RECORD OF SOCIETY OF ACTUARIES
1990 VOL. 16 NO. 1

MERGERS AND ACQUISITIONS

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This session will cover pension/benefit plan implications of a corporate merger or acquisition.

- o Funding
- o Expense
- o Effect on purchase price
- o Other

MR. JOSEPH P. STRAZEMSKI: With us are two guest speakers. Liz King is a partner specializing in employee benefits and executive compensation with the law firm Windels, Marx, Davies and Ives located in New York City. Carl Lerner is manager of Tax Planning responsible for all employee benefits with Pfizer working in the New York City office. Carl is active in ERIC, the ERISA Industry Committee.

Our presentation discusses the effects of mergers and acquisitions on employee benefit programs. Because mergers and acquisitions often involve pension plan spinoffs and mergers, I will cover some of the actuarial technical issues. Liz and Carl will discuss legal issues affecting merger and acquisition negotiations.

We thought a case study approach would be an interesting way to present our discussion. Table 1 summarizes our case study facts.

TABLE 1
CASE STUDY FACTS

Company XYZ is selling Subsidiary/Division X to Company ABC Benefit programs.

- o A DB plan covering the nonunion hourly employees of Division X
- o A DB plan covering the salaried employees of Division X
- o A DC plan [401(k)] covering the salaried employees of Division X
- o A DB multiemployer plan covering the union employees of Division X
- o All employees are covered by welfare plans
- o The company provides post-retirement medical benefits to all employees.

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Company XYZ is selling subsidiary division X to company ABC. Company XYZ has benefit programs. There's a defined benefit plan covering the nonunion hourly employees of division X, a defined benefit plan covering the salaried employees of division X, a DC plan covering the salaried employees of division X, and a defined benefit multiemployer plan covering the union employees. All employees are covered by a welfare plan, and the company provides postretirement medical benefits to all employees. All plan's are separate except for a company-wide salaried defined benefit plan. It covers the employees of the entire company, not just division X.

MR. CARL M. LERNER: One of the things I wanted to start with is to give you a general overview. A lot of you have clients that are large. Some of you have clients that are small, and in most situations we all want to provide the best service to our clients that we can. In a situation where the client is very large, he may have a dozen or so people representing him in various functions sitting around the table when the discussion of how to do a deal is being conducted. On the other hand, in some situations, there may only be one or two people, and for a small company, the actuary may be the only person sitting in the room with the client. In that case, the actuary, if he or she can, should be wearing a number of hats. Normally you are going to have a client there, and the client may have one or two business people representing the client or with the client, if it's an individual. In theory, you'd have a corporate lawyer, a tax lawyer, a benefits lawyer, and somebody from the personnel department who's going to be able to evaluate what these things mean and what the company wants to do for its employees, if it's selling something, or what it would like to do for its employees when it buys something. You will also have all kinds of other people sitting in the room. The actuary, if he or she is one of a few people in the room, may want to assume some other roles to provide further service to the client.

I want to talk about one issue, simple to lawyers, but not always as simple to other people. I want to use Table 2 to show you the difference between the sale of an asset and the sale of stock.

TABLE 2

Corporation XYZ

Subsidiary ABC	
DIV 1 DALLAS COWBOYS	DIV 2 NY YANKEES
DIV 3 BLOOMINGDALES	DIV 4 HÄAGEN-DAZS

(Corporation ABC)

For example, very often you'll have a large corporation, and it has a subsidiary. In this case, XYZ has a subsidiary called ABC, a subsidiary called DEF and 50 other subsidiaries. ABC has four divisions. Just to make it a little more interesting, one is the Dallas Cowboys, the second is the New York Yankees, three is Bloomingdales, and division four is Häagen-Dazs.

Now, let's assume that I am a buyer. I want to buy something and I want to buy (I'm from Texas) the Dallas Cowboys. I don't want the Yankees, Bloomingdales, or Häagen-Dazs. So I would go in, and I would say to corporation XYZ or to corporation ABC, I want to buy division one. Now, remember, this is all one corporation with four general categories of assets, one for each division, but all are in one corporate shell. So I say I want to buy division one, the Dallas Cowboys. I think the Yankees are fine. Häagen-Dazs is great ice cream, but I don't want that. All I want to do is buy division one. That would be an asset sale. I'm buying an asset, something specific, not a corporation, not a corporate entity. I'm buying exactly what I want, something that is owned by another corporation. XYZ could tell me, "Well, we like the Cowboys. We're not going to sell unless you buy the entire corporation." If you have to buy the entire corporation, you'd be buying everything in the corporation, which means I'd have to pick up not only the Cowboys, but the Yankees, Bloomies and Häagen-Dazs, things I don't want.

So the basic difference between buying stock of ABC, which would give me the whole thing, and buying an asset of this corporation, which would give me what I want, is exactly that. It is like walking into a supermarket and buying one, or two, or three, or four items, exactly what you want, rather than buying everything in a supermarket, even things you may not want. Now, this has a lot of ramifications. If you're buying assets, you're buying some particularly described and defined things that you really want. Those things would be spelled out in the contract, including what liabilities you're willing to assume. If you buy the corporation, instead of being owned by XYZ, it's now owned by the new purchaser, and the purchaser just assumes the role of owner. You can cross out XYZ and put in whatever name it happens to be.

Generally if you're buying the entire thing, you're going to get everything that goes with it including all the pension plans strictly associated with this subsidiary. If you bought the assets, say the Cowboys, and there was no particularly associated pension plan with the Cowboys, you wouldn't necessarily be getting anything unless you negotiated for it. Even if it did have a stand-alone pension plan, you may not have to take it over. You're buying assets, exactly what you want. You list them on a sheet of paper, and that's what you pay for.

The other thing to keep in mind is, if you buy the whole thing, for, say $100 million, your cost of $100 million would be your basis in the stock. The basis of the assets wouldn't change and wouldn't affect your purchase price. But if I bought, for example, just the Cowboys, then the $100 million would be my basis in the Cowboys. From an employee benefit perspective, I would have to look at the stand-alone plans for each of the corporations I might have to pick up, and I'd have to worry about what plans are associated with the corporation. If you're buying an asset, you have a lot less problems in that respect.

Also, there may be some ERISA Title IV liability issues if an entity leaves the controlled group. If XYZ has 50 subsidiaries and you're taking one of them out of the controlled group, there's joint and several liability under ERISA. That could be an issue that must be calculated.

Another important thing is, if you buy the entire corporation, you're generally continuing in the shoes of the previous owner. All employees will remain employed. When you're buying an asset, you don't have to take any employees. Very often in a deal, you'll list which employees you'd like to retain and which ones aren't going to be retained.

MS. ELIZABETH KING: I would just say that the first question to always ask is, "Is it an asset transaction or is it a stock transaction?" If it's a stock transaction, in the normal situation, the pension plans and the other employee benefit plans are included in the stock sale. The employee benefit plans of the subsidiary are going to transfer automatically with the subsidiary to the purchaser of the stock of the subsidiary. If it's an asset sale, you then have the issue of deciding, and the client negotiating, whether or not they will assume any of these employee benefit plans of the division that's being acquired. Even if it's a stock sale, you still may have a question as to whether or not you will assume any employee benefit plans. That's the situation in our example.

Let's say the salaried employees were covered under a pension plan that covered both the parent company, XYZ, and the subsidiary, ABC. The question then would become: Are you going to transfer the accrued benefits of the employees in the salaried pension plan down to the subsidiary as part of the acquisition, or will those assets and liabilities be retained by the parent company? So in a stock acquisition, you can still have the question of whether or not you're going to transfer plans, but it's only going to be in the situation where the plans cover other members of the controlled group.

The other issue that I think is important, in distinguishing asset and stock sales, is the Title IV liability when you terminate an underfunded defined benefit plan. If you're selling stock of a company, that company, immediately prior to the sale, may be jointly and severally liable under Title IV of ERISA for plans of the controlled group that have been terminated. That's something of concern to a purchaser of the stock of the company. If you're buying assets, you can pick and choose what assets you buy, and you can pick and choose what liabilities you're buying. You're only assuming those liabilities that you specifically say that you're going to assume. So you would make a point of not assuming any ERISA liabilities that you don't want. You can be more selective in the asset sale as to what you pick up.

MR. LERNER: Generally, if you're selling something, you'd rather sell stock and get rid of the whole thing and not retain any liabilities or any problems. If you're buying something, then you want to pick and choose exactly what you want. You want to avoid hidden liabilities that may not have shown up or that may be more expensive than you thought they were.

What are the facts? Lawyers want to say, "Don't confuse me with the facts, just give me the law." But that's the most critical thing. Does the buyer intend to provide the same type of plans and benefits? If you're advising the buyer and the buyer has much richer plans, then of course, you understand that the cost of these improvements means that the actual costs to the buyer are much more than what he's paying for. You have to look at what plans the buyer provides. Does the buyer intend to incorporate the new employees into already existing plans in its own system of plans? For example, in the company I work for, if we buy a plan, we try to incorporate it into our big plans as soon as possible.

That generally increases the cost beyond the cost level experienced by the seller, because we have a richer program than the small company generally has. Also, keep in mind that sometimes the plan that the buyer already has will include all employees of division X. When they buy an asset and incorporate it into division X, those people that come with it are automatically employees of division X. Therefore, they're already in the buyer's plans even if the buyer hadn't intended to do so. He'd have to exclude those people specifically, if he could without violating any of the ERISA rules. That's something to keep in mind. The buyer may be automatically bringing people into the plan, thereby increasing its cost. If you have union employees, what does the bargaining agreement say with regard to benefits? The last thing you want to do is to buy something and have a walkout or a strike immediately afterwards because you violated some kind of provision in the agreement.

Generally, someone is going to be looking to compare the benefits the buyer provides with the benefits the seller provides to see how the employees will come out. The last thing in the world you want is very unhappy new employees because certain benefit programs are being cut. Furthermore, you want to know if the plans are all qualified and current on government filings. You don't want to find out that they haven't funded the plan for the last five years and not told anyone. Finally, will the new employees know that their benefits are different than they were before, and if they're better, are you going to make sure that someone communicates to them so they'll be very happy? If it's not better, will someone communicate that to them in such a way that it will not make them too unhappy? The last thing you want to have is two employees sitting next to each other doing basically the same thing, one new and one old, but under different benefit structures. They do talk to each other, and when one finds out that he or she is not getting what the person next to them is getting it makes for some very unhappy campers.

You want to read what representations are in the contract to make sure they haven't represented something regarding the plans with which you, as the actuary, don't agree. So it's important for actuaries to read the contract. I don't know how many of you do, but I know that when we do a deal, our financing group, which has some actuaries, and our outside actuaries, all have the parts of the contract to read that could possibly have some impact on what they should be telling us.

401(K) PLAN ISSUES

One of the things that a lot of people want when they're sold is their 401(K) money. As you all know, when you make before-tax contributions, they're stuck in the plan unless you have a hardship or some other event as described in the Internal Revenue Code. Most people believe that if they stop working for XYZ company and go to work for somebody else, that's a termination or separation from service. That's one of the events listed which can cause a 401(K) distribution, as well as other types of pension plan distributions. Well, the Internal Revenue Service has this thing called the Same Desk Rule. If you work at the same desk, doing almost the same thing for your new employer as you did for your last employer, you have not separated from service. Even though your paycheck has a new name on it, the door has a new name on it, and you've got new business cards, you still, for pension purposes, work for the old employer, because you're sitting at the same desk.

MS. KING: My interpretation of the law is that the IRS's rule, for purposes of determining whether or not you're eligible for lump sum tax treatment, is that there hasn't been a separation from service. But the issue is still unclear, and you'll see, in acquisitions, people taking different positions as to whether or not a sale of the assets of a business results in a termination of employment for the employees that would enable them to take a distribution on account of termination of employment. But I would agree with Carl that the conservative approach is to interpret the current rules and regulations of the Internal Revenue Code as providing that there has not been a termination of employment.

MR. LERNER: There are generally two exceptions that will allow distributions. One of them is to say that the person is not at the same desk anymore. I was involved in an employee buy-out a number of years ago where the top management group needed their 401(K) distributions and their pension distributions to be able to pay for their piece of the acquisition. A key issue was whether there had been a separation from service or not. Were they doing the same job as before? The argument they made was that they used to be employees, but were now 5% owners of the company. They were no longer employees. They were owners and slept a lot less at night because it was their money that was on the line. You can often make the argument that if you changed situations you really have a separation from service. The other time that you can have distributions, which is also kind of iffy, is what's called the 401(K)(10) event. That's when there's a sale of all the assets in a particular business or the sale of a subsidiary. You can get rollover treatment, and if you can get rollover treatment, the argument is that you can have a distribution. Very often you can get the money out to people because of the (K)(10) event.

MS. KING: The two exceptions are sale of a subsidiary. That's pretty clear. Either you're selling stock of a company or you're not. The other exception, as Carl said, was the sale of substantially all of the assets of the business. There hasn't been any law developed yet as to what is meant by a "business." So some people are still holding back and not distributing assets upon a sale of a division if they're not comfortable that the division may amount to a "business."

MR. LERNER: The Service, at least in one private letter ruling, has said that if it's the entire business of the company then it is the sale of substantially all the assets. In other words, this company makes widgets and 15 other things. When they sell all these assets they will no longer be in the widget business at all. There's at least one ruling like that.

So what happens when there is a distribution of benefits directly to the employees? Generally, you make them very happy, with a few exceptions. For example, if the plan covers both pretax, 401(K) money and after-tax money, you can't roll after-tax money into an IRA. The Service will permit you to do so, but two things happen. First, they charge you a 6% penalty for rolling money into the IRA that you shouldn't have put in there. Secondly, when it comes out, they take it again. Now, remember, we're talking about money that has already been taxed when you put it into a plan. So it costs you at least 6% going in, and who knows how much it will cost you coming out. So people have to be very careful not to roll in the money that's been contributed after-tax.

MS. KING: If the 401(K) plan provides for loans, then you have a number of questions about how you want to treat the assets of the 401(K) plan. Do you, as a purchaser, provide for the transfer of the account balances to the new plan either in an asset sale, where you're buying a division, or a stock sale, where the plan covers employees of more than one corporation. If you have loans and the seller distributes the account balances to the employees, then the portion of the account balance representing the amount of the loan becomes a taxable distribution to the employee. It cannot be rolled over to an IRA. So, if you see that the seller's plan has loans, it probably will encourage you to consider a fund-to-fund transfer of the account balances, so that the employees can remain whole and not be subject to tax on the amount of the loans. The same thing is also considered if you have after-tax money. The employees need to have the opportunity to stay, basically, in the same position they are in now and be able to keep the after-tax money in a tax-exempt vehicle. The best way to do that also would be, again, a transfer of account balances from the seller's 401(K) plan of the purchaser.

MR. LERNER: I'd just like to raise one issue. When you transfer from plan to plan, as Liz was just discussing, there's very often evaluation problems. Let's assume that the deal is consummated effective February 1, and your last evaluation date is December 31st. You have a one month lag time before the deal is closed, and then it takes a while to transfer the assets. You just don't go in and say, "Okay, we closed today, the assets will be transferred by this afternoon." It takes a while for the paperwork to get done and the actual transfer to be made. In the meantime, people have lost appreciation, either interest, stock appreciation or something else. They could have lost, if it's in cash, interest from the last valuation date to the time the money's actually transferred and put to work for them again in the new plan. So, one of the things that people often consider is putting in some kind of interest from the last valuation date. If it's in a stock fund, often you can transfer the entire fund or you can move it to another similar type fund where the funding agent just picks up the assets and moves them. You don't have this loss of earnings potential for what ever time it takes from the last evaluation date to the transfer of the funds.

MS. KING: I just finished negotiating an acquisition where this was a particularly important issue. After we closed on the transaction, we started discussing the mechanism for transferring the account balances. I was representing the purchaser. The seller was offering to transfer, in cash, the account balances as of January 31st. The plan had been invested in three different Fidelity funds, two of which were stock funds. I don't know if you've been following the stock market the last few months, but in January, there had been quite a dip in the value of these account balances. So what we proposed and finally agreed to was a fund-to-fund transfer of the actual interest in the Fidelity funds to a plan that was established by the purchaser, so the employees did not incur any actual loss in their account balances.

MR. LERNER: There are two other things that are important to remember when you're transferring fund-to-fund. First you want to make sure that the money that you're transferring into your plan is clean. It's met all the requirements. Now, we've just transferred some money, and we are worried about 401(K) tests. Have they met the 401(K) tests? You have to run through the test to make sure, first of all, that the people knew what they were doing when they did the tests and that they passed. The other

thing you want to be concerned about, which is easily taken care of, is the alternative forms of benefits under section 411(d) of the Internal Revenue Code. This requires you to retain optional forms of benefits when you transfer money. If you're the seller and you're transferring money, you want to assure that all the requirements of Section 411(d)(6) have been met. If you put in the contract that the buyer agrees to retain all required forms of 411(d)(6) benefits, that's probably the best you can do, and you're fairly safe.

MS. KING: In an acquisition, if you're representing the purchaser and you're acquiring new employees, you have to be concerned about the existing plans of the purchaser and any effect the acquisition of any new plans will have on your coverage requirements under 401(a)(26) and 410(b). Congress provided, both for 401(a)(26) purposes for 410(b) purposes, time to comply with the coverage rules, basically, until the end of the plan year that begins after the closing of the acquisition. So you may have as much as one to two years after the acquisition to comply with the new coverage rules with respect to the new employees.

MR. STRAZEMSKI: Next, we'll look at some of the Code Section 414(l) issues. The treatment of the part of the plan covering division X will be decided during the sale negotiations. If there's a spinoff of the plans, whether it's a stock sale or an asset sale, it will typically be stated in the sale agreement.

I've assumed in our case study that the seller has agreed to spin off the portion of the plans covering the employees of division X.

- o The hourly plan is unfunded.
- o The salaried plan is overfunded on an accrued liability basis.
- o The buyer maintains a salaried plan, an hourly nonunion plan and has agreed to merge the spun-off plans.

SPINOFF ISSUES

Form 5310 should be filed at least 30 days before the effective date of the spinoff. The filing of this notice requires an actuarial statement confirming that the spinoff complies with Code Section 401(a)(12) and Code Section 414(l) and applicable regulations. Code Section 401(a)(12) and 414(l) specify that, as a result of the spinoff, each participant in either resulting plan is no worse off immediately after the merger or spinoff than immediately before the merger or spinoff on a plan-termination basis. Code Section 401(a)(12) is a plan qualification requirement. Section 414(l) and the 414(l) income tax regulations govern the minimum amount of liabilities to be allocated to each spunoff plan and so determine the minimum and maximum amount of assets that can be spun off. The actual amount of assets transferred should be between these two amounts.

New Code Section 414(l)(2), added by the Technical and Miscellaneous Revenue Act (TAMRA), requires an allocation of surplus assets between plans for plans spun off within the controlled group. This could have an impact on a seller's strategy. In our case study, for example, the seller could anticipate the sale of division X and spin off the portion of the plans covering division X. This would eliminate having to negotiate the asset transfer amount for both the hourly and salaried plans. However, because the

salaried plan has excess assets and the spinoff is within the controlled group, the surplus would be allocated between the two plans. Plans spun off and transferred out of the controlled group are exempt from Code Section 414(l)(2). Under current regulations Section 414(l) is satisfied if two requirements are met. First, the accrued benefits of each participant are allocated to only one of the spunoff plans. Second, the value of assets allocated to each of the spunoff plans is not less than the present value of vested benefits on a termination basis in the plan before the spinoff.

The term "accrued benefits" is referenced under the now-existing 414(l) income tax regulations which were adopted in 1979. You should be aware that the term "benefit liabilities" is a relatively new term. It is associated with the new rules for plan termination. Benefits, on a termination basis, depend on the funded status of the plan. They include only the benefit liabilities that would be covered by the then existing plan assets, assuming the plan is terminated and assets are allocated in accordance with the priority categories of ERISA Section 4044. The allocation ignores the final contribution an employer would have to make in the case of a standard termination.

The present value of accrued benefits is determined on the basis of reasonable actuarial assumptions. There are many considerations in the selection of actuarial assumptions, each having advantages and disadvantages. One of our first considerations is the sensitivity of the buyer and the seller to the selection of assumptions. Both the buyer and seller should understand the impact of the assumptions selected. Another consideration is the cost to annuitize benefits through an insurance company. Under recently released PBGC plan termination instructions, the value of benefit liabilities to be provided in annuity form is tied directly to the cost quoted by an insurance company. The disadvantage here is that insurance companies are not interested in bidding on an annuity purchase just to provide a contract price. Because of the competitive environment under which insurance companies operate, they do not disclose their pricing methods. Thus, the actuary is in the position of guesstimating the annuity contract price.

Another disadvantage is that the PBGC assumptions would be used in determining benefit liabilities for distress terminations. This applies more to plans that are underfunded, since the rules for standard terminations are different. Even in cases of standard termination lump sum forms of benefits must be based on the ERISA Section 203(e)(2) Interest Rate. This is either the interest rate specified in the plan, or if a greater benefit is provided, the PBGC interest rate. If the present value of the vested accrued benefits exceeds $25,000, then a rate no greater than 120% of the PBGC interest rate is used.

There are disadvantages associated with using PBGC assumptions. I think that the PBGC interest rates do not adequately reflect interest rate movements. For example, the PBGC interest rates for plan terminations occurring during the three month period, December 1989 to February 1990, remain fixed, with the immediate rate at 7.25%. Interest rates on other long term investments increased during the same period by 50 basis points or more. I also think that PBGC interest rates do not reflect the competitive environment under which insurance companies operate. Not all insurance companies will bid a contract at the same interest rate. Thus, all other things being equal, if on December 1, 1989, the cost to annuitize benefits was equal to the present value of

benefits based on PBGC assumptions, the cost to annuitize in mid-February would probably be less than the present value of benefits based on the PBGC assumptions.

At this year's Enrolled Actuaries meeting in Washington, IRS speakers indicated that the PBGC retirement-age assumptions are out of date and should be replaced by reasonable assumptions. The retirement-age assumptions can have a major impact on the spinoff amounts. If early retirement benefits are actuarially equivalent, then the rates of retirement or expected retirement age are not as critical. However, the retirement-age assumptions have a major impact on the value of benefits when early retirement benefits are heavily subsidized. The actuary has to decide whether or not the funding valuation assumptions or the financial accounting valuation assumptions are reasonable for the purposes of the spinoff calculation. Although both sets of assumptions may be reasonable for an ongoing plan, they probably are not appropriate in the case of a spinoff calculation, unless by coincidence.

BENEFIT ISSUES

Among the benefit liabilities that must be valued are the protected benefits under Code Section 411(d)(6)(B) and Section 417(c). These benefits include normal retirement benefits, early retirement type subsidies, optional forms of payments, return of contributions and qualified preretirement death benefits. These benefits are discussed in Revenue Ruling 86-48.

Several other issues should be addressed with respect to what benefit liabilities are to be valued. For example, benefits not protected by Section 411(d)(6) can be removed by plan amendment immediately before the spinoff. If these benefits have not been amended out, they are included in the benefit liabilities. Also, there are certain benefits whose coverage under Code Section 411(d)(6) is unclear. For example, should unpredictable contingent event benefits be provided? These benefits are not included in current liability until the event has actually occurred, and they are typically not prefunded. What about plans where employees get excess assets upon plan termination? Even if plans don't provide for this treatment of excess assets, will new legislation require employee participation in asset reversions? If there are excess assets, what part of the excess assets will the buyer want in order to fund future pay increases or future benefit increases?

In our case study, I have assumed that:

- the buyer's defined benefit plan will be merged with the seller's spunoff plan;
- the two 5310s along with the actuarial statement should be filed at least 30 days prior to the effective date of the merger;
- the sale agreement should specifically state the assumptions and benefit liabilities upon which the spinoff calculation is based;
- under ideal circumstances, the buyer's and seller's actuaries will have an opportunity to review and agree upon this part of the contract.

The seller's actuary will typically be familiar with the seller's plan. The buyer's actuary should obtain the necessary employee census data and review a number of documents, such as:

- o plan documents and amendments
- o trust agreements
- o SPDs, and recent statements of changes communicated to employees
- o administration manuals
- o determination letters
- o annual filings, including, Form 5500 and Schedule B, PBGC Form One and Schedule A
- o actuarial reports, both funding and financial accounting
- o funding waivers, if any
- o reportable events, if any
- o special termination benefits, such as shut-down benefits.

Documents discussed here are also important for measuring the impact on funding and financial accounting. If you do not have time to do a full and detailed valuation, they will be an important source for your estimate.

The merger must satisfy one basic condition in order to satisfy the requirements of Section 414(l). That condition is that the benefit liabilities for all participants in the merged plan are protected. Therefore if the total present value of accrued benefits is not more than the total value of assets immediately after the merger, this condition is satisfied. Every participant's total benefit is fully funded. However, if assets are less than the present value of accrued benefits, whether or not vested, the general rule is that a Section 4044 allocation is performed and a special schedule is created. This assures that in the future, as terminations or mergers occur within five years, accrued benefits in the higher-funded plan as of the merger date will be given a higher priority than certain benefits in the lower-funded plan.

The schedule created becomes part of the buyer's plan document. This special schedule requires that the buyer's actuary do an ERISA Section 4044 asset allocation on the plan termination scenario for the buyer's plan, as well as for the seller's plan that is being merged, unless the seller's plan is fully funded. The alternative to the special schedule is to maintain the data, needed to create the schedule for five years. The actuary may maintain the data or the actuary's certification may be based on a written statement of the plan sponsor concerning data maintenance.

The actuary should be aware that the data requirement may be extensive. For example, some active employees will probably have benefits that fall into both category three and category four. Therefore, sufficient data to calculate the benefits three years ago, as well as of the date of determination, are needed. Data maintenance is normally the easiest way to comply with Section 414(l), since the calculations to set up the special schedule do not have to be done at the time of the merger. However, if spinoffs or mergers are expected to occur within five years, it might be better to create the special schedule in the first place. The 414(l) regulations require that, when a transaction involves the transfer of assets or liabilities, the transaction must satisfy both the spinoff rules and the merger rules.

As a final note, the spinoff and merger rules relating to defined benefit plans contain a special 3% "De Minimus Rule." We have assumed the "De Minimus Rule" does not

apply in our case study. However, if you get involved with a spinoff or merger and the amounts spun off or merged are small relative to the original plans, you should investigate the applicability of this rule.

MS. KING: What if the defined benefit plan of XYZ corporation is retained and there is no spinoff? If the entire plan is retained by XYZ corporation, what do you with respect to the benefits of the employees of the division that's being sold? What do you do about the vesting? Do you just treat the employees as terminated vested on the date of the sale? Do you fully vest them? With respect to vesting, the legal issue is, has there been a partial plan termination. As you may know, under the Internal Revenue Code, if there's a partial termination of a plan, you're required to fully vest all affected participants. As you also may know, there's nothing really clearly defined saying what a partial termination is. People say it's probably at least 20% of the participants who have their participation terminated. There are some cases addressing higher percentages and finding there's been a partial termination. If there clearly hasn't been a partial termination, I've sometimes seen sellers still deciding they want to be fair to their employees. They're not really voluntarily leaving our employ, so we will fully vest them.

MR. LERNER: Look at the cost to vest all those people. If it's not a lot of dollars, there's really no sense in discussing it. Just do it. The only time you get into all these things is when it involves a lot of money. In large corporations, they usually vest because they found that people have generally been around for a few years. The vesting cost is not all that much.

MS. KING: Actually, with the change in the vesting rules as a result of the Tax Reform Act, the cost of fully vesting is probably not as significant now as it was before, when you might have had a plan with 10 year cliff vesting and you had a number of employees with two or three years of employment who were being vested. However, on the same side of the coin, if they only have two or three years of employment, their accrued benefit that you're going to fully vest is not going to be that significant.

As an alternative to fully vesting the employees, the purchaser may negotiate to obtain full vesting under the retained defined benefit plan, even though it might not have any actual direct cost effect on the buyer. It may have an indirect cost effect, because the employees may be unhappy and the purchaser may have to make it up to them in another way. But the alternative to full vesting is for the seller to provide, in its retained defined benefit plan, that future service with the purchaser will be counted for vesting purposes. That may cost less to the seller than immediate full vesting, because not all the employees may stay on with the purchaser for the full period of time required for full vesting. That's a backup position I frequently take if I'm representing a purchaser and we're trying to negotiate a vesting benefit for the employees at the time of acquisition.

The other issue is early retirement subsidies. For example, the seller's plan provides that if you retire after age 55 and you complete 30 years of service, then you'll get your unreduced accrued benefit at retirement. If at acquisition you have an employee that, let's say, has 25 years of service, it's a great loss to that employee (particularly, if he is near retirement age) to suddenly be told that he can never grow into the early retirement subsidy because he is being treated as terminated vested on the date of the sale.

He will just be entitled to his accrued vested benefit at age 65, reduced actuarially for commencement before age 65. It is more difficult as a purchaser to get a seller to agree to recognize future service for purposes of eligibility for early retirement, because it's quite costly to the seller. The seller's view is frequently we're not going to see these people again. There's no reason for us to stretch our necks out and provide this for them. Actually, recognizing future service with the purchaser for vesting and for early retirement can have a direct cost effect upon the purchaser if the purchaser decides to adopt a mirror image or closely similar defined benefit plan to the seller's plan and count past service with the seller with an offset arrangement (which is partially questionable now under the 401(a)(26) regulations). Hopefully, that will be cured with the next set of regulations that come out. There may be a problem if the purchaser is counting under their new defined benefit plan all service with the seller for purposes of early retirement subsidiaries. They are going to be paying an early retirement subsidy to an employee who retires with the purchaser with eligibility for early retirement based upon their entire service under both the seller's and the buyer's plan with no offset for the subsidy, because the employee is not going to be entitled to any early retirement subsidy under the seller's plan. That can be quite a substantial cost to the purchaser. If there's any intent on the part of a purchaser to adopt the same or similar defined benefit plan with an early retirement subsidy, you should either provide in your offset that you're not going to deem the employee to be entitled to early retirement, so that you don't pick up that cost that's not being paid for under the seller's plan, or try to get the service to be recognized under the seller's plan.

Another issue is with respect to the retained plan of the seller. What do you do with respect to the benefits? Do you treat these people as terminated and distribute the benefits to them? Do you wait until they retire from the purchaser to distribute their benefits to them? It's the same issue as with respect to the 401(K) plan. The law is unclear on this issue. I'd say the conservative approach is to not treat the sale of the division as a termination of employment for purposes of benefit distributions out of a defined benefit plan. Therefore, you will wait until the employees either retire from the purchaser, or, if you happen to be terminating the plan for some other reason, then you can distribute the benefits to the employees going to the purchaser in connection with the termination of the plan.

There's one other argument that I've seen made for distribution on the account of a sale of a business to the employees of the sold division. If there's a significant enough termination of participation by this group as a result of the sale, it amounts to a partial termination of the plan. Therefore, they can distribute on account of the partial termination of the defined benefit plan resulting from the sale. But, again, there's no real clear law permitting such a distribution out of a defined benefit plan without affecting the qualification of the plan. The point is whether the qualification requirements permit you to distribute benefits in the sale, not whether it enables you to get lump sum treatment or some other tax break.

MR. LERNER: You generally can't get a private letter ruling on qualification issues. So you amend your plan, if you haven't got it in there already, and request a determination letter. If the local IRS office approves it, then you have it. So very often, it's wise to try and highlight this in a cover letter when you amend the plan, submit your

determination letter request and see what the local office will do. Very often they will just run right by it, and then you have it in your plan with a determination letter from the service saying you can do it. It's often a way out.

MS. KING: Again, in either the spinoff or the nonspinoff situation, you have to consider what this means with respect to compliance with the coverage requirements. Do you have a problem now keeping some employees in a separate plan if you do a spinoff? Are you going to have a 401(a)(26) problem because you're not going to have 50 employees in the spunoff plan? Should you merge that plan with an existing plan? Will you then have a separate benefit structure with a 401(a)(26) problem? If you decide not to give the newly acquired employees any benefits, do you have a 401(a)(26) or a 410(b) problem with respect to your existing pension plans? The same issues that I've raised with respect to 401(K) plans apply here. Again, you do have this transition period. You have until the end of the plan year that begins after the closing of the transaction to determine what you're going to do during that period. You do not need to comply with the coverage requirements with respect to the new group as long as your coverage with respect to your existing employees doesn't really change. So you do have that leeway period.

MR. STRAZEMSKI: Next, we'll look at accounting for pension plans in mergers and acquisitions. Financial accounting for pension plans is covered in Financial Accounting Standards 87 and 88. It's important to consider the impact of financial accounting both before and after the acquisition of division X. If the purchase price is based on income, we should assess the impact of pension expense on income. We should also consider how a large balance sheet prepaid asset or accrued pension liability factor into the purchase price.

The financial accounting for the sale of division X is based on Statement 88. Table 3 lists the applicable paragraphs of the statement that impact a sample calculation that I prepared.

TABLE 3
Financial Accounting Issues

Financial accounting for pension plans based on SFAS No. 87 and 88
Look at company financials

- Was the purchase price based on income?
- If negative pension expense, income may not be the same after the acquisition
- How was the pre-paid pension asset or accrued liability used in determining the purchase price?

Curtailment and Settlement from SFAS No. 88

- ¶6, curtailment, and Q&A 25 and 39
- ¶3, settlement
- ¶15, special termination benefits
- ¶16 and APB Opinion 30 (¶15), timing of recognition
- ¶21 UNO is prior service cost and UNA is a gain.

The only one that I want to comment on is under ¶21. An unrecognized net obligation is treated the same as a prior service cost on the assumption that an unrecognized net obligation would probably be the result of plan amendments, rather than past losses. An unrecognized net asset is treated the same as an unrecognized net gain on the assumption that a UNA is the result of past gains or excess pension accruals. For the hourly plan, I have assumed that a transition obligation exists, and for the salaried plan, a transition asset exists.

In Table 4 we'll first look at an example of a curtailment calculation for the nonunion hourly plan. Accounting for plan curtailments is covered in ¶12-14 of Statement 88. Curtailments deal with the recognition of prior service costs, including the unrecognized transition obligation. Because a sale of division X results in a reduction in the expected years of future service, it is considered a curtailment. The curtailment or settlement typically triggers a remeasurement. All obligations are brought forward with the appropriate adjustments from the previous measurement date. The benefit obligations and the net unrecognized gains and losses should reflect changes in the interest rate and investment experience. The net periodic pension costs for the remainder of the year will be based on the new remeasurement.

TABLE 4

Hourly Nonunion Plan
Example of Curtailment Calculation -- SFAS No. 88, ¶12-14

- o Sale results in a reduction in expected future years of service
- o Remeasurement
- o Prior service to be recognized
- o Amount of reduction or increase in PBO to be recognized

	Before Curtailment	Effect of Curtailment	After Curtailment
1. PBO[1]	($1,485)	$73 [3]	($1,412)
2. FVA	1,160		1,160
3. UNL(G)	(177)[2]		(177)
4. UPSC	135	(81)[4]	54
5. UNO(A)	246	(148)[4]	98
(A)/PP PC	($ 121)	($156)[5]	($ 277)

1 Assumes plan has a pay related formula.
2 Reflects (g)/due to remeasurement.
3 Recognize decrease in PBO since gain subsequent to transition.
4 60% of remaining expected future years of service.
5 Since net loss, recognize when it is probable curtailment will occur and the effects are reasonably estimable.

The "before-curtailment" column shows the effect of the remeasurement. Our PBO was $1485. I assumed in this case that the hourly plan also has a pay-related formula. Our fair value of assets is $1166. We have an unrecognized net gain of $177, unrecognized prior service costs of $135, an unrecognized net obligation of $246 and an accrued pension cost of $121.

The curtailment calculation involves a two-step process. First, you calculate the amount of prior service cost to be recognized. Under Statement 88, as a result of the sale, the employer will no longer realize future economic benefits, and thus, the prior service costs associated with those years of future service of the curtailed employees are recognized. In our example, 60% of the expected years of future service are eliminated as a result of the sale of division X. Therefore, we recognize 60% of our unrecognized prior service cost and 60% of our unrecognized net obligation.

Next, you calculate the curtailment gain or loss to be recognized. This is the change in the PBO, from the curtailment, offset against the sum of the net unrecognized gains and losses and the unrecognized net asset. Statement 88 assumes that the sum of the net unrecognized gains and losses and unrecognized net asset will be reversed in the future. However, any remainder of the curtailment gain or loss cannot be reversed and, therefore, should be recognized. In our example, we settle 33% of our PBO. Therefore, we recognize 33% of our unrecognized net gain. The sum is the net gain or loss to be recognized. In our example, the sum is the net loss of $156. It is recognized when it's probable that the event will occur and the effects are reasonably estimable. The first three columns are the curtailment calculation. The after-curtailment column shows the amounts from the previous overhead reflecting the curtailment calculation.

Accounting for settlements is covered in ¶9-11 of Statement 88. If assets and liabilities are transferred to the buyer and nonparticipating annuities are purchased or participating annuities are purchased where the insurer is subject to all or most of the risks and rewards, the event is treated as a settlement. In addition to the adjustments to the unrecognized net gains or losses are also adjusted for the carrying amount of the PBO and the amount at which it settled. For example, assume annuity contracts are purchased. The rates at which the PBO was settled will probably be different from those used to project the PBO. Where curtailments deal with the recognition of prior service costs, settlements deal with the recognition of gains and losses. When the settlement occurs, gains and losses can't be reversed in the future since the PBO and assets are no longer part of the plan. Therefore, previously unrecognized gains and losses including, as noted earlier, the unrecognized net asset, are recognized. The percentage of the gains and losses recognized equals the percentage of the PBO settled. In our example, we're settling 33% of the PBO, so we recognize 33% of our unrecognized net gain, the $58. The impact of the curtailment and settlement on the net periodic pension cost is summarized in Table 5. Since we have fewer participants, our service cost decreases. We settled part of our PBO, so the interest cost goes down. We recognized some of our gains in the settlement calculation, so our amortization amount changes. We recognized some of our UNO and unrecognized prior service costs in the curtailment calculation, and we transferred some of our assets, so we have less of a credit. The order of recognizing curtailments and settlements can be in either order as long as the company uses the same order consistently. For example in our case today, assume that company

XYZ's policy is to first reflect the curtailment. The order will generally affect the amount recognized.

TABLE 5

Hourly Nonunion Plan

Example of Settlement Calculation -- SFAS No. 88, ¶9-11

- o Assets and liabilities transferred to buyer
- o Unrecognized net gains or losses to be recognized
- o Reduction or increase in PBO to be recognized

	Before Curtailment	Effect of Curtailment	After Curtailment	Effect of Settlement	After Settlement
1. PBO	($1,485)	$ 73	($1,412)	$466	($946)
2. FVA	1,160		1,160	(360)	800
3. UNL(G)	(177)		(177)	58 [1]	(119)
4. UPSC	135	(81)	54		54
5. UNO(A)	246	(148)	98		98
6. (A)/PP PC	($121)	($156)	($277)	$164 [2]	($113)

[1] 33% of UNG (percent of PBO settled).

[2] Accrued pension cost increased by excess of PBO over assets transferred.

- o Net effect of curtailment and settlement is $8 credit to income.

Next, we'll look at the buyer's side. First, the buyer should remeasure the assets and obligations. At the time of remeasurement, the PBO should reflect any plan structure required by the sale agreement. Then if an overfunded PBO exists, an asset or a prepaid pension cost is established on the company books. If an unfunded PBO exists, a liability or an accrued pension cost is established. The sale presumably results in an additional asset called goodwill to be established on the company books. Goodwill is equal to the excess of the purchase price over the value of assets minus liabilities. The amount of the unfunded PBO increases goodwill and the amount of the overfunded PBO decreases the amount of goodwill. Goodwill is amortized over a period of not more than 40 years. If a plan restructure is required by the sale agreement, the resulting change is a liability that's treated as an amendment.

Table 6 shows what the accounting looks like on the buyer's side. I've assumed that the buyer adopts the seller's plan, so we have a PBO of $539, fair value of assets of $360 and the buyer books the unfunded PBO as an accrued pension cost of $179. The net periodic pension cost is composed of just three components now, the service cost, the interest cost and the expected return on assets. Since the plan is being merged with the buyer's hourly plan, the minimum liability is calculated on a combined plan basis.

TABLE 6

Impact on Buyer Hourly Plan[1]	
1. PBO	$539
2. FVA	360
3. A(PP)PC	179
4. NUO: [1-2-3]	$ 0
5. NPPC:	
a. SC	$ 6
b. IC	44
c. ERA	(32)
d. Amort of PSC	N/A
e. Amort of (G)L	N/A
f. Amort of UNO	N/A
	$ 18
6. ABO	$466
7. FVA	360
8. A(PP)PC	179
9. Add Liability[2]	NC

1 Assumes restructure is part of sale agreement; remeasurement based on buyer's assumptions.

2 Based on combined plan.

Table 7 shows the curtailment and settlement calculations for the salaried plan. It's similar to the hourly plan, so I'm just going to point out some differences.

TABLE 7

Salaried Plan
Example of Curtailment Settlement Calculation

	Before Curtailment	Effect of Curtailment	After Curtailment	Effect of Settlement	After Settlement
1. PBO	($6,904)	$890 [2]	($6,014)	$2,460	$(3,554)
2. FVA	7,821		7,821	(2,960)	4,861
3. UNL(G)	(1,139) [1]		(1,139)	467 [5]	(672)
4. UPSC	116	(52)[3]	64		64
5. UNO(A)	(68)		(68)	28 [5]	(40)
6. (A)/PP PC	($ 174)	$838 [4]	$ 644	($ 5)[6]	$ 659

1 Reflect (g) due to remeasurement.

2 Recognize decrease in PBO since sum of UNL(G) + UNA is a net gain.

3 45% of remaining expected future years of service.

4 Since net gain, recognize when plan suspension or amendment is adopted.

5 41% of gain (UNG and UNA).

6 Accrued pension cost increased by excess of FVA over PBO.

The hourly plan was unfunded on a PBO basis. The salaried plan is overfunded on a PBO basis and also has a negative pension expense of about $135. The salaried plan also has an unrecognized net asset. So when you do your curtailment calculation, no part is recognized in the curtailment. However, when you do your settlement calculation, because it's treated as a gain, the portion of the unrecognized net asset recognized is equal to the percentage of the PBO settled. In this case, 41% of our PBO was settled, so we recognized 41% of our unrecognized net asset. The accounting on the buyer's side is, again, similar to the accounting for the hourly plan. I assumed that the buyer adopts the seller's salaried plan. In this case where the plan prior to the spinoff had negative pension expense, this plan now has a positive pension expense.

One last accounting issue to be considered is what happens if the hourly nonunion plan covering division X is spun off first and then the curtailment and settlement calculation is done. Based on Statement 87 and Question 81 in illustration eight of the Implementation Guide, the unrecognized prior service cost is allocated in proportion to the expected years of future service. The unrecognized net gain and the unrecognized net obligation are allocated based on the PBOs.

Table 8 shows the difference. It compares the difference between the spinoff-curtailment-settlement sequence and the curtailment-settlement calculation.

TABLE 8

Comparison of Results

	Spinoff/Curtailment/ Settlement	Curtailment/ Settlement
1. PBO	($946)	($946)
2. FVA	800	800
3. UNL(G)	(112)	(119)
4. UPSC	54	54
5. UNO(A)	157	98
6. (A)/PP PC	($ 47)	($113)

- o Different results in Hourly plan since UNO treated as UPSC in curtailment and as UNL(G) in spinoff.
- o Assuming same asset allocation, salaried plan results would be about the same since UNA treated like an UNL(G) in both settlement and spinoff. However, §414(1)(2) would require different asset allocation since spinoff within controlled group.

The first two items, the PBO and the fair value of assets, are the same. The unrecognized net gain is about the same. The unrecognized prior service cost is the same. Most of the difference results since the UNO is allocated on the PBO and the spinoff within the company, whereas, it's allocated on the expected years of future service in a curtailment. The spinoff-curtailment-settlement sequence results in a substantially smaller amount being recognized immediately and more being recognized in future years.

Assuming the same asset allocation for the salaried plan, the results of the sequence of events would not produce such a large difference in the amount to be recognized immediately, since the UNA is allocated based on the PBO in both the curtailment and spinoff calculations. However, Code Section 414(1)(2) would require a different asset allocation if the spinoff was done within the controlled group.

Next we'll look at some of the funding issues. Revenue Ruling 81-212 and Revenue Ruling 86-47 give pre-OBRA '87 guidance on how to split items in the funding standard account. Revenue Ruling 81-212 applies to plans where immediately prior to the spinoff, the market value of assets is less than the present value of benefits on a termination basis, and immediately after the spinoff, each spunoff plan has an unfunded accrued liability. If the spinoff is "de minimus," it's treated as an experience gain or loss in the large plan. The small plan establishes a funding standard account as a new plan not based on the funding standard account of the original plan. When the spinoff is not "de minimus," the funding standard account items are allocated based on the facts of the original plan and of each spunoff plan. The Revenue Ruling states two rules for allocating the credit balance, if any, to the spunoff plans. First, the sum of the credit balances allocated to the spunoff plans must equal the credit balance of the original plan. Second, the method of allocation must be reasonable and take into account the assets allocated to each plan. An illustration of an acceptable method is provided in the Revenue Ruling. Under this method, the credit balance is considered to be the last portion of the assets allocated.

The Revenue Ruling establishes three rules for allocating amortization bases. First, the sum of the outstanding amortization bases allocated to the spunoff plans must equal the outstanding amortization bases of the original plan. In addition, the amortization periods associated with the respective bases must be the same in the spunoff plans as in the original plan. Second, the allocation must reasonably reflect the assets and liabilities of the spunoff plans. Finally, the funding method, the unfunded accrued liabilities and the actuarial assumptions of the spunoff plans immediately after the spinoff must be consistent with the outstanding amortization bases in the funding standard accounts.

The Revenue Ruling also has a list of required items to be provided to the new plan sponsor. Revenue Ruling 86-47 amplifies Revenue Ruling 81-212 and applies, in spinoff situations, to the plans where the assets are greater than the present value of benefits on a termination basis and when one of the spunoff plans has an unfunded accrued liability and the other does not.

I prepared an example, Table 9, similar to that in the Revenue Ruling. I just want to note that the plan prior to the spinoff is in balance, items 1-6. Then you go through the allocation of the Revenue Ruling, and the plan with the unfunded gets the amortization basis. In order to make the balance equation work, a new base is established. Our new base here is base C, $55, item 9C. This new basis is amortized over the greater of the combined base period of 15 years. You should also note that the bases do not have to be combined, but rather just the combined base period be determined. In this example, the minimum required past service contribution for the spunoff plan increased. If our interest rate assumption was 8.5%, the contribution would increase from $1 to $6. We should also note that the possibility of deficit reduction contributions for the spunoff plan

should also note that the possibility of deficit reduction contributions for the spunoff plan exists. These should be taken into account when preparing cost estimates for the buyer. If this were a spinoff within the controlled group, Section 414(l)(2) would require a different asset allocation.

TABLE 9

Revenue Ruling 86-47 Example

	Plan	Retained	Spunoff
Summary of Facts:			
1. PVBTB=PVAB	$1,120	$ 620	$500
2. AL(UC)	1,400	775	625
3. MVA	1,500	1,000	500
4. Credit Balance	50		
5. AVA (alloc on MVA)	1,320	880	440
6. Amortization bases			
a. Base A (29 yrs.)	200		
b. Base B (5 yrs.)	(70)		
Allocation:			
7. CB:			
a. Smaller of PVBTB and 3-4	1,120	620	500
b. Excess assets:	380	380	0
[3-(a)]	50	50	0
c. LCB: alloc on (b)	80	0	185
8. UAL: [2-5]			
9. Amortization bases:		0	200
a. Base A (29 yrs.)		0	(70)
b. Base B (5 yrs.)		0	55
c. Base C (29 yrs.)			

Credit Balance

- Allocate lesser of (i) MVA-CB or (ii) PVBTB per §1.414(l)-1(n)
- Allocate CB based on excess MVA

Amortization Bases

- Allocate to plan with UAL
- New base amortized over greater of combined base period and 15 years.

Net amortization goes from $1 to $6 for spunoff plan

In our case study, I've assumed that the spunoff plans will be merged with the buyer's plans. The funding standard account items of the spunoff plan and any new base resulting from the plan restructure or from bringing the funding standard account into balance becomes part of the merged plan's funding standard account. The IRS has issued two revenue rulings regarding the funding standard account and plan spinoffs. However, there are no Revenue Rulings covering mergers. The method the actuary uses to treat the mergers should be reasonable taking into account the facts and circumstances. There are some examples of funding standard account mergers that have been presented at Enrolled Actuaries meetings. Copies of these examples can be found in the transcripts to those meetings.

A number of other factors that impact the future funding requirements should be considered by the actuary. For example, the actuarial methods and assumptions used in the valuation of the seller's plan may not be consistent with those used in the buyer's plan. The impact should be quantified.

Next, the impact of certain plan provisions should be examined carefully. For example, the merger or acquisition may eventually lead to a plant shutdown or a work-force reduction. You would have to investigate whether or not shutdown benefits would be provided in this case. These benefits were very costly prior to OBRA '87, and are now even more costly due to the unpredictable contingent event amount. If early retirement benefits are heavily subsidized, significant experience losses may occur if more-than-expected retirements at younger-than-expected ages occur. The extent to which optional forms of payments are subsidized, especially lump sums, should be considered.

Formal and informal obligations of future benefit increases should be reviewed. The buyer's actuary should consider the cost of scheduled benefit increases, as well as expected increases resulting from new rounds of collective bargaining negotiations. In addition, it should be established whether or not a regular pattern of unscheduled increases has been established. If a regular pattern has been established, the plan participants may expect this pattern to continue.

We should also see whether or not the plan has been updated for Tax Reform. If it hasn't, then what's the expected impact on cost? The deficit reduction contribution introduced by OBRA '87 tends to impact negotiated plans, since standard policies are to increase benefits periodically through the negotiation process. Hourly nonunion plans with the same type of periodic increases would be affected similarly. Funding of these plans tends to lag behind that of salaried plans, which are permitted to anticipate increases in benefits through a salary increase assumption. The instructions for the 1989 Schedule B do not permit an offsetting component to the deficit reduction contribution when bases have been combined. This can have a major impact on a plan where bases have been combined. Rumor has it the IRS is rethinking its position on the combined bases and, hopefully, will come to a different conclusion.

Some of the funding requirements and funding restrictions introduced by OBRA '87 are based on the current liability rather than the unfunded accrued liability and on an interest rate other than the funding rate. Because of this, the IRS has decided to make the balance equation work by introducing a reconciliation account, which is made up of

the components that upset the old balance equation. The new account is similar to a credit balance. Hopefully, the IRS will issue guidance on how this is to be allocated in mergers and spinoffs. In the absence of guidance, I would assume that the actuary should determine a reasonable allocation method based on the facts and circumstances. Another change introduced by OBRA '87 was quarterly contributions. This should be considered in order to help the buyer with cash flow planning.

Increased governmental regulation has substantially increased the cost to administer a pension plan. In addition, distress terminations have resulted in increased PBGC premiums. These administrative costs should be considered.

MR. LERNER: One of the other things to consider is the effect of plan funding on the purchase price. For example, if the purchaser is assuming the subsidiary's pension plans and they're significantly underfunded, that could result in one of two results. Either the seller funds them at the proper level before they're transferred over, or if the seller doesn't have the cash to do that, the buyer can say, "Well, if the underfunding is 20 million, or 10 million, or whatever it is, I'll pay you that much less, and I'll take care of the plan." Consequently, with overfunding, the seller may wish some credit, and logically so, for the fact that the buyer will not have to fund that plan for the next five or so years, depending on the amount of the overfunding.

When the buyer funds the plan for past service or past liabilities, then there may not be a deduction available. It may have to be capitalized and treated as part of the purchase price, depending on the exact facts of the particular situation. The Webb Case dealt with nonqualified compensation and said it had to be capitalized. There was also a general counsel memorandum from 1984 that discusses Webb, relative to nonqualified and qualified plans. But even in the GCM, it does discuss some capitalization requirements based on termination amounts if the plan is still underfunded. It has to be capitalized to other amounts that I was not all that familiar with, but I'm sure more of you than I understood what that GCM was talking about. Some of it has to be capitalized, and some can be deducted. For those who may want to know the GCM number, it is 39274, and it was issued in 1984.

MS. KING: I'm going to very briefly talk about multiemployer plan issues. As you know, multiemployer plans are usually industry-wide defined-benefit pension plans, to which a employer contributes pursuant to a collective bargaining agreement. ERISA was amended in 1980 by the Multiemployer Amendments Act to provide that, if an employer stops contributing to a multiemployer plan, the employer is liable for its share of the unfunded vested benefits.

This has two ramifications in an acquisition. The first concerns the purchaser of a business that contributes to a multiemployer plan. If you're representing the purchaser, you'll have concerns regarding the withdrawal liability of the target company. You never know, in the future, if you may have to close the plant down or incur a withdrawal from the plan resulting, possibly, in liability. I have found that large multiemployer plans are willing to send you worksheets to be used to calculate at least an estimate of what the target company's withdrawal liability would be. The smaller multiemployer plans may not necessarily have that data available, and you may also be less willing to contact them

and get them starting to question what's going on at this stage in the game. Your client and the seller may not be willing to publicize to the union that they're contemplating this acquisition. I always recommend that a purchaser get specific representations in the purchase agreement with respect to what the contingent withdrawal liability is based on and what it would be if the company being acquired were to withdraw on the date of the sale. If they can't calculate that exactly, then I just ask that there be a minimum number in the agreement with which both parties feel comfortable.

Going back to what we said before regarding asset versus stock sales, it's very important with respect to multiemployer withdrawal liability. The sale of the stock of a company that contributes to a multiemployer plan is not considered to result in a withdrawal itself. The acquired company just continues to contribute to the multiemployer plan pursuant to the collective bargaining agreement. It retains the same history, with respect to contributions which are relevant to withdrawal liability, that it had before the sale.

If there's a sale of a division and that division is contributing to a multiemployer plan, the result is different. ERISA specifically provides that a sale of assets is considered to result in a withdrawal from a multiemployer plan unless certain conditions, set forth in ERISA Section 4204, are satisfied. The consequence would be that if these conditions are not satisfied, the seller of the division would be considered to have withdrawn from the multiemployer plan. If the multiemployer plan has unfunded vested benefits at the time of the sale, the seller could be held liable for withdrawal liability. So a seller is always very interested in complying with the provision for the exception to avoid triggering withdrawal liability to the seller on a sale of assets. These conditions are:

1. The purchaser has to agree to become obligated to contribute to the multiemployer plan at substantially the same rate as the seller had been obligated to contribute prior to the sale.

2. The buyer must also provide to the multiemployer plan a surety bond for five years equal to the greater of the annual contribution that the seller made to the plan for the three years prior to the sale or the annual contribution that the seller made to the plan for the year prior to the sale.

3. The purchase agreement must also provide that, if the buyer withdraws from the plan during the first five plan years after the sale, the seller will be secondarily liable for any withdrawal liability that would have been due to the plan absent this exception. Additionally, if all or substantially all of the seller's assets are liquidated before the end of this five year period, then the seller must also provide a bond equal to the amount of the withdrawal liability that the seller would have had absent this exception. If this exception is applied, then the purchaser basically steps into the shoes of the seller with respect to (1) its contribution history, and (2) to determining the purchaser's liability if the purchaser were to withdraw from the plan subsequent to the sale.

So it's important to try to determine whether or not the plan is underfunded at the time of the sale. A purchaser might prefer, if there is no liability, not to comply with this exception, so that the purchaser can step in and start fresh without any of the history of

contributions by the seller to the plan. If the purchaser were to ultimately withdraw from the plan, it may result in the purchaser having a smaller liability by taking the fresh start approach. The seller won't care, if at the time of the sale the plan has no unfunded vested liabilities and the plan would not impose withdrawal liability on the seller at the time of the sale.

I should just briefly mention that regulations under ERISA Section 4204 provide exceptions to the bond requirements. If the buyer satisfies certain asset and income requirements, or if the amount of the bond is less than a de minimus amount, the purchaser can apply to the PBGC for a waiver of the bond requirements. The regulations say that the PBGC will issue a waiver if it concludes that it will not significantly increase the risk of loss to the multiemployer plan.

MR. LERNER: I just want to mention how really important this withdrawal liability is. I have had, fortunately, only one experience with a multiemployer plan. It blew my mind. We were looking at an acquisition. It was a multiemployer plan. The plan was underfunded by $4 billion, and the last thing in the world anybody on my side wanted to do was acquire any piece of that obligation. Now, it was some kind of Teamsters plan out west. Who knows who had the money, where the money was or who wasn't contributing. We didn't want to find out. That didn't wreck the deal, but it was just horrifying and terribly frightening to find out that you could end up with a piece of that kind of liability. So keep it in mind; you never know what you're going to find. You don't need such a horrendous number. If you tell your client that he's buying into an unfunded liability of a $100 million, which is not so radical, it still could make a big difference.

MR. LESLIE JOHN LOHMANN: Liz, you were talking about the partial terminations and requiring full vesting, and I understand that actually you can still fund only to the extent funded despite Tax Reform and OBRA.

MS. KING: That's true in the event of partial termination, if the plan is underfunded.

MR. LOHMANN: The other thing you mentioned was that the seller could retain the liability and the benefits and, perhaps, count vesting service with the buyer. The experiences I've had with that have been much less than thrilling. The buyer's not real interested in responding to any sort of data requests from the seller, and the seller ends up not really being interested until something happens, and that can be five or 10 years down the road. And with an actual client, what happens is they've decided they want to terminate the particular plan. If we're lucky enough it was a single plan and none of those people could be found. They had quit working for the buyer years before PBGC premiums had been paid for the entire time. It was just a total mess and I really recommend not doing it that way.

MR. THOMAS D. BURGESS: Are the benefits under 414(l)(2) essentially the same benefits under 412(l) given that we knew what they were? I know it doesn't refer to 412(l), but the language seems consistent.

MR. LERNER: Yes. It was 412(l).

MR. BURGESS: Given that the person responsible for doing something is not always necessarily the person who does it, is it not, nonetheless, true that if you're going to maintain the data instead of setting the spinoff schedule, the plan administrator is responsible for maintaining the data for five years? It's not the actuary who must maintain the information necessary for five years to do the schedule if it ever needs to be done, but rather the plan administrator.

MR. STRAZEMSKI: That's correct. That's my understanding.

MR. BURGESS: It appears that if you're going to do this data maintenance alternative to setting up a schedule for a spinoff, that one way you can do that is to rely on a statement from the plan administrator that the data are sufficient and you, therefore, as the actuary, can put your attachment on the 5330. But it seems to say in there somewhere that, before you trust the plan administrator's opinion that the data are sufficient, he has to get the opinion of an actuary to say that it's sufficient. But it doesn't seem to say who the actuary is. It's certainly not the same actuary who's relying on the plan administrator's opinion.

MS. SUSAN M. SMITH: I'd like to remind people that when you're doing a Form 5310 and there's a spinoff with a subsequent merger, people forget that you really need to file two Form 5310s, one for the plan that's having the spinoff and one for the other plan that's accepting those monies and liabilities.

MR. LERNER: Right.

MS. SMITH: Another thing that people have problems with is the actual time of the signing of the purchase agreement versus the time when you can effect these mergers. If the buyer is sitting there and they're going to put a wrap-around plan in, you can have that plan in place without having gotten any assets or liabilities, because you essentially value the net, which is what you're going to value afterwards. Generally, there is a big time lag between the time you've gone through this purchase agreement and the time in which these assets and liabilities actually get transferred. The IRS does not like retroactive transfers, so another thing you might consider are PBGC premiums in the meantime with respect to who's going to pay them. The seller may be giving you everything. But when you're considering leaving people behind with the seller and you're putting them in another qualified defined-benefit plan with the buyer, you've got two PBGC premiums per person.

In another situation, there were people from a UAW type of environment where when you are hourly and you go to a salaried, you're left behind with your UAW benefit in the hourly plan. That company decided, to avoid variable premiums, to put them in the salaried plan that was overfunded. So double premiums were saved.

In an hourly plan that generally renegotiates benefits every now and then, it may be wise for you to set up an assumed indexation of the benefit level at the time that you go through your purchase accounting, because that will give you a little bit of a hedge against the additional liabilities should the assets suddenly go down. We've got a real gyrating market these days, and when you set your PBO, you don't have any transition

obligation to give you a little bit of a hedge in that hourly plan situation. Salaried plans, because they get to have a salary increase assumption, have some hedge. A buyer may also consider using a different measurement date than what was used by the seller. That sometimes gives you some different purchase accounting numbers. It's very important that the buyer's actuary be involved in the determination of the purchase accounting. Those decisions can affect that current year's costs and all future years for a number of years.

MR. ROBERT SAMUEL HAWS: You said that the PBGC rates would be a safe harbor, but I guess you also gave us the impression that it's not necessarily the only approach. So, for example, you could have plan sponsors that might use 8 or 9% for the whole stream of benefit payments rather than just using the PBGC rates.

MR. LERNER: The current regulations say that the PBGC assumptions are a safe harbor, but your assumptions have to be reasonable.

MR. HAWS: So if you judge, for example, that 9% at the time you did the transfer was reasonable, even though it was beyond the safe harbor, it could be a suitable alternative to use.

MR. LERNER: Yes. You're the one that's saying it's reasonable, and you're responsible for making that decision.

MR. JAMES E. GLASGOW: You indicated that the PBGC rates were a safe harbor. Does that mean also the expected retirement ages?

MR. LERNER: I think the current regulations say that PBGC assumptions are a safe harbor.

MR. GLASGOW: Are you also referring to just the immediate or also the deferred?

MR. LERNER: That would be the deferred also.

MR. DUANE A. BOND: I was involved with several spinoffs between utilities and it turned out that they neglected to take into account incurred but unreported claims, one of which was a $300,000 cancer case, and the other of which was a $50,000 a year disability case. We had written into our part of the contract that anything that was incurred but unreported as of the time of the sale was completely the responsibility of the buyer. Needless to say, the buyer took this to court and lost.

MS. KING: One of the items that is first on my list, in the welfare plan area, is that the purchaser is only going to pick up liabilities that are incurred after the acquisition. You also have the problem with assets at acquisition. Do you want to pick up liabilities for people who are on disability? Or what about people who are on short term disability? Are they going to transfer over into long term disability? You don't want to pick those up. Basically, the purchaser wants to minimize its liabilities as much as possible. In a stock sale, the automatic consequence would be that, unless you specifically negotiate otherwise in the purchase agreement, you're going to pick up any liability for retiree

medical benefits. In an asset acquisition, again, you only pick up the specific liabilities that you agree to assume in the purchase agreement. Therefore, retiree medical liability would be a specific item that would be negotiated between the parties. In a stock sale, again, I have seen transactions where the purchaser was successful in reaching an agreement with the seller that the seller would retain that liability. But it has to be specifically negotiated. If you're silent on the issue, that liability is going to come over to the purchaser.

MR. STRAZEMSKI: If a buyer asks you to estimate postretirement medical benefits, some of the things that you should look at are what benefit liabilities are going to be offered. You should find out what groups will be covered, actives and retirees, and what kind of commitments are made. Since you're doing an estimate, what employee census data are available to do your estimate? You'll need some claims and premium data, assets and book accruals. It's also possible that a recent valuation on the postretirement medical benefits has been done. You can use that as the basis for your estimate. I have a sample estimate calculation. We have a sample plan that provides eligibility at age 55 with 10 years of service. The plan provides spouse coverage. It's a noncontributory benefit and it provides Medicare integration at age 65. I assumed in this estimate that the buyer was able to provide us with an actuarial valuation report of the pension plan and the employees covered in the pension plan are the same employees that will be covered by this postretirement medical benefit. From the pension plan, I was able to get these data. I have nine nonactive eligible employees for every active eligible employee. By nonactive eligible employee, I mean an employee who hasn't yet attained age 55 and reached 10 years of service. The ratio of retired employees over 65 to retired employees under 65 is 4:1. And the ratio of active employees to retired employees is 2:1. To give some relative weight to this estimate, I said that we have 10 active employees. So that means that we have nine active noneligible employees with average age 40 and average service 10. There's one active eligible employee, average age 57 and average service 27. There's one retired employee under age 65, average age 62 and four retirees over 65, average age 68. Our buyer was also able to provide us with the annual retiree claims. This includes the spouse coverage. You have to be careful with the average annual retiree claims, especially, when it includes the spouse coverage. A lot of times the under-65 coverage provided is just a continuation of the plan that covers the active employees. So the average annual claim may include the active employees also. Our buyer also tells us that there's no assets and there's nothing on the books.

To do this calculation, I assumed a medical trend rate, as seen in Table 10.

I'm starting at 15%, grading down by .5% per year to 8%. The discount rate is 9%. I'm basing my estimate on the average annual retiree claims. My other assumptions include 1978 GAM mortality and a retirement age of 59. My turnover rate is 3% per year prior to age 55, and my marital assumption is included in my average annual retiree claim. The estimated liabilities I break down between the under-65 and over-65 for the employees age 40, because generally the most flexibility for plan change is in the under-65 nonactive, noneligible category. For the other employees, I provided a breakdown for the retired employees, since the under-65 employees are sometimes included in the active coverage. So if the buyer does not want to take on the postretiree medical for the retired, he is able to split out the cost. For 20 employees, we end up with a pretty

substantial liability of $533,000. I think it's also interesting to note that, based on this medical trend rate, our average annual claim rate for the age 40 employee will be $34,700.

TABLE 10

Assumptions for Sample Estimate

- Medical trend rate: 15% grading down 0.5% per year to 8%
- Discount rate: 9%
- Average claims: AARC
- Other:
  - -- Mortality: 1978 GAM (with margin)
  - -- Retirement age: 59
  - -- Turnover rate: 3% per year prior to age 55
  - -- Marital status: Included in AARC

Employee Age (#)	Estimated Liabilities			AARC When First Paid	
	Under 65	Over 65	Total	Under 65	Over 65
40(9)	$198,000	$126,000	$324,000	$34,700	$16,500
57(1)	N/C	N/C	62,500	6,600	4,100
62(1)	N/C	N/C	44,500	5,000	2,300
68(4)	N/C	N/C	102,000	N/A	1,500
Total	N/A	N/C	$533,000		

Table 11 shows that under the current FASB exposure draft, I estimated the effect on current expense. The postretirement benefit cost increase the current accounting or the current accrual by about six times.

TABLE 11

Sample FASB Exposure Draft

Employee Age(#)	EPBO		
	Under 65	Over 65	Total
40(9)	$198,000	$126,000	$324,000
57(1)	N/C	N/C	62,500
62(1)	N/C	N/C	44,500
68(4)	N/C	N/C	102,000
Total	N/C	N/C	$533,000

Employee Age(#)	APBO		
	Under 65	Over 65	Total
40(9)	$79,200	$50,400	$129,600
57(1)	N/C	N/C	62,500
62(1)	N/C	N/C	44,500
68(4)	N/C	N/C	102,100
Total	N/C	N/C	$338,600

Employee Age(#)	Service Cost		
	Under 65	Over 65	Total
40(9)	$8,100	$5,400	$13,500
57(1)	0	0	0
62(1)	0	0	0
68(4)	0	0	0
Total	$8,100	$5,400	$13,500

Benefit Obligations:

- EPBO: Full present-value of projected benefits (20% increase for 1% increase in trend rate)
- APBO: Portion of EPBO allocated to past service (16% increase for 1% increase in trend rate)
  -- Projected-unit-credit
  -- "Attribution" period = Date of credited service to date of first eligibility
- S.C.: Projected-unit-credit based on "attribution" period (15% increase for 1% increase in trend rate)
- 1997: Recognize additional minimum liability [APBO fully eligible minus assets minus accrued (prepaid)]