employer's pension plan. This way, employees will feel as if they are still with the same company with a new boss, so to speak, who improved their pension benefits instead of feeling they have been fired from one job and are just starting another.

This kind of arrangement, counting predecessor service, can be made even if the buyer is simply going to continue the plan of the seller for these employees, or extend the seller's plan to all <u>his</u> salaried employees because it is the better plan. However, two cautions if the buyer is going to extend all service credit under his plan and offset benefits under a prior plan.

First, there is usually some kind of shakedown within the period closely following an acquisition. I talked about functions being consolidated which put employees working side by side and covered under different benefit programs. These conditions usually result in a smaller staff than the sum of the two former staffs, with the result that some employees are terminated shortly after the sale. The buyer may intend to phase out a particular department, or a product line that does not fit in with the combined companies, or where he thinks he can buy a certain part cheaper than he can make it. Lastly, some employees are bound to be apprehensive or dissatisfied with the new arrangement and leave shortly after the sale. Do not make a pension commitment that results in substantial increased liabilities for these terminating employees. Try to delay the effective date of any big improvements until just after this shakedown period if at all possible.

Second, if the seller is retaining a liability for accrued benefits for active employees, try to have him amend his plan

so that service with the successor employer counts for vesting under his plan. This way the buyer does not pick up any liability for benefits earned under the predecessor plan for employees who were not fully vested at the time of the sale.

The seller should be cautious about any ongoing commitment in his plan by which the buyer could trigger a substantial extra liability for him. For instance, if service with the successor company counts for vesting and early retirement, and his plan has substantial early retirement subsidies, the new owner could trigger large liabilities for the seller by a future shutdown, much larger than the liabilities he would expect from a normal pattern of early retirements.

If the seller retains the liability for accrued benefits for his former employees, what about the ERISA-required joint and survivor benefit? If it is company-paid, it probably just continues to be attached to the accrued benefit liability in the future. But if it is employee-paid, how does the seller handle employee elections for coverage in the future? This kind of arrangement may involve a continuing coordination of pension plan administration between buyer and seller after the sale, for vesting, for early retirement, for election of options.

All of these decisions which a buyer or a seller has to make, with our help, have important cost and liability ramifications, which our other panelists will explore in detail, can also have important employee relations aspects and important public relations ramifications in the business community and the local geographic community, which both the buyer and the seller should try to anticipate during the process of planning the details of pension and other benefit arrangements in a merger or acquisition situation.

MR. JOSEPH R. ZATTO: Any discussion of the current state of the art in Pension Mergers and Acquisitons has to be greatly influenced by, and concerned with, the effects of ERISA and the various regulatory requirements of the IRS, the Department of Labor, and the PBGC. Certainly the picture has changed and become more complicated with the introduction of the heavy regulation in this area. However, in addition to these new problems and complications, we cannot afford to ignore or overlook the standard pension problems that have always existed when one company acquires another. I hope that today we can discuss both aspects of this question. In some instances I will be raising questions in connection with regulatory aspects for which there are not as yet any established answers.

For the purpose of our discussion, let us assume that we are talking about the usual case of two separate corporations. One is selling an operation and the other is buying that

operation. Further, the operation to be sold has a pension plan, either a separate plan or as part of a larger plan, and the buyer also has a pension plan. Starting with this routine situation, there are several combinations of events that may occur. However, if you bear in mind that I am relating to the financial aspects of the merger or acquisition, not the people or benefit design aspects, I think that we can divide the events into two basic categories and discussions.

I will classify the first category as the Negotiable Arrangements and I will call the second category the Regulated Arrangements.

Under the first category, I would include all of the questions and concerns that I think the actuary must consider that can have some impact on the financial negotiations between the buyer and seller. Under the second category, I would include the concerns and requirements that have to be followed because of ERISA and its regulations. In a manner of speaking, the first category could be viewed as the standard acquisition problems, most of which have always existed, and the second category is a package of new problems because of ERISA.

Negotiable Arrangements

The first category then covers the consulting actuary's role in working as the financial advisor to his client who, we will say, is the buyer.

The bottom line objective here is to provide the client with the facts in a manner that will give him a clear understanding of the financial implications involved with taking over the seller's pension plan. Obviously, in some cases, the information provided may affect the purchase price that the client is willing to pay to the seller.

A suggested approach is to determine, as much as possible, certain basic financial information. This should include:

1. Annual operating cost of the pension plan (i.e., normal cost plus amortization of unfunded past service liability).

2. Unfunded past service liability - based on true past service method as compared to the valuation method used for plan funding. In the case of a final-average plan, this can be done both with and without allowance for projected salary increases.

3. Unfunded vested liability - calculated as per APB Opinion 8 which, under Interpretation I of the American Academy of actuaries, will also be the same as the calculation method for the vested liability information in Schedule B.

Now these are some standard items, nothing fancy, but they serve as a basic measurement that can be valuable in the purchase negotiations between a buyer and seller. In the real world situation, the time and data available to make the financial measurements that I have been referring to varies considerably. Sometimes it is possible to obtain reasonably good data in advance and make independent measurements; sometimes it is necessary to work with the seller's actuary and, between the two, make "best-estimate" type judgments, and sometimes it is necessary to make estimates working from the prior actuarial valuation report for the seller's plan.

In any case, there are some critical items that should be considered in preparing the measurements or estimates.

Actuarial assumptions - it is unlikely that the buyer's actuarial assumptions will be the same as those used by the seller. The last thing that the actuary wants to have happen is for the buyer to think that the unfunded vested liability he will assume if he takes over the pension plan is $3 million, say, because the seller shows that amount in his annual report to stockholders, and then finds out that on the buyer's actuarial basis, the unfunded is $5 million. Thus, it is important that the measurements reflect the buyer's basis, and/or that the difference between the buyer's and seller's basis be understood by the client.

We have found that in an acquisition, it is the measurement of the unfunded accrued liability or the unfunded vested liability that often takes on the most importance to the buyer. Usually, if the buyer tries to adjust the purchase price of an acquisition, it is because of these unfunded liabilities rather than because of the on-going operating costs of the plan.

In measuring or estimating these liabilities, it is obvious that the valuation interest rate used is critical. However, you should also carefully review the early retirement benefits in the plan and the retirement age assumptions. A heavier early retirement decrement in the buyer's assumptions may result in a significant increase in the value of vested liabilities.

Another area to review carefully is the benefit formula in the plan. It is not too uncommon to find retirement plans (particularly negotiated plans) that have benefit amounts that are scheduled to increase each year over a period of three or so years in the future. With the establishment of the minimum funding standard account and Revenue Ruling 77-2, the cost for these scheduled future increases is generally not now included in the current annual valuation. Recognition of these scheduled increases can have a significant impact on the unfunded liabilities and the annual operating costs that the buyer is considering.

Typically, the buyer will try to introduce the amount of unfunded accrued pension liability, or unfunded vested liability, into the negotiations for the purchase price of the company. The seller will take the position that the unfunded pension liabilities should not affect the purchase price since these represent routine operating costs in the running of an ongoing business. The point of view that at least the unfunded vested liability should be reflected in the purchase price is reinforced, I think, by APB Opinion 16 which requires that an unfunded vested liability involved in an acquisition be treated as an interest-bearing liability. Ideally, the actuary does not become involved in the reconciliation of the two opposing companies. The important thing is that we provide the best information possible and that we make sure we communicate it so that it is understood by the client.

When the time or the data is not available to make calculations, there are still many instances when a careful review of the most recent (or the two most recent) actuarial valuation reports on the seller's pension plan will provide sufficient information to focus on a misunderstanding by, or a potential problem area,for the buyer. The operating rule is that we want to do everything we can to prevent any surprises later on, particularly unpleasant ones.

Aside from providing the financial information and preventing surprises, there are other areas in which the actuary can be valuable during the acquisition process. Obviously, he can help in the design of the pension benefits, but that is outside the scope of this discussion. We have found that we can be helpful in drafting or reviewing the pension sections of the purchase agreement. Details that we usually point out to the buyer include such items as:

(i) requiring that the seller make all accrued contributions to its plan, including pro-rata contributions, in the event the acquisition is at other than year end;

(ii) providing for reimbursement from the seller if subsequent benefit claims are made by participants not included on a master list as of the transfer date;

(iii) ensuring that no deficiency exists in the Minimum Funding Standard Account as of the transfer date, or that the seller be responsible for it if it does exist;

(iv) provide for recognition for required investment income on pension fund assets for time up to date actually transferred to buyer, either in the pension assets transferred, or with an additional payment by the seller.

Now, having discussed the actuary's role as financial advisor in connection with the standard acquisition problems which I categorized as Negotiable Arrangements, let us go on to the second category of the new ERISA-related problems.

Let us track through the situation where a corporation acquires a retirement plan from another corporation and the plan acquired was a separate or single plan.

In those circumstances, the situation may be relatively simple for the seller. With the transfer of assets and liabilities to the buyer, the selling corporation may be able to wash its hands of any liability or concern with the on-going operations of the plan. However, even in this simple case there are certain complications that should be considered.

Perhaps the most important is the possibility of an employer liability reverting back to the seller in the event the plan is terminated at some future date by the buyer. It would seem to be an unlikely occurrence, but in its Guidelines on Plan Termination, the PBGC points out that it has the authority, under certain conditions, to reach back to the selling corporation. It is suggested the corporations involved in a sale or acquisition request a determination from the PBGC as to the potential liabilities of the buyer and seller. The PBGC may be able to give a firm assurance that no liability will revert back to the seller.

Other loose ends that have to be considered are the 5500 Form, Schedule B, and maintenance of Minimum Funding Standard Account. Simply put, if the acquisition is during a plan year rather than at year-end, what are the proper procedures?

> Does the seller and his actuary prepare a 5500 and Schedule B for a short Plan year? Must the Minimum Funding Standard Account be maintained through the end of the short year?

The instructions for the 5500 are pretty clear that the Form and associated schedules should be completed through the short year period in the event of a merger, consolidation or liquidation of assets, but I am not sure about the case we are talking about, which is more a transfer of assets and liabilities to a new employer, but not necessarily a new plan.

Now let us look at this acquisition situation from the buyer's perspective. Remember, we are talking about the acquisition from the seller of a single, separate retirement plan. The buyer may either continue this as a separate plan or he may merge it into another retirement plan.

If he continues it as a single plan, the buyer's situation may be relatively uncomplicated. A similar uncertainty remains in my mind regarding the Form 5500, Schedule B and Minimum

Funding Standard Account, namely, are the forms prepared for a partial plan year starting with the acquisition date? Then a related question is whether a new Minimum Funding Standard Account is to be established, or whether the old one is continued. Logic would indicate that the old funding standard account is continued, but I think that there is probably a variety of approaches being followed in actual practice.

In acquiring a single, separate retirement plan, the buyer's other option is to merge that plan into another on-going plan. This makes the acquisition transaction somewhat more complicated for the buyer, since we then enter the fascinating world of Section 208 of ERISA and Section 401(a)-12 of the IRC.

With the proposed IRS regulations to guide us, we have at least a minimum comfort level that a merger is possible. Without going into too much detail, I will point out that the merger is possible if:

(a) the funded ratio of each plan is identical, based on the PBGC termination priorities (this is not likely to generally occur); or

(b) a Special Schedule of Benefits is calculated, covering the participants in both plans to be merged; or

(c) in the case of a small plan/large plan (accrued liabilities are less than 3% of other plan's assets) merger, the Special Schedule of Benefits is calculated only for participants in the small plan; or

(d) rather than actually calculating the benefits the data necessary to calculate the benefits is maintained for a period of five years after the merger date.

I am not going into a detailed description of these items I have just mentioned although I will be happy to answer specific questions if I can. Rather, let me just highlight some items connected with this transaction.

(i) Inherent in each of the approaches is the calculation of, or the potential for, the calculation of certain pension liabilities. The proposed regs state that the valuation basis shall use reasonable assumptions and that the PBGC basis shall be considered reasonable. Prudence would seem to indicate the PBGC basis only, but does anyone feel that the use of the actuarial valuation assumptions would be impossible?

(ii) It is probably that the data maintenance route will be followed in most instances. We have just completed one and have some perplexity regarding our role in certifying that the data will be maintained for five

years. We have outlined the information required and obtained a letter from the client saying that they have it and will maintain it. We assume that this is satisfactory.

(iii) A practical question that comes up in a merger in connection with the data maintenance approach is what amendments, if any, must be made in the plan text in the termination category provisions. We suggested that rather than amend the plan document, the board resolution make reference that a Special Schedule of Benefits would be calculated if required during the next five years and would be established in the required priority category. The IRS indicated that this approach was satisfactory to them.

(iv) Questions arise regarding the Minimum Funding Standard Account in the event of a plan merger. If there was a credit balance in the plan that was merged into the on-going plan, what happens to it? How is a change in assumptions treated? In this case, logic would indicate that there is no carry-forward of the Funding Standard Account information from the old plan into the merged plan.

We have discussed the sale of a single, separate retirement plan and the acquisition of a retirement plan that is then either continued as a separate plan or merged into another on-going plan. There is one other major category in this type of transaction. That is a spin-off, or the sale of a unit or a retirement plan to a buyer.

I think that it is in the spin-off procedure that most of the problems exist in the merger and acquisition of retirement plans. The main problem is that in order to spin off an operation, it is necessary to establish the amount of pension fund assets allocable to that operation. In the good old days, there was no one universal method but most were in some way related to the relative value of accrued liabilities. Now the proposed regulations are quite specific. Unless a separate accounting of assets has been maintained for the various groups, or unless the group to be spun off is very small (total accrued liabilities are less than 3% of the pension fund), the assets <u>must</u> be allocated to a spin-off group on the basis of a Section 4044 calculation. As you know, this can be a staggering calculation, and it is really complicating the situation. I think it is a factor in more corporations deciding <u>not</u> to transfer plan assets and liabilities. In those cases where assets and liabilities are to be transferred, it is making the actual transfer take longer and longer. That is one reason why I think some recognition of investment return on assets should be made in the purchase agreement between the buyer and seller.

In making the calculation to determine the amount of assets for the spin-off, the regulations make the same reference to reasonable actuarial assumptions that I referred to earlier. Thus, it is possible that the PBGC basis must be used in making the calculation necessary to determine the amount of assets to be spun off, although I do not think that is the case.

Thus, at the present time a pension spin-off is a very torturous procedure. If the total accrued liabilities, both vested and non-vested, of the group to be spun off is less than 3% of the amount of assets in the pension fund, the Section 4044 termination calculation can be avoided and assets equal to the full accrued liability can be spun off. Interestingly, that treats the spin off group better than the group that is remaining but the main point is that it is a short cut that will only be available to some of the spin-offs. In many cases the detailed calculations will be required. I think that this may be a factor in an approach that I seem to be seeing on a more increasing basis. That is, when a company spins off another unit instead of transferring the assets and liabilities of its pension plan to the buyer, the seller retains the assets and liabilities in its own fund and the buyer picks up the employees on a new basis. Sometimes complicated amendments are made between the plans of the buyer and the seller in an attempt to have the ultimate benefits payable to the participants the same as if it had been a continuation of an on-going plan. These arrangements can be an administrative nightmare, even though most of the problems will not surface until several years in the future. In other cases, the treatment of the participant is as a new employee, with the result that the ultimate benefits received are not as good as would have been the case had the plan been continued in an on-going manner. In this respect, it seems to me that the proposed IRS regulations resulting from the ERISA legislation are working to the disadvantage of the employees that were spun off and acquired by the new company.

The IRS has provided a third alternative approach in connection with determining plan assets in the event of a spin-off that is a relatively temporary one. Basically, the IRS has said that if you had a single pension plan but maintained a separate accounting of assets between units, and then spin off one of those units, you can use the assets that have been allocated to that unit as the basis for your spin-off. However, the regulations make that a temporary arrangement only through July, 1978. In order for it to be available after that date, the plans had to be amended to officially require the separate accounting and availability of trust fund assets between the different units. One ironic fact here is that at just about the same time the IRS was coming out with regulations on allocating assets, another branch of the government, the Cost Accounting Standards Board, came out with a standard in connection with the reimbursement of pension costs for

corporations which have government contract work. In this standard, the CASB outlined in detail methods for allocating existing assets between different segments of the corporation and required that the assets be allocated in this manner in order to obtain satisfactory reimbursement for pension costs. As you might guess, the method required by the Cost Accounting Standards Board is not the same as the Section 4044 calculation method. The result of the CASB standard will generally be to require that large corporations calculate their pension costs more and more by separate unit. When these units happen to be the same type of separate units that are involved in spin-offs, we will be faced with more confusion in the future as the trust fund amounts that have been allocated to the various units for cost accounting purposes have to, in effect, be tossed aside and new allocations made for spin-off purposes.

In summary, the ERISA-related problems in connection with mergers and acquisitions have been partly answered by the proposed IRS regulations. The regulations, although generally reasonable, do result in considerable complications and in some respects they are going to be very difficult to follow to the letter. If there is not some simplification made, the question of pension plan spin-offs is going to be a very sore one for years to come. In general practice, I think there are several open questions with regard to the treatment of the Minimum Funding Standard Account upon spin-offs, acquisitions or mergers, and it is probable that different approaches are being used in preparing the Schedule B for acquired companies. In those situations, I am always guided by my own personal basic rule that says when I am not sure how to do something, I decide on an approach, do it, and then put all kinds of footnotes on the Schedule B explaining what I have done, together with any relevant references.

MR. SHAUN F. O'MALLEY: I am delighted to have the opportunity to participate in this meeting of the Society of Actuaries for two particular reasons. First, this is my initial appearance at a meeting of your profession. And second, and more important, I am convinced that there is a tremendous need for greater cooperation between accountants and actuaries in the course of providing the best possible service to their mutual clients.

The accounting profession's publication of Accounting Principles Board Opinion No. 8, "Accounting for the Cost of Pension Plans," accomplished a number of things -- among them, an increased level of cooperation and I hope understanding, between our two professions. Unfortunately, the typical communication involves the year-end pension liability and the exchange of letters concerning the APB 8 disclosure requirements. Personally I have found that more direct and yet informal contact with our clients' actuaries has proved highly beneficial in helping us to understand our clients'

pension situations and, in turn, for actuaries to gain a better perspective on our role and requirements.

I believe that this need for cooperation and communication is even more critical in the case of mergers and acquisitions. Why? In my experience, the one area most susceptible to surprises and to subsequent gnashing of teeth in merger planning, negotiating and consummating -- and an area of tremendous financial significance -- is that relating to the pension plans and other benefit plans of the merger candidates.

If I were to list the pension accounting considerations in acquisitions and mergers, I would then put at the very top of the list the absolute need to involve either or both in-house and consulting actuaries very early in the proceedings leading up to a business combination. I say this not to seek your goodwill, but because the status of a company's pension plans and other benefit plans is, or ought to be, a significant factor in the negotiations of purchase price in any acquisition or merger. If reliable actuarial information is not obtained until the end of the process, or if the information is developed only in the process of determining the accounting entries necessary to record a consummated transaction, it is simply too late. The result may be a cancelled deal with a lot of expensive and time-consuming effort wasted or a completed deal which yields some very unpleasant surprises after the fact. It is incredible, but often true, that a buyer will hassle for days over whether the seller's inventory is worth $10-million or $10,200,000 or whether the seller's bad debt reserve ought to be $1-million instead of $950,000, and this same buyer will breeze right by a pension liability which could literally dwarf those amounts. And that is not by any means a rare occurrence. On the contrary, many buyers have been badly burned in acquisition transactions where the input of professional actuaries could have provided the necessary ounce of prevention.

With respect to the technical aspects of pension accounting considerations in acquisitions and mergers, the first accounting pronouncement of significance is APB No. 8. I assume that most of you are familiar with that document and its requirements concerning the annual income statement charge for pension costs, as well as the balance sheet liability amount and the related disclosures of actuarial methods and unfunded vested benefits.

What a number of persons outside the accounting profession are not aware of, is the fact that APB Opinion No. 16, entitled "Business Combinations," contains provisions for pension accounting which can, and often do, change significantly the accounting result which would be derived from the application of APB No. 8.

To explain that will require a brief discussion of the two basic accounting methods for business combination. The first is called"pooling of interests"and is applicable generally to mergers consummated by an exchange of common stock not involving cash payments or the issuance of debt. In this type of transaction, the historical book amounts of the two merger candidates are simply combined as if they had always been together with no adjustments to the carrying amount of assets and liabilities. This suggests that the recorded pension accruals and liabilities of the combining companies (determined under their separate application of APB No. 8) are added together and their future pension accounting would continue on the same basis as when they were separate companies. There is however a critical exception. APB No. 16 states in part: "The separate companies may have recorded assets and liabilities under differing methods of accounting, and the amounts may be adjusted to the same basis of accounting if the change would otherwise have been appropriate for the separate companies."

The opinion goes on to state that, if a method of accounting is so changed, the change should be applied retroactively to the combined entity. The practical significance of this may be explained by two simplified examples. If we assume the company being acquired is a privately-owned company whose accounts are not audited, it is possible that its pension accounting may not be in conformity with APB Opinion No. 8. Amounts charged to income for pension or other deferred compensation arrangements may be on a cash basis as funding payments are made. In this circumstance, it would be necessary to restate the seller's accounts onto an APB No. 8 basis. The result might be a significantly different statement of operations on a restated historical basis which could bear importantly on either the advisability of the acquisition or the purchase price to be paid.

Another example, perhaps more typical, would be the situation where a buyer uses what we may term "realistic and conservative" actuarial and accounting assumptions and procedures. The selling company, on the other hand, might be straining on the outer limits of the requirements of APB No. 8: forty-year past-service cost amortization, aggressive interest assumptions, questionable assumptions as to future pay levels and the like. In any event, assume that the two companies are at opposite poles of the APB No. 8 requirements -- a condition made possible by the wide latitude of assumptions and procedures permitted within APB No. 8. In this instance, the initial recording of the transaction may not have significant impact, but the future operation of the acquired company may be much different from that projected by the buyer after the acquired company's plan is merged into the buyer's plan. Say the seller is earning $800,000 pre-tax, which is a key factor in buyer's offer of $6,000,000. The $800,000 pre-tax earnings is after a pension accrual of $150,000. If, on a

going forward basis, using buyer's pension accounting procedures, the seller's pension accrual will be, say, $350,000, so that the $800,000 pre-tax earnings become $600,000, and buyer would want to reconsider the purchase price of $6,000,000.

Again, the key here is that flying blind into a transaction without full information and awareness of the pension plan status can make for a very bad deal. The accounting considerations are an important aspect, but they are only a signal of the significant business and financial aspects of a proposed merger or acquisition. What corporate buyers must understand is that there can be wide differences in pension accounting and that compliance with APB No. 8 is no guarantee that seller's pension accruals will continue at the same level after a merger is completed.

The other method of accounting for business combinations is the so-called purchase method. This method is used typicaly where cash or debt is involved, and the transaction is viewed more as an acquisition of one company by another rather than as a pooling or combining of common stock interests. In a purchase transaction, a whole new basis of accounting exists, and all assets and liabilities of the acquired company are recorded at their fair values at date of acquisition -- that is, the total purchase price (representing the arm's-length-determined value) is allocated among the various assets and liabilities.

Any residual amount of unallocated purchase price is recorded as "Goodwill." With respect to the pension amounts, APB Opinion No. 16 states in part that, in combinations accounted for by the purchase method, "accruals for pension cost...(are recorded) at present value of amounts to be paid determined at current interest rates." The real key is then stated in the following footnote: "An accrual for pension cost should be the greater of (1) accrued pension cost computed in conformity with the accounting policies of the acquiring corporation for one or more of its pension plans or (2) the excess, if any, of the actuarially computed value of vested benefits over the amount of the pension fund."

This is a critical exception. In practical terms, it means there are three possibilities for recording the pension accrual at date of acquisition:

1. the same as the liability already recorded on the books of the acquired company;

2. the acquired company's liability computed on the basis of the buyer's accounting method; or

3. either of the above methods <u>plus</u> a full accrual for unfunded vested benefits.

As you can imagine, the difference between recorded amounts on the acquired company's books (even though computed in conformity with APB No. 8) and the amount required to be recorded by virtue of the acquisition can be a tremendous amount.

From a purely accounting standpoint, this difference can significantly impact future reported earnings of the combined entities, as well as balance sheet amounts and related ratios -- such as tangible net worth, debt/equity ratio and the like.

From a business standpoint, this liability could and should be a significant factor in the negotiations on purchase price and on the relative merits of the proposed transaction. There can be a substantial decrease in tangible net worth arising from the requirements to record a much higher pension accrual which, in turn, could impact the buyer's future borrowing capacity. In other words, these accounting requirements have important business consequences, and failure to obtain current actuarial data to determine the amounts required to be recorded can be disastrous. Let me use a simple example, which is not unlike situations which I have encountered in combinations accounted for as purchases.

Assume that both the buyer and seller in a purchase transaction are well within the requirements of APB Opinion No. 8 but that the seller has unfunded vested benefits with a present value of some $5,000,000 and has a total book value and tangible net worth of $10,000,000. Under APB No. 8, the seller's pension accruals have been entirely proper, and its historical reported earnings and balance sheet may be relied upon by the buyer in evaluating the company and considering a purchase price offer. As required by APB No. 8, the unfunded vested benefits of $5,000,000 are tucked away in the footnotes. A number of buyers consider this information as mere compliance disclosure and attach no great significance to it. The practical implications are tremendous however. The accounting requirements of APB No. 16 require that the full accrual for the unfunded vested benefits be recorded as a liability on the balance sheet of the combined entities at date of acquisition.

Assuming that buyer's investigation indicates that the fair value of the recorded net assets of the seller approximates the book value of $10-million and offers that $10-million as purchase price, he will be confronted with the following problem when the transaction is recorded. The additional $5-million of unfunded vested benefits must be recorded as a liability. In effect, this represents an additional $5-million of purchase price, making the total price $15-million instead of $10-million. But, since the fair value of the recorded net assets has been determined to be $10-million, buyer is required to record the additional $5-million as "Goodwill" on the combined balance sheet. The tangible net worth of the acquired company has gone from $10-million to

$5-million, and the debt/equity ratio is adversely impacted by the requirement to record the $5-million unfunded vested benefits as a liability. What is incredible about this situation is that buyers have allowed this to happen more than occasionally. Failure to consider the pension plan ramifications and the related accounting requirements in a business combination have soured a number of acquisitions.

Having covered the two basic accounting methods involved in acquisitions and mergers and the tremendous impact which the pension situation and underlying actuarial measurements can have on the amounts to be recorded both at date of acquisition and in future operations, I would like to spend a moment on some other frequently encountered employee-benefit problems in business combinations.

Frequently, the merger of two companies will result in the creation of excess capacity in the combined enterprise, particularly when the two companies are in the same business. The practical result of this occurrence is the business decision to close down certain operations to achieve the cost-effective synergism contemplated by the combination. Often, major plant shut-downs such as this can result in one-time charges to income to accrue for all the pension and other retirement benefits due to the employees terminated as a result of the shut-down.

Any such contemplated plant shut-downs should be carefully considered and their effect quantified before the transaction is consummated, again, to eliminate unpleasant surprises after the fact.

Most of the considerations involving acquisitions I have spoken about involve the buyer's needs and cautions. The same considerations need also to be dealt with from seller's standpoint. Acquisitions will often leave behind certain pension liabilities with the seller, with buyer picking up only costs incurred after the acquisition date. In such instances, there is a need for seller to understand exactly what liability and commitment he is undertaking so that an apparently profitable sale is not reversed by the assumption of pension liabilities and the related need to record such liabilities at time of sale. Again, the input of actuarial consultants and the company's accountants are of critical importance in evaluating the proposed transaction.

In closing, I should like to summarize as follows:

1. Pension accounting is, to begin with, a subject not widely understood by operating management.

2. In today's inflationary environment, the cost of pension and other employee benefit plans is becoming a more and more significant factor in the operations of business enterprises.

3. In acquisitions and mergers, the pension accounting requirements are even more complicated than under the normal requirements of APB Opinion No. 8 because of the requirements of Opinion No. 16, "Business Combinations."

4. In the circumstances, there is a clear need for management to understand fully both the business and accounting ramifications of pension plans of companies involved on either side of a business combination.

5. And, finally, the best way to accomplish this is through the combined input of actuaries and accountants in the early stages of a proposed combination so that the parties at interest have a full understanding of the liabilities and future costs they are undertaking.

MR. HOLLOWAY: I would like to ask Mr. O'Malley if in purchase accounting, a seller must record the unfunded vested liabilities if the buyer does not acquire the plan?

MR. O'MALLEY: The buyer has no liability so he would not have to record the unfunded vested benefit, but the seller, on the other hand, has <u>had</u> a termination, in effect, of employees. There is no future benefit to be gained from payments that would be made against that liability and depending on the circumstances I would expect that termination to be part of the recording of the transaction of sale.

MR. WILLIAM FARQUHAR: With respect to the unfunded vested liability that is shown on the books after an acquisition, do future contributions cause this liability to be written down each year so that it does not affect the earnings until it is paid off, or is it done on some other basis?

MR. O'MALLEY: That is a question that there is no guidance for in the accounting literature. When this comes up, it usually ends in a discussion with the actuaries, the accountants and the management to try to find the best way to represent fairly the diminishment of that liability as payments are made into the plan. There is no hard and fast rule. Practical approaches are usually taken to relieve that liability over a ten or fifteen year period.

MR. BOYD MAST: Shaun, could you share with us the rationale for the booking of the unfunded vested liability on the occasion of a purchase as compared to the accounting practice of identifying this on the footnote, APB No. 8?

MR. O'MALLEY: In the case of APB No. 8, you are going to amortize this liability over the life of your employees who

will benefit the corporation. The non-recording of vesting is an arbitrary rule and the liability does not have to be recorded. Hopefully, you are moving toward eliminating the unfunded vested liability. In the case of an acquisition, you have not enjoyed the benefit of these employees. At this point in time the liability is for service performed in the past. It is a liability and the requirement is that you record it at that date.

MR. DONALD SEGAL: I would like to comment that it seems, in the case of a sale of a company, you have a liability which existed and did not exist. Suddenly, it exists and you freeze that amount which will change as the plan goes on and you have created a magic figure which does not seem to have any meaning.

In the case of a spin-off where assets have to be allocated according to the 4044 calculations on some actuarial basis or PBGC basis, do the accountants ever get involved in setting that basis, in terms of what is a true measure or an appropriate basis for allocating the assets?

MR. O'MALLEY: Typically, we do not get involved. We may try to contact the actuary to find out what he is doing.

MR. ZATTO: Regulations say, use a reasonable basis. The PBGC basis is deemed to be reasonable. The safe approach is to use the PBGC basis, but I have seen several instances where other bases have been used in spin-offs.

MR. HARRY MORGAN: With regard to APB No. 16 and the booking of the unfunded vested liability, I do not see any logic in that procedure since you are not talking about a real liability. It is merely a contingency. Any purchase price is based on this company's gross income and its general business expenses. The general business expenses of the seller have included an annual contribution to the pension plan. For those facts a cost for the company is estimated. I find it incredible that the purchase price is adjusted for the unfunded vested liability.

MR. O'MALLEY: In purchase accounting, when you make an acquisition there is an attempt to freeze in time every asset and liability at its precise value, the assumption being that all this was known by buyer and seller during the negotiations that led up to the deal. There are a number of things that are recorded at the time of an acquisition that would not be recorded typically in the historical accounting of a company. For example, if a company has bonds outstanding at an unreasonable interest rate, those bonds are recorded at the date of acquisition at their present value using current interest rates. A number of favorable or unfavorable lease situations are recorded as assets or liabilities at the time of a purchase transaction. The basis for this is the attempt

to freeze every asset and liability at its precise value at the point in time of the transaction, so that in recording, the purchase price is a starting point. Liabilities that have been assumed are added to the purchase price and that total is allocated to the assets valued at that point in time. If there is anything left over, it becomes goodwill. Historical cost has nothing to do with current value. The purpose is to try to record as best as possible the values that were exchanged and to see that future operations measure accurately the stewardship of the company that has been acquired from the moment it was acquired, and that there are no accounting ramifications that will impact those operations. Whether or not it is a legal liability is something that I am not qualified to answer. The accounting principles board has articulated that this unfunded vested liability is a liability that must be recorded.

MR. JAMES JACKSON: In writing down the goodwill over a period of time, is there also a detrimental effect on the income statement?

MR. O'MALLEY: Yes. Goodwill has to be amortized over a period not to exceed 40 years, so there will be an impact on the income statement each year.

MR. FARQUHAR: If, after the acquisition, unfunded vested liabilities grow even though contributions have been made, how would you reflect this?

MR. O'MALLEY: The liability at the time of the transaction would be frozen and written down by payments to amortize this liability. Increases due to future accruals would be disclosed in a footnote.

MR. ZATTO: Would the frozen liability be increased with interest and decreased for payments, but not increased for future accruals?

MR. O'MALLEY: Yes.

MR. HOLLOWAY: Our time is up. I want to thank the panelists for their contributions, especially our guest Shaun O'Malley. From the questions, it is clear that Shaun added an important perspective to our discussion.