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EFFECT OF MERGERS AND ACQUISITIONS ON PENSION PLANS

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o Panelists will discuss the various pension plan issues which must be considered when buying, selling, or merging a company, including:
  -- Funding issues
  -- Plan design for a merged or successor plan
  -- Eligibility, coverage, and participation issues
  -- FASB accounting issues
  -- Comparability of plans
  -- Legal and actuarial requirements

MR. AILEY BAILIN: Some of us experienced a severe shock last month when it was announced that Jim Henson's Muppets were going to merge with Disney Enterprises. In the news articles that have followed the announced merger, no mention has been made of pension arrangements. But older people in the audience will immediately identify with the concern expressed by Mickey Mouse regarding the welfare of his pension. Kermit may not be too worried given his relative youth. But Mickey is fours years away from normal retirement age.

The continuing whirlwind pace of mergers, acquisitions and spin-offs have created a significant amount of extra work for many of you. As many of you are well aware, when management is involved in the frenzy of activities surrounding a merger or acquisition, considerations for pensions and other benefits are still, more often than not, relegated to some afterthought. Yet, there are some very significant dollars involved.

It is apropos therefore for the Society of Actuaries to sponsor a session on the effect of mergers and acquisitions on pension plans. I am sure that you will all learn something from this session. Yet when it comes to getting your Enrolled Actuary credit for this session, you will be able to tell your colleagues that you did it by taking the Mickey Mouse course.

Jeremy Gold operates his own firm here in New York as a benefit finance consultant. He is a Fellow of the Society of Actuaries and a Member of the American Academy of Actuaries. His firm serves plan sponsors in two fashions: one is by providing investment analysis from an asset/liability point of view, and the other is by providing strategic benefit advice from a corporate finance perspective. He was formerly head of Morgan Stanley Pensions with responsibility for developing and marketing Morgan Stanley products and services to the pension community. Jeremy is frequently quoted in benefit and investment periodicals. He coauthored "In Search of the Liability Asset" in 1987 and "Longing for Duration" in 1988. He is a frequent speaker at benefit and investment conferences and has testified before Congress on the subject of postretirement medical benefits.

William Bortz is a lawyer and partner in the New York law firm of Dewey, Ballantine, Bushby, Palmer & Wood. He received a J.D. and Ph.D. in Philosophy from the University of Wisconsin in 1974. He has practiced exclusively in the employee benefits field, including design and drafting of all types of retirement plans, with a focus on benefits policy considerations as well as compliance with tax-qualification requirements and ERISA. He also has substantial experience advising corporate employers with respect to ERISA's fiduciary responsibilities, multiemployer

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pension plan withdrawal liability and nonqualified executive compensation. Most recently, he has spoken at seminars and conferences concerning termination of overfunded pension plans and post-employment fringe benefits.

Joel Rich is a principal and senior consultant at William M. Mercer Meidinger Hansen Inc. in Morristown, New Jersey. He has a B.A. in mathematics from Yeshiva University. He is a Fellow of the Society of Actuaries and the Conference of Actuaries in Public Practice and also a Member of the American Academy of Actuaries. At Mercer he is chairman of the Regional Professional Standards Committee and a member of the Regional Operating Committee. He also serves on Mercer's National Retiree Welfare Benefits Standards Group. Along with his many other employee benefit activities, he has conducted seminars for the Society of Actuaries on mergers and acquisitions.

MR. WILLIAM K. BORTZ: I am a lawyer. I'm not an accountant. I'm not an actuary. That means I will try to relate my comments predominantly to legal issues and, probably therefore, I will say things that are more trivial, perhaps, than the other speakers, because you will be interested in dollars and how to do calculations that are more in your line of specialty.

I thought I would try to structure my talk a little bit along the lines in which a corporate acquisition or sale agreement is structured. For people not in a legal practice I will cover the bases with respect to the legal requirements of acquisitions and divestitures.

A corporate document of a sale, acquisition or merger generally includes a number of reps (representations) and warranties that are designed to ensure that the purchaser doesn't get any surprises when he buys a business and, in particular, to reveal information about contingent liabilities that are otherwise not on the balance sheet of the entity that is being acquired. The most significant element in any kind of agreement of this sort is whether or not stock is being acquired or whether or not assets are being acquired; or whether you are acquiring stock and all of the liabilities, including the contingent liabilities that might not be shown but would be transferred to the purchaser. Whereas if assets are being purchased, then the only things that are transferring are things that are specifically identifiable in the document.

By and large, there aren't any legal requirements relating to pension plans that require advanced government approval with respect to transfers. There are a lot of ancillary government notice requirements that come up in connection with the substantive issues that arise in a merger or acquisition. For example, some types of pension plans get involved in the financing of acquisitions. If that's so, you can raise prohibitive transaction issues that may require Department of Labor exemptions in order for the plan assets to be involved in the transaction. Those are pretty rare, though, and that is probably the only example I can think of where you need advanced government approval to effectuate an actual acquisition involving a pension plan. Other situations where government approval or notice is required include, for example, reportable events to the Pension Benefits Guarantee Corporation (PBGC). Reportable events are situations listed in ERISA (Employee Retirement Income Security Act of 1974) Section 4043. They include a number of relatively trivial events and some other more significant events, one of which is, for example, a 20% decrease in the overall level of participation in the pension plans. One can be required to report that information to the PBGC. That statutory list has been developed in regulations of the PBGC and those regulations include situations where the notice requirement to the PBGC has been waived and some other situations where notice requirements have been added to the list that is in the statutory list. In addition, of course, where there is a transfer of pension plan money from one plan to another or a merger of one pension plan into another, there is a requirement of advanced notice to the Internal Revenue Service on Form 5310. As I suppose you all know, in the context where it is a defined benefit plan, it requires an actuarial certification that the requirements of 414(l) have been satisfied.

There's been a lot of discussion over the last few years and very little guidance from the government on the issue of retroactivity of these kinds of mergers and transfers. The government has never really told us whether or not one can do a merger or transfer in any sort of a retroactive fashion. By and large, in the context where it is a merger that is being effectuated, it doesn't make a huge difference whether it is done retroactively or prospectively. Where splits are involved, of course, the dollar numbers can change significantly, depending on the actual date of the transfer and, thus, there would be more need for care in the context where you have a split or

transfer of assets occurring to make sure that it was done prospectively to honor the requirement that you give thirty days advanced notice to the government.

Sometimes IRS approval gets raised in deals of this sort. The most common situation is where a purchaser wants absolute assurance that the plan he is taking over qualifies under 401(a) of the Internal Revenue Code (hereinafter referred to as "Code") and, accordingly, the plan is required to be submitted for IRS local office approval before he will fully assume all the liabilities under the plan. That used to more common when I started practicing in 1974, 1975, and 1976. I think now that would be considered generally very conservative practice.

Union consent is something that is quite significant in the context of a stock sale, in particular if there are any benefit design changes that are required to be adopted in the arrangements. By and large, of course, union arrangements are not subject to the same sort of nondiscrimination requirements as nonunion arrangements. Accordingly, there are very rarely any legal requirements that mandate changes in union benefit arrangements. Nevertheless, of course, there could be financial considerations that demand that and you can't make changes where you have an agreement with the union unless you negotiate those changes with the union.

Another whole set of issues in merger and acquisition agreements and in the reps and warranties sections of them involve general legal compliance. By and large, this is an area where you simply don't want any surprises. You want to find out what is going on. We used to, in the old days, require reps and warranties from a seller that all of his plans were in legal compliance. Nowadays, of course, that would be a silly thing to ask for. Practically no one has amended their plans for January 1, 1989 compliance. Indeed, I suppose the remedial amendment period is the significant period for these kinds of arrangements and that's the time for filing tax returns for the current-type plan years and that is quite a period of time away. There is a lot of scuttlebutt that the IRS will even defer that further.

Accordingly, what you look for is operational compliance. In this context one of the things that is important is to decide who is doing what in the way of due diligence. Sometimes, I think, the actuary will find himself to be the only real expert on employee benefit plans involved in a deal of this sort, in which case the actuary has to take a more aggressive posture to make sure that everything is going the way it is supposed to go, to make sure, for example, there is operational compliance. For example, he must make sure there is compliance with the requirements that the employer, the administrative committee, or the trustee not retain discretion over things like lump sums and other forms of payment.

There will be other situations arising where there is an employee benefits lawyer involved as well, in which case you need to have some sort of agreement between the attorney and the actuary as to who does what, so as to make certain there are no bases that are missed but, of course, things are still being done in an efficient fashion.

There is a whole category of issues which arise where multiemployer pension plans are involved. They are very difficult; they are subject to very specific rules and provisions of ERISA adopted as a part of the Multiemployer Pension Plan Amendments Act (MEPPAA) provisions. Where the stock sale is involved, the general theory under these MEPPAA provisions is that it is a reorganization of the employer, so that in the context of the stock sale there will be no automatic withdrawal of the employer which would trigger contingent withdrawal liability. That provision has an exception in any context where the sale has as a principal purpose the avoidance or evasion of withdrawal liability. That provision is one that is rarely paid a lot of attention to by the employee benefits community, but it is something that you have to watch out for, particularly where the purchaser is a very thin entity, where he does not have a deep pocket. If, in the few years following a sale, a purchaser goes belly-up and, thus, incurs the withdrawal liability, rest assured if the multiemployer plan can't get its withdrawal liability paid by the purchaser, it will look to the seller. Many people think of this provision that I am focusing on as the provision that applies where a sham occurs. It really doesn't read that way, it speaks about a principal purpose being to avoid or evade withdrawal liability. It is very rare, when an employer has sophisticated employee benefits counsel, including actuaries, for the MEPPAA liability not to be taken into account in a sale and, accordingly, it is hard to show, when you've got good consultants, that, in fact, these kinds of liabilities weren't taken into account. So, you've got to watch yourself. It's something to be carefully drafted when you're dealing in a situation where the purchaser is very thin.

There are a variety of very technical issues that arise where both the purchaser and the entity being sold are in the same multiemployer plan. People who have worked with the MEPPAA provisions will be familiar with one of the withdrawal liability triggers, which is a 70% decline in the contribution-base units of the plan over a three-year period. In the context where the purchaser is in the same plan as the entity that he is buying, one can discover all kinds of anomalous results by application of this provision, including situations where the seller automatically withdraws as a result of the sale or situations where the purchaser, simply by virtue of the purchase, automatically has a withdrawal from the plan.

It is rare that any other kinds of direct liabilities are triggered in connection with an acquisition in the context where it is a stock purchase. If it is an asset purchase, of course, you've got to specifically worry about the MEPPAA provisions. There is a specific MEPPAA provision designed to ensure that, even in an asset sale context, you can get a result that is somewhat comparable to stock acquisition; namely 4204 of ERISA allows a purchaser of assets to agree to undertake to contribute at the same level of contributions as the seller was contributing and in that context there is no withdrawal. Frequently, a bond will be required to be purchased in that context and there are specific regulations of the PBGC in which that bond is waived. The provision relating to asset sales in enabling an asset sale to be treated much like a stock sale is actually a little bit different than the stock sale provision because the asset sale provision makes the seller contingently liable for a period of years if the purchaser withdraws and is unable to satisfy the withdrawal liability demands. Consequently, in many contexts, a purchaser may be asked to include this special provision to save the seller the withdrawal liability, particularly in a context where the purchaser expects to continue the business. However, if in fact this has been designed as an asset purchase so the purchaser does not want to take on the special contingent withdrawal liability, the purchaser may want to have an indemnity back from the seller. It gets kind of complicated in these sorts of situations.

In general, though, stock purchases and similar acquisitions will not trigger withdrawal liabilities. The other kinds of liabilities that one sometimes focuses on as being triggered in connection with acquisitions and divestitures are ones relating to so-called parachutes, "golden parachutes" and, more commonly, I think, for this group, "tin parachutes." There are all different kinds of these parachute arrangements. They have a wide range of aggressiveness to them. I've seen arrangements under which the plan that is being acquired by a purchaser indicates that, where any such purchase occurs, the plan automatically terminates and any surplus in the plan is reallocated to provide additional benefits to participants. That's about as aggressive as I've ever seen.

There is a variety of other situations where pension plans include specific provisions designed to ensure that the surplus that is inherent in the plan can't be used for purposes of the purchaser: provisions under which the plan can't be terminated for a period of years, or can't be involved in a merger, or can't have new participants added to dilute the assets, etc. Those are ones that you have to watch out for. They require due diligence. You have to read the seller's pension plan to see whether or not it has the provisions.

Sometimes there are specific payouts that are triggered in connection with sales and acquisitions. Those rarely though involve tax-qualified plans; more commonly they involve nonqualified plans. Sometimes, the issues that may come up are whether or not you can pay someone off. I recently represented a corporation that was purchasing a major subsidiary of a controlled group. The major subsidiary had its own plan, but about five people at the parent corporation were in that plan. The purchaser wanted to take over the subsidiary plan, but didn't want to have the five people of the parent corporation remaining in the plan, so it would have been nice to pay them out. That raises a wide variety of issues under the IRS code, the most significant of which has been concern that it is not permissible to pay out people from pension plans during the periods when they continue in their jobs without any interruptions. This is something that is generally under the heading of "Separation from Service." It's a doctrine that comes out of 402(e) provisions of the code relating to lump sum provisions but there have been concerns that even pension plans can't pay out people who continue with the same jobs. By and large, the IRS has never pursued this with any aggressiveness and may have periodically taken the position, I think, informally, that, in fact, you can make payouts to people who continue in the same jobs.

The other function of reps and warranties in these arrangements is to determine and find out any contingent liabilities that otherwise are not on the balance sheet of the entity being acquired. The most obvious of these, of course, are the surplus and liabilities in the pension plan. Others, of

course, that are nongap arrangements that would not be shown on the balance sheet would be nonqualified plans and surpluses of various sorts, as well as affiliated liabilities, which are something also to watch out for. Generally, liabilities do not cross corporate boundaries. That is to say, if you have a controlled group and one subsidiary is being sold, you typically don't have to worry about the liabilities of the other entities in the controlled group that you are not acquiring. Certain of the ERISA liabilities, of course, do cross corporate boundaries; in particular, the Title IV liabilities for a terminated pension plan, withdrawal liability with respect to a multiemployer plan, and, in addition, accumulated funding deficiencies. So if you are acquiring a subsidiary, you need to worry about those liabilities being hidden in some of the other subsidiaries of the seller, even though you are not acquiring those entities.

Typically, the reps and warranties in a sale agreement, unlike covenants in a sale agreement, which is kind of a legal term, are typically of the sort that we have been talking about so far. They usually are limited to the time period involved. In other words, the purchaser wants to make sure there are no surprises but the seller also wants a time period after which he is out and clean and doesn't have to worry about the sale and after the purchaser has had time to find out what is going on. So, commonly, there is a limit to the time period during which you can sue under reps and warranties. It could be three years, it could be one year, whatever it is.

Covenants are usually in a separate section of an acquisition agreement because they typically don't have any time limit associated with them. They require specific actions to be taken by the purchaser or the seller. The most common one that comes up in the pension context is plan continuation. A lot of companies, when they sell a large subsidiary, want to make certain that the employees are taken care of and that their benefits are not taken away from them for quite a while. That's an area that is now increasingly under pressure because of the new nondiscrimination rules.

As you know, where a sale or acquisition occurs so that there is a change in the controlled group, there is a one-year period during which the plans are deemed to continue to be in compliance with the 410(b) nondiscrimination rules. The requirements in order for that provision to apply include the fact that there are no changes in the coverage of the plans and that the plans comply with 410(b) immediately prior to the acquisitions. The actual period that is covered is the period including the plan year of the sale all the way through to the end of the next following plan year. Thus, there is a lot of difference if an acquisition occurs early in a plan year rather than late in a plan year. It could be as long as 23 months; it could be as little as 13 months. Given the fact that there is this one-year limit, this one-year provision, generally nowadays one would expect requirements that plans be continued, that benefits not be cut back, to include this period. But, beyond that, such a covenant or rep and warranty given in an acquisition agreement would bump against the 410(b) requirements. You have to make sure that you comply with 410(b) and still comply with the requirement that you not cut back benefits and not terminate the plans that are involved.

I'm not going to focus a great deal on pension plans, splits, mergers, and transfers, because I am certain the other speakers will address the issues, but I want to cover some of the issues relating to these kinds of arrangements. Obviously, they are governed predominantly by regulations under 414(l) of the Code and the application of those requirements depends on the funding levels of the plans with respect to whether they have adequately covered their termination liabilities.

There is a thirty-day advanced notice requirement to the Internal Revenue Service, as I have already mentioned, in the case where one plan's assets are being transferred or merged into another plan or a plan is being split up. In the context where a merger occurs, there is also a requirement that a special schedule be maintained for a five-year period to ensure that the individuals whose plan's liabilities and assets have been merged into the other plan don't get less during that five-year period if the successor plan is terminated than they would have gotten had the plan been terminated immediately prior to the transfer. This requires that the administrator, sometimes the actuarial firm involved, maintain records in order to be able to reconstruct that special schedule.

There is also a special 5% deminimus situation where a plan transfer is less than 5% of the total obligations of the plan when aggregated with all other plan transfers and mergers in the same year. In that context, the same sort of minimum amount transfers are not applicable in the

context of an underfunded plan. In particular it is permissible to simply transfer an amount equal to the present value of the accrued benefits being transferred.

All of this discussion so far is pretty much the way the law was until fairly recently. There was a fairly significant change recently involving situations where the acquisition involves another member of the same controlled group, and internal transfers within the controlled group. I think, by and large, that is not the focus of this discussion, but let me mention it anyway, because it is something that you will have to watch out for.

Specifically, there is a new provision that became effective sometime in 1988, as I recall, requiring that some portion of a surplus be transferred in connection with a transfer or merger or split of a pension plan. The technical requirements of this statutory provision I find to be rather difficult. Perhaps you can understand it. They seemed to be based on the full-funding limits applicable to the individuals involved. Any sort of a merger or transfer is actually a kind of amendment to a plan and that triggers all of the special rules and provisions that require protection for a merger. In other words, if you've got a group of people who are being transferred to a purchaser's plan, you've got to protect all of their accrued benefits the same way as if you were adopting an amendment with respect to those accrued benefits. Those require, for example: preservation of lump sum options with the accrued benefit being transferred, if there is a lump sum option there; early retirement subsidies, including the right to grow into an early retirement subsidy; minimums and, presumably, also offset provisions; all of the things that are protected by the regulations under Code Section 411(d)6.

Another feature to be concerned about in these kinds of transfers is the assets themselves. Frequently, this will become an issue, particularly for you who are involved in the financing and the impact on market value of any of these kinds of transfers. The assets that are involved may not in all cases be liquid, insurance policies in particular, as well as investments in real estate. Other special kinds of plan asset problems can arise when you have employer stock or, so-called employer real estate; that is real estate owned by a plan leased to the employer that is involved in any particular plan. Those are more rare and unusual.

The other thing to watch out for in the context of transfers from one plan to another is changes in the plan year, for example, if you want to move the seller's group into your own pension plan and have the same plan year for the merged and move them into as group as your pension plan. There are various rules that apply. You might discover a one-year acceleration in the vesting schedules for different plan years applied previously for purposes of vesting.

Now there generally are two major sets of acquisitions and sales agreements that deal with pensions, namely the reps and warranties and the covenants sections. There are some overall features of these arrangements that I didn't know about when I started as a legal practitioner. It took me a long time to discover them by talking to corporate lawyers. Let me just discuss a couple of those.

One thing I found when I was working on a sale or acquisition agreement is that frequently a purchase price was to be adjusted depending on the audited book value of that particular entity. You didn't know at the time you purchased it exactly what you were going to pay for it. You had to wait for the final audit to come through. That has an impact on the employee benefit arrangements. To the extent you can generate accruals that arise before the purchase that will, in effect, decrease the purchase price that is being paid and, accordingly, it will have an impact on what amounts to the assets that are being transferred to you. It doesn't affect directly, of course, the fair market value of the plan's assets, but, in effect, the purchaser has saved money if you can structure it in that fashion. Get a market value adjustment that includes the accruals for employee benefit expenses.

One problem that is a specific income tax problem that you have to watch out for is that it would be very nice if we could, in our acquisitions or sale agreements, reduce the actual purchase price to reflect certain kinds of unfunded employee benefit liabilities, such as the employee benefit liability inherent in an underfunded pension plan. However, I think tax lawyers are concerned that, if you were to do that, the liability you assume with respect to an underfunded pension plan might be considered payments of a capital liability and, thus, when you pay off the expense to the plan, those payments would not be deductible. Accordingly, people avoid that kind of approach. If there are underfunded pension plans being assumed, one simply reduces the purchase price by

some estimate of what these amounts will be as opposed to an actual mechanism in the document that reflects a precise and actual number that has been calculated after the acquisition occurs.

Third-party beneficiary rights are something that have become really significant lately, particularly in light of leveraged buy-outs (LBOs) and hostile acquisitions. I never saw one under which third parties would have the right to sue under the acquisition agreement. Until recently, I'd never seen any. However, they are negotiated items in recent LBOs. Situations where a purchaser guarantees that plans will continue for a certain period, or benefits will not be cut back and that there is someone around to sue under that provision, specifically gives employees the right to sue under the sale agreement. It's a very unusual provision. It's one that I think lawyers, by and large, believe is given impact. In other words, if the provision says the beneficiaries do not have the right to sue under the contract, courts will take that position and, likewise, if the sale agreement provides for beneficiaries to have such rights, a court will recognize it.

Another issue is simply indemnifications. Those are situations where there is some risk involved in the deal and there needs to be a special allocation associated with that particular risk. An indemnity, which is a specific agreement, is entered into between the purchaser and the seller. Indemnities are only as good as the person giving you the indemnity, so where a purchaser is getting an indemnity for a particular kind of liability from the seller, you had better be sure that the seller has a deep enough pocket to pay for it later on if it comes home to roost. These kinds of indemnities, of course, are never seen in context where a public acquisition is done because you can never expect to collect from the public on any kind of indemnity.

A common technique which is very popular nowadays in these kinds of arrangements is to have a so-called "basket." It's a technique for aggregating liabilities that are unexpected and arise after the sale and they are a violation of the reps and warranties. In fact, what the basket does is provide that a purchaser can collect for violations of the reps and warranties until the aggregate amounts that are violations under these provisions exceed certain thresholds. These indemnities frequently also are net of taxes, which is quite significant in the employee benefit area because it reduces the obligations that are involved.

The most significant thing nowadays, I think, are the new nondiscrimination rules where a purchaser that is an ongoing entity and has preexisting business is going to meld a new business into its own. I've already talked about the one-year period during which there isn't any requirement that the seller's plan be taken into account with the purchaser's plan for purposes of complying with those requirements.

The other thing to focus on in the context of this type of acquisition situation where you have a preexisting entity is the separate line of business rule. We don't have any regulations from the IRS. There is a long list of regulations we don't have from the IRS, and this is certainly one of them. The most direct discussion of how the separate line of business rule works is in the Blue Book to the Tax Reform Act of 1986. I think most of us have a feel for what's going on in that area; however, there are a lot of situations, indeed, where it is unclear whether an entity that's being acquired would qualify as a separate line of business. I don't know whether or not the Muppets, for example, would be a separate line of Disney's business. The Blue Book also indicates that there would be special allowances for a separate line of business even though the purchaser and the entity being acquired are in the same business but they operate in different geographic portions of the United States. That's been fairly rare for my clients, but it's certainly something always to keep in mind.

If you want to keep the plans going for more than a year after the acquisition because you believe you have a separate line of business, you also have to worry about concentrations of highly-compensated employees. If it is the headquarters or parent corporations that you are worried about, in particular, the Blue Book talks about a 50/200% safe harbor. The Blue Book indicates that isn't in all cases a safe harbor.

For those of you who are not familiar with it, let me make it clear so that we know what we are talking about here. In a context where a purchaser is a preexisting business, you are required to look at the overall highly compensated percentage of the entity. Let's suppose, for example, that the highly compensated percentage of the acquirer is, say 10%. In other words, 10% of its employees are highly compensated; they make more than, for example, the $54,000 threshold number. In that context, if it is acquiring a unit that either has less than 50% of that percentage

as its highly compensated percentage -- in other words, 50% of 10% would be 5% -- or if the entity being acquired exceeds the purchaser's highly compensated percentage by more than 200%, it would have to be especially alert to problems associated with parent company personnel and headquarters personnel and it may not be able to continue those plans even though the entity being acquired otherwise has the look and feel of a separate line of business. If it can't qualify under the separate line of business rules, then after the one-year period is done, it is going to have to face the requirements of 410(b). They may require that the purchaser's plan be adopted to the seller's plan or vice versa and those are arrangements that would be of great significance to the purchaser who will have to know about them even though they don't have an immediate consequence for his own funding arrangements. These are some of the most difficult areas to deal with from the perspective of employee communications and they have tremendous impact.

MR. JOEL I. RICH: As Ailey mentioned, one of my responsibilities within Mercer is professional standards. So, I'd just like to tell you one thing that I'd like you to remember even if you forget the rest of what I say, which is: If you've never been involved in a merger-acquisition situation and you are called upon to become involved in one, I strongly suggest that you get somebody, either within your firm or someplace else, who has been through one of these and can guide you through the pitfalls. Even if you've done these, I strongly suggest that you get a peer to bounce ideas off of on what you're doing. It's been my experience that this is an area where it is very easy to get into trouble, if for no other reason than when the client calls and tells you the deal is scheduled to be closed at 3:00 that afternoon and he needs an estimate of the MEPPAA liability plus any unfunded pension liabilities. So, it's kind of difficult to do and that's really not an overstatement.

What am I going to talk about? How did I decide what I was going to talk about? Obviously, mergers and pension plans and the like is a very broad topic that could be spoken about at least for a full day, so what I will try to do is pick those areas where I have, in the course of my practice, found people to be somewhat deficient. I thought that I would try to focus on those areas and then maybe go through a couple of other issues, at least mention them so you will be aware of them.

The first thing I am going to talk about in pensions is accounting for these types of transactions. It has become more and more important to become cognizant of the financial accounting details and recordings of these kinds of transactions. Just to give you a pretty brief history, why we care about this is because our clients care about it. Why do they care about accounting? They care about accounting standards because, if you do things according to the accounting rules, then you get what's called a "clean" opinion and everybody thinks your financial statements accurately reflect what is going on with your company. If you don't follow what might be called accounting standards, then you may get an opinion that's something along the lines of, "We're recording this as we were told to, but we don't really believe it."

This is important because, for some reason, investment buyers are going to sometimes take those notes seriously. Historically, we had the Accounting Principles Board. Those of you who have been around for a while may recall the Accounting Principles Board Act (APBA) and the halcyon days when you could fund and expense at the same level and everybody was pretty happy and did not concern themselves with the difference between funding and expensing. Unfortunately, those days are gone. APBA was modified by FAS (Financial Accounting Standard) 36 and most recently, superseded by FAS 87.

Now, I am assuming to an extent you are all somewhat familiar with FAS 87. You may not be familiar with APB 16, which, again, for generally accepted accounting principles, deals with what to do when a company is sold, or, for that matter, anything else that would require a restatement of financial statements. You should know something about it because FAS 87 does mention it in Paragraph 74.

APB 16 deals with two types of accounting, one is called purchase accounting and the other, I think, is called pooling of interest accounting. We'll be dealing with purchase accounting. From my understanding, pooling of interest is not particularly common. However, that brings us to another point, which is of great importance: with all due respect to your FSA or ASA or whatever you have, for some reason, most people will look to an accountant to issue an accounting opinion and not to an actuary to issue an accounting opinion. So, while anything that we say here may, hopefully, be true to an extent, in a specific situation, you'll either want to talk to people, either

internal accountants of your client, internal accountants at your own company, or your company's or the client company's external accountants to make certain they are in some agreement as to what you are doing.

With that behind us, let's look at a purchase accounting case. We're dealing with a firm called BS & Associates whose only asset is a manure spreader. The company has no other liabilities. Now this particular piece of equipment has been fully depreciated in an accounting sense. In other words, it's been written off by the company in its financial statements. But, lo and behold, it was made in the good old days when people made things that lasted and, if you went out to sell this, you could still sell it for about $200,000. BS & Associates is owned by a single individual. I'm assuming you all know what a balance sheet is, it's basically a point in time. Look at the assets and the liabilities of the company and the corporate balance sheet.

CASE 1

Assets	Liabilities
Manure spreader: $200,000	$0
Accumulated depreciation: $200,000	
	Shareholders' Equity
Net assets: $0	U.V. Bottle: $0

So the assets would be the manure spreader with its original $200,000 value, but it's been depreciated over some number of years and, now we have zero net assets on the books. That doesn't mean in real life that it doesn't have any value, but the way accounting is done, we look at the books. We have no liabilities and, consequently, shareholder equity is zero. Assets equal liabilities plus shareholders' equity.

Now, let's say that another corporation called Fools 'R Us purchases this BS & Associates for $200,000, which, just in this case, happens to be equal to the fair market value of the piece of equipment. Now, what would happen under APB 16? This is an unusual situation, by the way. It's not usual that it turns out that the purchase price is exactly equivalent to the market value of the assets. If you restate the books, you will have assets of $200,000. That's the fair market value of the equipment. Liabilities of $0. Shareholders' equity of $200,000. So, again you have the fundamental accounting equation of balance working there.

This is a classic example of APB 16 but it is unrealistic, because in most cases the sale price is just not going to equal the book value of the asset being purchased. I guess the classic example of this is real estate being valued on the books at book value. So, if you pay more for the company than its assets, in theory, are worth, how do you get this accounting equation on the left-hand side to be equal to the right-hand side at the start? You're paying all that extra money for something and what accountants have chosen to call it is -- goodwill. That's what you're purchasing.

So, let's look at Case #2, which is basically the same as Case #1, except now, instead of paying $200,000, Fools 'R Us is paying $600,000. There's probably a good reason for this; perhaps it's reputation or perhaps it's because of a trained staff that BS Associates had. There's some reason that they are going to pay a premium price. With that given, let's look at what, under APB 16, the book will look like. Again, the market value of the equipment is $200,000, yet shareholders' equity, because they paid $600,000 is going to be there, so what's going to make up the difference is you are buying $400,000 of goodwill, which is what we've become familiar with as intangible assets.

CASE 2

Fixed Assets	Liabilities
Manure spreader: $200,000	$0
Intangible Assets	Shareholders' Equity
Goodwill: $400,000	Fools 'R Us: $600,000

It's a little more complicated than this. For example, fixed assets can't go on the books at greater than market value and there are other limits: goodwill can't be negative if you paid less for the company, but the important point that I want to make here is that market value can tend to be a

very subjective thing. Again, if you look at the real estate area, you can get a couple of appraisers to come in and look at the same piece of property and come to vastly different conclusions. You can get people to come in and look at the value of a company on Wall Street and see that, obviously, people have different values of what a company is worth.

If you look, what really happened is that goodwill became a balancing item. So, if the value of the fixed assets is raised or lowered, the intangible asset will change as well. People are interested in this. I remember when FAS 87 first came out, we received a copy of a loan covenant which talks about borrowing money. The banks don't just give money and say, "Come back when you can pay us." They put in various covenants that say, "If your assets or some ratio of your assets fall below certain measures, then we're going to come and demand payment or take your first-born." Or something like that. So, if you then start changing around what a real asset is versus something that is intangible, these people become concerned.

Now, let's take a look at an actual example here in this same basic example. Now a couple of things have changed. One is that Fools 'R Us has borrowed money to make this purchase. You will see the impact is to raise goodwill by another $160,000 if that was the amount that was borrowed.

CASE 3

<u>Fixed Assets</u> Manure spreader: $200,000	<u>Liabilities</u> Debt: $160,000
<u>Intangible Assets</u> Goodwill: $560,000	<u>Shareholders' Equity</u> Fools 'R Us: $600,000

If we look at case #4, we get to look at the impact, that I was talking about before. Let's say Fools 'R Us goes out and gets an independent appraiser to look at this particular piece of equipment and they come back and, independent of any influence of course, determine that the value of it is $500,000. Well, then that impact from the last case is different. You'll see that goodwill all of a sudden went down from $560,000 to $260,000.

CASE 4

<u>Fixed Assets</u> Manure spreader: $500,000	<u>Liabilities</u> Debt: $160,000
<u>Intangible Assets</u> Goodwill: $260,000	<u>Shareholders' Equity</u> Fools 'R Us: $600,000

Now, you probably at this point are wondering, what does all this matter? Why do I care about this? Getting back to what I talked about before, debt ratios are usually used to look at the financial status of a company and they are usually looked at as a ratio to fixed assets or some measure of assets. Usually, assets will not include intangible things like goodwill or other pension-related intangible assets.

When you look at Case #3, if you try to take a ratio of that to fixed assets, you'll see that it's about 80% and if you look at Case #4, it's 32%. Now, if you have numbers relating to that in some kind of loan covenant or what have you, you'll obviously care about that.

Now, you might say, "Well, if that's all there is to it, then all I really have to do is, first of all get somebody to tell me whether we like high numbers or low numbers when it comes to these percentages and then I'll just go out and get some independent appraisal to be closer to what I like." But the fact is that, not only is there a differing impact on the balance sheet, but there's also a differing impact on the income statement and that's the next thing I want to look at here.

If you look at the same case that we've been talking about, we're going to try to make an income statement where goodwill is amortized over forty years (40 years being pretty standard although it could be shorter in some situations). Let's say our company has total sales of $600,000, total expenses of $560,000 and the market value of the equipment is being written off over 10 years. Now, if we follow the appraisal of Case #3 where it was worth $200,000, you'll see the impact on

the profit and loss for that year. Sales are $600,000. Expenses are $560,000. Depreciation of $200,000 -- that's the value of the equipment -- over 10 is years is $20,000. Amortizing goodwill over 40 years is another negative hit of $14,000, which ends with a net income of $6,000. That's not the greatest net operating income, but the return for that is you get the debt ratio that we talked about at 80%.

Sales	$ 600,000
Expenses	(560,000)
Depreciation (200,000/10)	(20,000)
Amortization of goodwill	
(560,000) / 40	(14,000)
Net Income (loss)	6,000
Debt ratio 160 / 200	80%

Let's contrast that with the fourth case where we valued the goodwill at $260,000 rather than $560,000 and the equipment at $500,000. You'll see the numbers look fairly the same -- the only difference is that now we are writing off $500,000 over ten years for a negative $50,000 and $260,000 over forty years, for a negative $6,500. All of a sudden we have come up with a net loss of $16,500. It doesn't take brilliant insight from an actuary to realize that the difference is because of the amounts being written off over different amortization periods. The return for that is that the debt ratio is 32%.

Sales	$ 600,000
Expenses	(560,000)
Depreciation (500,000/10)	(50,000)
Amortization of goodwill	
(260,000) / 40	(6,500)
Net Income (loss)	(16,500)
Debt ratio 160 / 200	32%

The impact of all of this is that the second appraisal provides a better debt ratio, but worse net income. The question that you're probably asking yourself is, "Which is better?" I'm not going to ask for a vote. The answer really is that it depends on what your client cares about. There are some clients that care about cash flow and don't really care about the income or expense items for a couple of years. They may be more concerned with the debt ratio. There are other clients whose shareholders are going to be banging at their door everyday to see the results and, so, they care more about the net income or loss. Now, does this really concern us? Yes, it does.

The reason I made this such a simple example is because I want to drive home the point that it impacts pension cases as well. As I mentioned before, paragraph 74 of FAS 87, and 75 as well for that matter, does deal with this. What it basically says is fairly simple. If your projected benefit obligation (PBO) is greater than your assets, then you're going to put that total value in an accrued amount on your books and, if it's less, you're going to put a prepaid amount on your books for that amount. So, these pension plans will impact corporate statements in a much similar way.

I just want to run through an example here to show that Stage 1 of a case deals with the disclosure that might have been for the pension plan of a particular corporation. I don't think it's worth it to run through the particular numbers at this point. Then Stage 2 shows what the disclosure becomes after purchase. Again, there's nothing magical here. Basically, you've just gotten rid of all the amortization or the unrecognized items and you're just left with the PBO and assets. Now, again, this is oversimplified. If you were actually doing this in the real world, it might likely be

the case that this didn't happen at the beginning of a plan year, so you might have to do a reevaluation of the pension plans under FASB.

STAGE 1

Pension Plan A presents the following disclosure as of 12/31/89

PBO	$(240,000)
Assets	308,000
Unrec Tran (Asset)/Obligation	(90,000)
Unrec PSC	0
Unrec (Gain)/Loss	22,000
(Accrued)/Prepaid Pension Cost	0

The second question is what date do you pick? Do you pick the date the deal is announced? Do you pick the date that the documents are signed? Do you pick the effective date of the plan? Those are questions that your accountants are going to have to be looking at. Net result here of Stage 2 is that on the balance sheet goodwill be reduced by $68,000 to offset this prepaid item.

STAGE 2

Purchase as of 1/1/89 -- disclosure becomes

PBO	$(240,000)
Assets	308,000
Unrec Tran (Asset)/Obligation	0
Unrec PSC	0
Unrec (Gain)/Loss	0
(Accrued)/Prepaid Pension Cost	68,000

Another case shows the results of the profit and loss (P&L) prior to purchase and after the purchase. Again, as was the case in our simple example, you'll see the service costs and the interest costs stay the same. The return on assets stays the same, but now we're going to not have this transition. In the prior to purchase example, we had a net periodic pension expense of $2,000 and after it we have a net pension expense of $8,000.

P&L PRIOR TO PURCHASE

Service cost	$ 14,000
Interest cost	24,000
Return on assets	(30,000)
Trans asset	(6,000)
PSC	(0)
G/L	(0)
Net periodic pension expense (inc)	2,000

P&L AFTER PURCHASE

Service cost	$ 14,000
Interest cost	24,000
Return on assets	(30,000)
Trans asset	(0)
PSC	(0)
G/L	(0)
Net periodic pension expense (inc)	8,000
Change in goodwill amortization ($68,000) / 40	(1,700)
Total new cost	6,300
Net change = $6,300-$2,000	4,300

What a lot of people fail to recognize is that you also have to take a look at the change in goodwill amortization which might not necessarily be looked at in terms of the pension plan; it may show up someplace else. In our example, we came up with a net cost after the purchase of $6,300. So, the next stage here was we increased pension expense by about $4,300 because this was an overfunded pension plan. We've increased the expense, but the trade-off for that was that we reduced goodwill. Vice-versa, it could also happen. I went through that because it's been my experience that a lot of people don't really understand the financial impact of pension plan issues.

Another accounting issue which comes into play is FAS 96, which deals with accounting for deferred income taxes. I've begun to think of this as the Section 89 of Accounting, because every year they sort of push it off from applying. I have talked to clients about it, and they have all come to the independent conclusion that it's not going to make a material difference on their statements and, therefore, they are not going to worry about it at this point. Just keep in mind that for pension accounting, certainly for supplemental plans, which aren't funded, there will definitely be -- if FAS 96 ever does come into play -- a difference in the accounting from what you're used to seeing.

We're onto some of the more mundane sections of the Internal Revenue Code, which Bill alluded to earlier. Perhaps I won't go in them in as much detail either. The first was section 401(a)12 of the Code, which basically regulates that you can't have less of a benefit after a spin-off or a merger or consolidation than you would have had before. Then 414(l) regulations come into play. They cover two types of transactions. One is mergers and consolidations. The other is asset or liability transfers. They apply only if more than a single plan is involved and the single plan is assuming liabilities or receiving assets from another plan. It does not cover multiemployer plans and also, there are some other sections, such as governmental plans that this doesn't apply to either.

The general rule is, again, the same as stated before. Following a transaction such as a merger or consolidation, each participant must be entitled to receive a benefit on termination which is equal to or greater than the benefit that the participant would have received on a termination basis prior to the transaction. Then there's a whole set of regulations that deals with what exactly that means in practice. How do you define a single plan? What are benefits on a termination basis? How do you get the present value? And it also deals with issues such as defined contribution plans, etc.

Again, I don't think this is the forum to go into those in detail, but you certainly should know they exist because they will impact what you're doing and this is another point that I guess Bill was alluding to. Your role is probably going to depend on who else is involved in the transaction. If you're fortunate enough to have an experienced pension attorney, then, as an actuary, you have a lot less that you probably have to do and you will get a lot more guidance. Also, perhaps you will get into a lot more arguments. On the other hand, if you're on your own, then you probably are going to have to bring some of these things to somebody's attention.

There are also rules under the regulations having to do with what kinds of things you have to promise are going to continue if you do some kind of a merger. Optional forms of benefits must, by and large, be continued and an employee can't waive his right to that unless certain requirements are met. You can't allow voluntary election in certain cases. You still need the spouse's okay. Things like that all come into play. The IRS in 8648 has issued some guidance as to what benefits are included in these types of calculations and those are all things you'll want to look at if you do get involved.

Also, the IRS has given guidance as to how you handle funding standard accounts. Section (Revenue Rulings) 81-212 and 86-47 both talk about how you adjust your funding standard account. The logic is really not that difficult to follow. They do give a couple of good examples and I just urge that if you are involved in something like this, take a look at those adjustments.

Now, Bill mentioned earlier under TAMRA (Tax and Miscellaneous Revenue Act of 1988), there were rules issued for spin-offs within a controlled group. I assume that one of the reasons for that was this issue about being able to spin-off a group of retirees and recapturing all the excess assets. The rules there have not been clarified. I guess the underlying logic is something along the lines of the spin-off of the assets and the excess assets has to follow the same way the liabilities are being spun off so that you couldn't spin off $1 of liabilities and $100 million of excess assets.

Since I haven't had to do one of those yet, I haven't bothered to try to figure out exactly how that will be done. In the past, splitting the surplus in a pension plan has been subjected to a lot of different negotiations and still will be if it's outside of a controlled group.

If the seller should keep the entire surplus of that somehow, these amounts should be related to the PBO or the accumulated benefit obligation (ABO) or some funding limit calculations. That's all subject to a lot of negotiations.

There were a couple of other issues that I just wanted to touch on. Not to discuss but to indicate to you that they exist so you can keep them in mind. The most basic one is keeping in mind whether you are performing a technical role or a consulting role in these calculations. Some of the things that are clearly more technical are, "How do you do a funding standard account spin-off?" Some of the other things that might be dealt with in more of a consultative role is if you have a business plan where you are going to lay off half the people, it may be well and good to know what the adjusted funding standard account is this year, and how that is going to impact, at least the pension valuation if nothing else, down the road.

Also mentioned were multiemployer plan amendment act type plans. Again, those are very difficult, to get information and, even when you do get the information, unless you are going to go in and actually audit the current actuary, you're just going to have to rely on some very broad rules of thumb and hope that they are doing a professional job.

Other liabilities may be triggered. You may have a plan that sets up a plant to shut down. All of a sudden, though, retirement is not age 55 and 20 years of service, but becomes a rule of 45 or something else and that would, obviously, have an impact on your financial statements as well as your funding, especially after OBRA (Omnibus Budget Reconciliation Act) 87.

Trust contracts. If you are going to terminate a plan, then you may not have the same values that the company, the insurance company, has been reporting all along as their "market value." If the transfer doesn't happen until six months or a year later, how much interest is going to be credited? Who's going to make the contributions to those plans in the interim, etc?

Nonqualifying plans. You don't get Enrolled Actuaries credit for discussing nonqualified plans, so I'm not going to discuss them other than to say that they are quite an issue.

The tax reform act. I'll be glad to answer questions on this later, if you want. Obviously, a key issue in the consulting process is that you get a plan document and it says that the benefit formula is 50% of final pay offset by 50% of social security and the second half of that is not related to years of service. The client asks, "What's my unfunded liability and what are my ongoing pension costs going to be?" You have to try to explain that you don't really have a clue because you don't know what the plan is going to be on an ongoing basis. Suffice it to say that clients don't particularly appreciate, "I don't have a clue" as an answer. So one generally phrases it in more flowery language.

Separate line of business is a very basic issue as indicated before. Can you even keep that plan separate and do a valuation for it or are you going to have to merge it into one of your other plans? You may have a plan coming in that has 401(a)26 issues as well. All of those are things that you are going to be expected to raise. So, on the one hand, I think if you are just doing an administrative type job, the rules are somewhat clearer and where they are not, you can probably get someone to tell you what to do. When you move past that to try to figure out what the grey areas are and what they are going to mean, it's a bit more difficult.

Integration is a perfect example. At the previous session to this one, where the pension section met, it was conjectured that the IRS might, in fact, go back and say that you could use social security offset plans based on having some grandfathers or safe harbors.

MR. JEREMY GOLD: I consider myself to be a transition between all that substantive stuff and the questions and answers and that's just as well because I don't have 20 minutes or a half-hour of talking to do. In fact, although you are a big group, it would be nice if, in the transition, because there are so many senior people out there, we could get to questions and answers fairly soon and maybe get some experiences to kick around. Or ask, "Why are those other people, like investment bankers, doing this to me and what do they really mean?"

EFFECT OF MERGERS AND ACQUISITIONS ON PENSION PLANS

I'm going to make a few comments about the relationship between actuaries and all those other guys doing this Merger & Acquisition (M&A) stuff and what you might want to say to them or they might want to hear from you.

Joel made a distinction between technicians and consultants.

I don't think that the choice -- or the world that you're operating in -- is a choice between technical and consulting. I think consulting is a far cry from investment banking and I want to make some of those distinctions because, in fact, most of us are consultants. We've spent our whole lives getting good at qualities that overcome the technical and make us good consultants and become good teachers. We become good presenters of alternatives. That's what consulting is. We're not principals on the transactions. We're not principals even on the pension plans that we're involved in. So, we give people choices.

I'd like to give you an idea of what the Chief Financial Officer (CFO) and Chief Executive Officer (CEO) want to know. The CFO and the CEO want your best judgment about value, about opportunity and about risk. He or she doesn't want an education. No ifs. No ands. No buts. No credentials. (Speaking as if quoting a CEO or CFO), "Don't waste my time with credentials. You wouldn't be in my office if I didn't think you were good enough. Don't demonstrate how good you are by showing me all the choices. I can't deal with them. I don't want to deal with them. I don't want introductions. It's nice to know your name, but let's sit down and let's talk about money. I don't want caveats. I don't want assumptions. I don't want methods. I don't want consulting. I want the answers to questions I want and when I want them and I want them prepared in a fashion that I'm used to having them in."

In that regard, by the way, let me say that Joel's Stage 1, Stage 2, Case 1, Case 2, and so on is very much a good style. The folks you're talking to aren't afraid of numbers, but they are uncomfortable with indecision. They are uncomfortable with lack of certainty. They are very uncomfortable with caveats. "What's your best guess? What would you do, maybe?"

Now, I'm trying to give you the impressions that bankers and financial officers are tough. You know they are smart, too. Maybe actuaries are smarter, but they are not tougher, as a group. You have been trained to be fair. You have been trained to be objective. You have been trained to be a protector of the weak, but that isn't the world you're in. Now, you're probably, as an enrolled actuary -- in fact, you are definitely as an enrolled actuary -- a protector of all the plan participants and beneficiaries under your care. However, with you as an advisor, and particularly if you are not the enrolled actuary, there are other things that the principals of these transactions want.

I should separate that I am talking about "them" as though they were one group, but, in fact, the principals in a highly leveraged transaction can behave very differently from the corporate financial officers in the sale or purchase of a division between big companies. The major difference is in the principals. They are both looking for value, but for the principals value is fairly unequivocal. It's cash, and cash, and more cash; sooner rather than later. They are usually operating with very high costs of capital and the value of a dollar today may be twice the value of a dollar only three years from now. Maybe, in fact, it is worth twice what a dollar is only two years from now. The financial officers, the less cash players, are going to be more interested in the accounting issues of the kind Joel was raising.

I should make a second distinction and explain that most of these folks spend a lot of their time on the righthand side of the balance sheet, the capital side. Let me contrast what kinds of things happen when you have a fairly low-debt company in a very regular cash-flow basis. Now, think utility. You can borrow money if you have a fairly low-debt company. Actually utilities have a fairly high debt, but their cash flow is so certain that at least they are not thought of as highly leveraged. If you're in a nonleveraged environment, you can borrow fairly cheaply and there are shareholders who are not at great risk who will accept a relatively low total return on their equity investment. This translates from a CFO's point of view into a low cost of capital. He can actually have assets that, on a cash-on-cash basis, do not provide a fabulous rate of return and they can stay in business for a long, long time. I guess that's why we can afford nuclear reactors and the other things that utilities use, or the cables on the ground and all that stuff.

Now, of course, if you get leveraged, the game changes and the classic form of leverage is the leveraged buy-out (LBO). When you want to maximize the return on your equity, you do so by

borrowing and you do so by borrowing at a cost that is less than what your assets return. That leverage is the return on your equity. When you do that and you keep borrowing, and you keep borrowing, the cost of your borrowing goes up, because the more leveraged you are, and the more risky you are, the lower your credit rating and the harder it is to raise capital.

So, leveraging raises the cost of borrowing. It also raises the cost of equity capital. Most of us think of equity as representing ownership, but a financial officer thinks of equity as just another capital cost, so I think that you really do need to know the capital environment in which you are working because it is going to prioritize mid-term cash versus long-term cash.

This raises the next issue in this corporate finance vein that I seem to have wandered into, which is what I call the "weak hands" issue. From time to time, we sell a division from strong hands into weak hands. In fact, I think that's probably more common than the other way around. The LBO is a classic version of that. The management of an LBO may view itself as strong and it's certainly tough, but, in financial credit terms, they are weak hands. Now, if weak hands promise you something, by and large it's worth less than if strong hands promise it to you. The classic promise made by corporations are bonds. The bonds of a troubled steel company require higher rates of interest. If you look at the size of the promise made -- in other words, the high rate of discount -- you can discover the present value as compared to a company that would be viewed as a strong hands, with a strong balance sheet.

Now, if strong hands sell a division to weak hands and say to the bond holders of strong hands, "Oh, by the way, weak hands is going to pay off this debt, don't look to us any more" the covenants that we mentioned before will come into play. You just can't do that. You cannot hand your promise off into weaker hands. Unless, of course, it's a benefit promise. Think about that. You'd think that, with all the regulations and stuff, there is probably nothing holier than a benefit promise. In fact, however, unfunded benefit promises can be passed from strong hands into weak hands with what appears to be little recourse. So, the question of who should hold the surplus, who should hold unfunded liabilities, becomes a corporate finance question. It's not an actuarial question. I won't go much further in that vein, but I think I've given you the track you can pursue.

That kind of track of looking for opportunity, telling people that you know these liabilities are worthless, starts to raise questions of professional judgment and ethics. What are you going to tell people? Will you advise people of things that are legal, but that injure employees? I don't propose to have answers. I am the transition into questions.

The whole merger and acquisition process, particularly as it applies to the kind of work we do, consists of basically four steps: collect data, analyze data, plan your strategy, and negotiate.

Every time I go to an M&A presentation at a conference of this sort, I hear a lot about the collection and analyzing of data. Most of the strategies I hear about are how to discover yet new hidden liabilities and warn people about them, but, in fact, strategies from the point of view of the people who do these deals are finding opportunities. They want you to tell them about all the problems that you can't make go away, but they would also love to hear about an opportunity.

Through the process of negotiation, the people you are dealing with are looking to win and winning, in their case, means that they come out ahead at the time the deal is done. Coming out ahead means somebody else loses. I only see three possibilities of who can lose if your client wins.

- The trading partner. You can outsmart the other side.
- Uncle Sam. You can structure the deal so that he doesn't get his taxes until later or maybe never.
- The employee.

You know these things and you can provide advice on them and the questions for you in part are, "Will you?" and "Will you be of value to the people who want that advice?" Again, I don't have answers. I'm raising these questions because I find them troublesome.

MR. NORMAN R. MINOR: I address this question to Mr. Bortz. Assume seller and buyer are unrelated. Assume seller has a pension plan and assume the accrued benefit to closing date is frozen and the assets stay with the seller. Assume the possibility that the buyer sets up its own

totally independent pension plan. Would you comment on a provision in the purchase and sale that prevents an employee who was with the old company and now is with the buyer from getting access to his accrued benefit until he retires?

MR. BORTZ: That's actually an excellent question. It's highly sophisticated and it hasn't been discussed much. Most pension plans are written with a key concept left terribly vague. Vesting credit, when you enter the plan, early retirement subsidies, spousal rights -- all those things are written with great specificity. When you actually get your pension is left very vague. "When you terminate employment" is typically how these arrangements are written, but there's no definition of when that might be. There is very little in the way of high-risk guidance, as to how to deal with those issues apart from some of the rules relating to lump sums in 401(k) plans under the heading of "Separation from Service."

You begin with the question of what would the proper interpretation be of the seller's plan. There have been situations in the past where employees have left a particular corporation, but stayed in the same job. How does that effect their pension? That's the basic issue that has to be dealt with by the individual who is in charge of the administration of that plan. There is a very good argument that, in fact, they have terminated employment, which, of course, is the case. They have left the corporation they were employed by. It seems to be very difficult for the person interpreting the seller's plan in your context to conclude that the individuals are not, in fact, entitled to a pension.

The situations where most questions have come up that I have dealt with, usually have more specific provisions added into the seller's plan to insure that, in fact, the employees don't get paid.

MR. MINOR: Mr. Rich, again assume seller and buyer are unrelated. Would you discuss the requirements versus what's usually done as to funding standard account credit in a plan spin-off?

MR. RICH: You're talking about a case where buyer and seller are unrelated and the buyer's pension plan is moving?

MR. MINOR: Yes, unlike the last situation, we are going to spin the plan off to the buyer.

MR. RICH: He's going into a new pension plan?

MR. MINOR: No. He's just going to keep the old plan as a continuity.

MR. RICH: The whole plan or part of it?

MR. MINOR: Let's say half of it.

MR. RICH: We'll look at that first as a spin-off as described in the various rulings that I mentioned. What you would have gotten through that funding standard account then becomes the funding standard account for the ongoing plan.

MR. MINOR: Do you consider that a mandatory requirement? That a piece of the credit be spun-off.

MR. RICH: I'm not real sure though I'd say, if anything, that's mandatory any more.

MR. MINOR: Thank you.

MR. BORTZ: On that termination of employment question, by the way, I would just add that, maybe one of the issues there is because they are also concerned about severance plans. Most people try to say that if the company did spin off and you were sitting at the same desk the next day, you haven't triggered a severance. So, it's pretty hard to say that you were not severed for terms of a severance plan, but you were severed for terms of a pension plan. I guess maybe that's part of the issue.

FROM THE FLOOR: I recently had a situation where a client has several different businesses, and one of them has become inactive. The plan that covers that unit is in a plan that covers another active unit and there is a significant surplus in that plan. What they wanted to do was

transfer the assets and liabilities and, to the extent possible, the surplus applicable to the former employees at the ceased unit over to another plan that they have in the controlled group that's substantially underfunded. We bumped our nose up against the new TAMRA requirement in 414(l) because it would be a transfer within the controlled group and those rules function off the full-funding limitation. The way the full-funding limit rules work, it's quite different for a group of active individuals than for a group that includes only retired individuals. Has anyone had any experience doing a calculation in that context? I've never seen it addressed.

MR. PAUL A. CAMPBELL: I'm going to stick my neck out and simply say, in response to Mr. Gold's comment about how the actuary should most effectively conduct himself in the presentation, I'm not positive that we can do so in full satisfaction of our requirements under the Actuarial Standards and I would invite somebody to confirm that in specific terms, but I believe we have requirements to state the assumptions under which we are offering our comments and to provide the caveats that we, as professionals, think a nonprofessional should hear.

MR. GOLD: I think that's probably true and I think there are places where you can put the caveats to make sure they are part of the material. I was expressing what I think is a chief financial officer's view and I don't think he has a great deal of allegiance to the American Academy or any of the professional organizations that we belong to and, so, he might be impatient if you are placing your professional responsibilities before his business interests. Again, that's not advice, that's just a comment. I'm advising you on what you can expect from the CFO.

MR. RICH: I would draw a distinction between the oral advice and the follow-up written advice. Usually, you won't get more than 48 seconds to explain what your limit is and perhaps the sensitivity of it and that's about it. Of course, you follow up within the next couple of days with a long letter, perhaps to the person who works for the CFO just explaining how you came up with that number and all the assumptions that went into it and where you didn't meet the appropriate Academy opinion on that or something else. I do think you have to do that. I think that's a necessary step.

MR. GOLD: And I think some of that, Bill, is effected by the environment in which you are doing it. I think the general principle is when you prepare an actuarial statement, you are required to give out information so that another actuary has a reasonable shot at figuring out what you did. In some of these instances you are not providing actuarial statements. A guy might ask, "What do you think my unfunded supplemental executive retirement plan (SERP) is worth? What do you think my health care plan is worth?" He really does want a number, and I'm not sure you are providing an actuarial statement when you simply try your best to answer that question.

MR. RICH: If you want something to think about, I'd think more about how or where the two roles cross of enrolled actuary versus consulting actuary, if you will. I know that we're all perfectly moral and honest, etc., but to the outside world, there could be some questions of a conflict of interest. As someone once told me, "The actuary picks the assumptions, but the client picks the actuary." So, it's something to think about.

MR. GOLD: I already was asked once this week whether I was in uniform 24 hours a day. The answer to that was, "Yes." However, there is a distinction between an enrolled actuary for a plan and providing management advice based on the knowledge that you've acquired. Now, there probably is more structure when we are talking about a plan for which we are an enrolled actuary or for which your firm is the enrolled actuary. I think that we have a hard time taking off that enrolled actuary hat.

MR. RICHARD A. BURR: I was interested in the comment about the perspective of the CEO and the CFO, because I was involved in a purchase/sale agreement, which the 24 hours or the 3 hours was an issue. The purchaser agreed to an incredible number of things with regard to the benefit plans, particularly the pension issues, that I'd never come across before, but it was basically the financial issue. They were very, very interested in having this particular organization.

Among other things, Organization A was selling off practically its main business to Organization B and therefore Organization B now had the whole plan, or series of plans, but there were a few executives who were going to be staying with Organization A. In the process, the purchaser agreed to spin-off not only accrued liabilities with respect to the pension plans that would not be continued with A but also surplus. It agreed to the transfer of surplus relating to assets in excess

of liabilities to B. The comments that you were making would put some perspective on that. I mean, obviously, B definitely wanted that organization and it didn't really care that it was going to be losing the surplus. Its issue was cash.

MR. GOLD: You need to consider a couple of other things, one of which is corporate ego. The other implication is taxes and cost of capital. An example of that: In my view, for a weak hand company with a high cost of capital, unfunded benefits are financing. Sometimes that funding is a method of financing benefits, but in fact unfunded benefits that end up in an adjusted sales price constitute a financing to the weak hand that end up with the unfunded benefits. It may be a very cheap form of debt.

MR. RICH: On the other hand, I would add that they often tend to be very sensitive to first-year cost versus second-year cost. In other words, if they get a surprise in the second year in the amount of cash that they have to come up with, they are not very happy with it.

MR. GOLD: But they don't mind if they get surprised in year six.

MR. RICH: No.

MR. GEORGE BERAM: We're a medium-sized actuarial firm in Boston and have done a fair amount of merger and acquisition activity in recent years. We represented the buyer and one of the major actuarial firms represented the seller, and we were involved in all the negotiations and consulting that goes along on a merger and acquisition. The actuarial firm, in determining the amount of assets to be transferred -- we'd already agreed on the method -- made a million dollar mistake in favor of our client, the buyer. So, we were faced with this incredible dilemma. What do we do? This is a real life actual situation and it caused us a major problem in the office. We had many discussions with the actuaries trying to resolve this because it was a major ethical professional problem. So, you all might want to take ten seconds and decide how you would have handled the problem.

This is not to say that we're terrific people, but we decided that we did have a responsibility to all the participants and we also felt we had a responsibility to the profession, so we quietly notified the other actuarial firm that they made a mistake and they thanked us profusely and that was the end of the matter.

MR. BORTZ: What conversation took place with your client before or after that disclosure to the other side's actuary?

MR. BERAM: "We found a flaw." They weren't against that except that they were mortified. They were not particularly happy, but we felt we had no choice.

MR. BORTZ: My experience with clients is that, by and large, they will be sympathetic to those kinds of constraints in your kinds of situations. Frequently, CEOs in purchasing transactions are greedy individuals. However, on the other hand, they involve themselves in other economic deals in the market and they don't want to get a reputation for taking unfair advantage of others and they would expect you to, in fact, speak up in the context where you discover those sorts of errors. Of course, clear it with them first before you tell the other side.

MR. RICH: I suppose a spin-off question for that would be what if it hadn't been the pension assets that were transferring, but some sort of make-up in the purchase price, where it wasn't a matter of the participants getting any more or less, just the other side getting a little less in the total sale price? Would our response be the same?

MR. GOLD: As professional proprietors of the contract rules I think the problem remains the same. Maybe to an enrolled actuary it's mooted, but the actuarial rules as a profession don't make the distinction that I think you are making. You can quote an actuarial opinion in a paragraph in the sales agreement. I'm not saying which course I would necessarily take. I don't think that the distinction that it is outside the plan is, for us as professionals, critical, although in a real context for an enrolled actuary, it may be -- there may be a distinction there.