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MERGERS AND ACQUISITIONS

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- How is the pricing and structure of the transaction affected by pension and/or postretirement costs and liabilities?
- What special problems arise when a United States or Canadian company is acquired by a company from a different country and vice versa?

MR. WILLIAM B. GULLIVER: I am an actuary in the Stamford Consulting office of Towers Perrin. Doug Tormey is an attorney, also with Towers Perrin, and serves as a technical resource to us.

In looking for someone who had credentials to step in at the last minute, the first question was, who needs continuing education credits? And who is willing to moderate this session for four times the credit you get for attending it? Over my 10-year career with Towers Perrin and prior to that, I have had the opportunity to become involved in a number of acquisitions and divestitures. What we've tried to do is put together an informal discussion outline that will allow us to walk through the many issues that come up in the context of an acquisition and a divestiture that need to be addressed by both parties.

We're going to talk a little bit about the types of financial transactions that go into acquisitions and divestitures, and about the fact-finding missions that actuaries and attorneys go on to learn more about the benefit programs. We'll also talk about the kinds of hidden liabilities that may exist with respect to those programs. Then we'll talk about some benefits or obligations that may emerge or be precipitated by the acquisition or divestiture itself. At that point, we'll pause for questions. That discussion will be handled largely by Doug. Following any questions you may have, we'll get into some of the more traditional actuarial issues, such as the treatment of benefits in an acquisition and divestiture, the types of purchase-price considerations that exist, and issues involved in implementing the ongoing programs. Time permitting, we'll finish with a brief discussion of miscellaneous topics.

One of the topics to be covered is issues that emerge when Canadian or U.S. companies are involved in acquisitions involving foreign countries. My expertise does not include that topic. Doug will be speaking about a couple of those issues, but for those of you who were hoping to hear a lot more about that topic, you may be disappointed.

MR. DOUGLAS TORMEY: I was wondering if I could just have a show of hands to indicate who among you has had substantial experience in mergers and acquisitions. Some? And none? Okay, so I think we're more in the "some experience."

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Let's start off then by looking at various types of transactions. The two principal types of transactions we're going to be dealing with are stock transactions and asset deals. In a stock deal the seller is selling the stock of a subsidiary, for example, to a buyer. In an asset deal, the buyer is acquiring assets and maybe only certain enumerated liabilities of the seller.

In most cases, employee benefit issues will not drive or determine whether the deal is an asset transaction or a stock transaction. This will usually be driven by other tax considerations or other general corporate considerations. It's also quite possible, depending on the size of the transaction that you're involved in, that the deal may have both stock and asset components. For example, you may be buying the stock of a subsidiary and assets of some second-tier subsidiary. So there may be other corporate transactions involved where assets of certain parts of the business are dividended up to a parent, and you're not acquiring those assets. In short, the principal difference between an asset deal and a stock deal is that in the stock deal, you're buying not only the assets, but all of the liabilities that go along with it.

That puts a great deal of focus, particularly in a stock deal, on the due diligence components of the transaction. So there's a great effort undertaken to discover, examine, and quantify any liabilities that the corporation might have, including those that aren't on the balance sheet, those that are lurking out there to destroy the financial viability and the prospects of the purchased business.

In an asset deal, on the other hand, the exposure of the buyer is somewhat limited. Very often there will be a schedule in the purchase agreement saying that I am buying all of these assets, but I'm only assuming these certain liabilities. That may or may not be successful, but as a general rule, the exposure is somewhat less. Some exposure may still exist. For example, where the seller essentially ceases to exist and there is only a shell left, the buyer may be assuming more liabilities than those that are merely scheduled. For example, there is a point regarding the impact of a union contract. Under the Federal labor laws, where there's been a sale of a business, even though the form of that sale was an asset sale as opposed to a stock sale, the buyer is not going to be able to just walk away from those union obligations. This is a factor that has to be taken into account when going through the transaction. You can't just assume that there's not going to be any liability.

Similarly, you may have trouble with Pension Benefit Guaranty Corporation (PBGC). If there are insufficient assets left with the seller, you may find that some of those liabilities are following you around as a buyer.

It is important to note, too, that the form of the corporate transaction is not going to necessarily determine or preclude you from doing certain things with regard to any one plan. For example, let's say we have a defined-benefit plan that is the plan of a subsidiary. If I'm buying the stock of that subsidiary, normally the plan comes over to me automatically. I just assume that plan. However, if I don't want to assume the plan, and there's a parent corporation that will remain after the transaction, it's quite possible to have the parent corporation become the sponsor of that subsidiary's plan. We can leave the plan with the parent or transfer spin-off assets and liabilities as agreed by the parties. Similarly, if I was buying substantially all the assets and liabilities of a business in the form of an asset transaction, I could assume sponsorship

of that subsidiary's pension plan as the buyer. So again, I could take over the whole plan. I may be required to structure my part of the transaction a little differently, depending on how the corporate part of the deal is structured, but it won't necessarily preclude me from doing what I'd like to do on the employee benefit side.

Bill, do you want to talk about the accounting aspects of these types of transactions?

MR. GULLIVER: Basically when you talk about the accounting for an acquisition, two terms will arise: "pooling of interests" and "purchase method accounting." Pooling of interest is a concept that chiefly goes with stock deals. As Doug described, if a company has acquired the stock of a corporation, that corporation is ongoing, and its accounting entries are ongoing. Whatever accruals or cost measurements that existed with that corporation are kept largely intact and are often merged with those of the acquiring company if, in fact, it's going to become a subsidiary. Or they become a starting point for a new corporate entity.

That does not mean, however, that there cannot be adjustments to the accounting entries that prior corporation has made. Let's go back to Doug's example of a subsidiary that participates in the plan of a parent. If you acquire the stock of the subsidiary, whatever has been accrued by the subsidiary with respect to pension expense doesn't necessarily represent what's reasonable for the new owner to accrue. Adjustments can be made.

Under purchase method accounting, it's an entirely new deal. Basically the buyer has come in and acquired assets. It marks the assets to market value on day one. It assigns a value to all the assets that have been acquired. The buyer assumes certain liabilities, and those liabilities are measured on the acquisition date. Obviously, employee-benefit plans have assets and liabilities. Very often those assets and liabilities may not be accurately represented on the financial statements of a business that a buyer has been reviewing. The evaluation of the assets and liabilities in benefit plans can be a significant factor in purchase-method accounting.

Now in an ideal world, if I valued the assets of a company that was sold at their market value, and valued the liabilities at their market value, I might find that the excess of assets over liabilities exactly equals the purchase price. But of course, that doesn't happen. What usually happens is that an acquirer has paid a price that is higher, and that excess value shows up as a good-will entry on the opening balance sheet. To a large extent, what we as actuaries get involved with in these kinds of situations are balance sheet adjustments which reflect the relative value of assets and liabilities that an acquirer will be assigning to the benefit plans it has assumed. That has a corresponding effect on a good-will entry which is, in turn, amortized in an expensing policy of the new company.

You can see that in both "pooling of interests" and "purchase method accounting," it's important to measure the assets and liabilities of benefit plans that you've assumed. Very often the accountants will view an acquisition as an opportunity to position an opening balance sheet for ongoing expense calculations with some strategic planning in mind, in terms of cost control. How you measure initial assets and liabilities can have a big impact on the financial statements that exist not only on day one, but down the road as well.

MR. TORMEY: I just want to make one further point. I'd say that, at least in my experience over the last few years, the number of transactions that have been accounted for as poolings has been small, a very small percentage, when compared with those accounted for under the purchase accounting method. We've seen some in the financial sector in the last few years. The point I want to make relates to executives. There are a number of conditions in order for a transaction to be accounted for as a pooling under ABP-16. One of those that you may want to be aware of will restrict, at least for a certain period of time, the ability of affiliates, or your corporate executive officers, both the buyer's and the seller's, to exercise stock options, sell stock, and otherwise reduce their exposure to the combined entity. The limitations stay in place until you publish some combined financial results for a period that covers at least 30 days. So if you have a client who is constantly engaging in pooling transactions, this is something to point out to the executives regarding their ability to deal in the stock.

MR. GULLIVER: Next, we'll talk about fact finding and evaluating some of the hidden liabilities that may exist. Before we talk about that, I jotted down some reasons why we should do this. The reasons may be obvious, but nevertheless I'll list some of the considerations that we'll be addressing.

First, there's legal compliance. If you're assuming benefit plans, you want to make sure that they conform with the applicable laws. A real confusion now exists, because of the uncertain state of the nondiscrimination rules for qualified plans. What I've been seeing is that in an acquisition, it may be unclear that a plan can comfortably demonstrate compliance on even a good-faith basis. Even if it can comply before the acquisition, it may not comply with regulations in their final form. You need to evaluate what, if any, changes may be required to comply once the good-faith standard has disappeared. There is some relief in the nondiscrimination regulations for acquisitions, but the relief is relatively minor. It's also short-lived, and you have to ask, as an ongoing business, what will this plan look like in its final form? Another reason why nondiscrimination rules can be particularly complicated in an acquisition is that very often in a large corporate setting, a plan may meet nondiscrimination standards as part of a large controlled group, but when the business is acquired, as either a stand-alone entity or as part of a different controlled group, a whole new set of issues emerges.

I was recently involved in a situation in which a company was selling a business. The employees of that business had historically been covered under a plan which, for salaried people, had a fairly generous benefit relative to nonunion hourly employees. Within the controlled group of the seller, we were comfortable that if we aggregated that plan with other plans of the controlled group and tested the benefits, it would be nondiscriminatory. If we considered only that one plan on a stand-alone basis without aggregation, there was clearly a problem. Well that becomes a major impediment to a sale. To stay on a stand-alone basis, this plan may not be able to continue to be operated, but as part of our large controlled group, it can. These are the kinds of things that will come up in a legal compliance mode. In the qualified plan area, nondiscrimination rules have been slow in coming and their impact on acquisitions and divestitures is unclear.

A second reason for fact finding is to quantify assets and liabilities. That includes not just those that are in existence with the current plans. If you're acquiring a company that has previously terminated plans or has undergone any number of other prior actions, you want to understand the history of the plans. I'll give you an example. I was involved in an acquisition in which the salaried group was covered under a terminated and reestablished plan. It turns out that the termination benefits were provided through annuity contracts purchased with Executive Life. Now, if you just looked at the terminated reestablished plan, you would say, "here's how well funded the plan is, etc." But if you didn't go a step beyond and find out the details of that termination and reestablishment, you would not have known about a potentially large liability.

A third reason for fact finding is to evaluate the company's financial statements. What you'll often find is that a letter of intent is struck after what is believed to be a thorough review of company financial statements: a balance sheet, profit & loss (P&L) statement. With respect to benefit plans, very often the company financial statements are not necessarily an accurate measure of the cost of the plans. Particularly if issues, such as spinning off assets and liabilities, are not handled in a way which is consistent with the existing funded status of those programs. It becomes important to properly evaluate the costing of those programs that the company is recognizing in its P&L and on its balance sheet, and to try and reevaluate those costs within the context of the deal you're trying to strike.

A fourth reason, and this may be obvious, is that the more you know about the benefit plans, the more equipped you are as a buyer and the more equipped you are as a seller, to negotiate adjustments to the purchase price. There is almost always a negotiation process that is undergone with respect to benefit plans, in which a purchase price in an original letter of intent is adjusted to reflect more and more knowledge that emerges with respect to how these plans will be operated after an acquisition.

A fifth reason is to structure appropriate language in the final-sale agreement to deal with issues that are uncertain. An example might be indemnification of the buyer if someone sues over the operation of a medical plan, or there are lawsuits that deal with how the plan had been operated in the past. You want to hear about those issues. Do they exist? Are there pending lawsuits and what kind of indemnifications might you seek in the sale language to protect yourself from liabilities that might emerge? Some liabilities won't be apparent from just looking at the plan documents and the financial statements.

And the last reason, and probably the most important from my perspective, is to avoid surprises. Companies don't like surprises. The more homework you do, the less likely surprises become. It is particularly uncomfortable when surprises occur after the deal is done. We go on this fact find to try and uncover as much relevant information as we can, so that buyers and sellers can properly structure the price, the agreement language, etc.

MR. TORMEY: Okay. We'll start out by going through our inventory of plans. Let me just say that this due diligence process may take a number of forms, and you may have to have more than one cut at it. For example, if a company was being

shopped, if there was an active process of trying to sell the company, you may be contacted and asked to bid on that company. The seller in that case may make available to prospective buyers certain information regarding various employee benefit plans. The information provided may be more or less complete. You'll be invited to come into a room, rummage through various files to your heart's content, take whatever notes you want, and then go back and prepare a bid.

Once your bid has been submitted, and if your bid is accepted and you negotiate a letter of intent, then you'll get down to even more serious looking at the documents. The first step we're going to take is try to find out what's out there. This goes far beyond the usual suspects. We'll, of course, ask about defined-benefit plans, defined-contribution plans, whether there are savings plans, 401(k) plans, whether there are medical plans and the like. Those are all straightforward. We're also going to look at other informal arrangements that some people may or may not consider to be plans. For example, we will want to look at severance policies. A lot of employers are fond of saying, well we really don't have a severance plan, but we do have a severance policy. It's very important for you as a potential buyer to understand these policies, the potential exposure, the terms of those policies, and whether any benefits will be triggered either by the transaction or subsequent to the transaction under the terms of that policy. Also, you'd want to be on the lookout for any individual arrangements. These can take the form of employment contracts, individual parachute arrangements, individual termination agreements, and so forth. All those should be provided for you, as part of the due diligence process.

The due diligence process will be backed up when you get down to actually negotiating the terms of the agreement, to asking the seller to represent to you that the seller has disclosed to you all the various plans that it maintains or has maintained within the past X number of years, and delivered to you all the documents, all the communications, and everything else governing the operation of those plans. And then you'd want the further protection that if there's going to be a seller after the transaction, for example, a parent, you'll be looking for some sort of indemnity, if in fact, those representations turn out to be wrong. As Bill said, those are merely the backup, in case you miss something in the due diligence process. Due diligence is where your energies need to be focused. Here's where you really need to ferret out any potential problems, since it's much easier to deal with them before than after. Just about every deal I've been involved in has required some adjustment after the closing. Sometimes there is an adjustment and sometimes even fairly substantial benefit issues get lost in the wash because there is something else even more important or a bigger dollar value going on. So therefore, in order to avoid those sorts of difficulties, you need to spend a lot of time and devote a lot of energy and effort to the due diligence process, to identify these problems.

Particular things to be aware of include not only these individual arrangements and informal policies, but also the fringe benefits, things that are harder to discover. They often show up in employee handbooks, for example. These are things that have been given to employees and that they've come to expect. You know, it's one thing to say that an employee is not legally entitled to a certain perk, but it's quite another, from an employee relations or human resources standpoint, to go in and tell employees, particularly after they're your new employees, that they're no longer going to get this perk or benefit. Remember what you (employees) had before and we (the buyer)

told you that things were basically going to continue the same? Well, this is a new day and there's a new program in place.

As a buyer, you want a happy workforce; a happy workforce is a productive workforce. So if there are any of these concerns, you want them dealt with upfront.

Also, in performing an inventory of plans, you'll be able to discover whether any plans of the seller have assets invested in employer stock. Again, depending on the terms of the transaction, this could affect how you're going to deal with that fact. For example, if there was a leveraged Employee Stock Ownership Plan (ESOP), that could have a significant impact on how your deal is going to be structured and what level and type of benefits you're going to be providing. Where there's not a leveraging transaction, you may nevertheless have significant assets invested in employee stock, particularly in thrift plans and 401(k) plans. Although not terribly common, your employer stock could also be in Voluntary Employees' Beneficiary Association (VEBAs) and of course, defined-benefit plans.

This segues right into the document review. Once we have an inventory of the plans, we want to look at the documents. It's not merely enough to say, okay here's the list of the plans, and there are the documents sitting over on that table. Someone really needs to go through the documents, read them carefully, and try to understand how they work. For example, when you see a pension plan that you know hasn't been amended for Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Deficit Reduction Act of 1984 (DEFRA) or Retirement Equity Act (REA), some bells should ring. And certainly you may find one that hasn't been amended for tax reform, so that should ring more bells. What have they been doing with this plan? Have they frozen benefits? Have they been operating under IID, for example? Exactly what's been going on? These are jumping off points for further investigation.

In addition to the formal plan documents, I think it's very important to look at whatever employee communications there have been. I think it's important to go beyond Summary Plan Descriptions (SPDs). SPDs are, however, very important, particularly in the area of retiree medical benefits. In fact, the growing case law on the subject of retiree medical benefits and the employer's ability to modify those benefits or perhaps eliminate them entirely focuses to large measure on the language in the SPD. If you are concerned as a buyer about retiree medical liabilities, and I daresay you should be, it'll be very important to you to focus on the language in those plan descriptions. The language should make sure that the seller has reserved to itself the right to terminate, amend, change, or otherwise modify those programs. I think you also then need to go beyond the summary plan description. You don't want to find yourself in a situation where there's this nice language in the back of the summary plan description saying we can change this. Then lo and behold, as you're rummaging through the files of the business that you've acquired, you find letters and policies basically guaranteeing retirees those benefits. If there have been communications either in writing or orally, with all employees, or some employees, regarding their particular benefits, it's important that you discover them.

One perhaps more obvious example would be where the seller had an open window program. As we know, over the last few years, open window programs have been very, very common. It's not uncommon in those programs to promise employees

who accept the window that their retiree medical benefits will continue for life. That's part of the consideration. The employer says, if you go now I will not only give you an increased pension, but I will also let you keep your retiree medical benefits. Now, maybe the employer meant to say, if you go now I'll give you this pension and the retiree medical, but maybe I really won't guarantee not to change the retiree medical. Definitely, that's not the usual form of communication, but you certainly want to be aware that even though the SPD says you can change this retiree medical program, you may not be able to do that with all retirees. So there may be some constraints on your ability to act.

The point of this exercise is that you can't just take the documents at their face value. You have to go further and determine what's going on. I don't want to spend too much time on going through all the documents, but, for example, we talked about Executive Life and we have a point here about insurance contracts. You may have a thrift plan that has a number of Guaranteed Investment Contract (GICs) or a GIC fund. It certainly would be prudent for you to determine what carriers they're with, what the terms of those GICs are, what maturities they have.

MR. GULLIVER: Just to follow up on that point, Doug. With respect to reviewing insurance contracts, two things come to mind. In the savings plan arena, if you think about today's environment, interest rates are probably at a relatively low level. There may be a pool of GICs in existence which are generating yields in excess of today's yields. It would not necessarily be fair to assume that you can go in and acquire an operation and somehow spin off those GIC contracts and preserve the current yields in the savings plan. That can represent a very significant issue to your employees. It may be that the insurance company, while willing to talk to you, will have a bias for saying, this is just a cash flow disbursement like any other cash-flow disbursement. It comes out at book value and the fact that market value is a little higher, well that's our gain and your loss.

In an opposite interest rate environment, you may find insurers very anxious to talk about cloning GIC contracts and spinning them off, rather than treating them as disbursements in the context of an acquisition and divestiture. So it's important not only to know where the contracts are and when the maturities are, but also if there are issues that need to be addressed with respect to the investment of the savings plan money. We should be talking to those insurance companies with an eye toward getting the kind of financial deal that we want at the end of the day, so that the benefit entitlements are preserved.

MR. TORMEY: At least part of that would be also affected by the size of your deal with respect to the seller. For example, if you're taking a good chunk of the business, it becomes more and more important. If it's a smaller piece, maybe not.

MR. GULLIVER: Right. A similar issue arises with respect to pension plan investments. Insurance contracts will very often be written so that the plan sponsor is the contract holder and not a trustee. Any change in the ownership of a company or change in plan sponsor will certainly raise issues with respect to the insurer. The insurer will want to understand the new owner's view with respect to the contract. Identifying these contracts and the constraints that may exist with respect to those contracts is important in both the savings area and the pension area. I also find you

can get a lot of very good information out of most actuarial reports. What I like to do in a pension situation is to take a look at the actuarial report and put together estimates to evaluate a number of items. For example, if we continue this pension plan for these employees as a buyer, how are we going to account for it? What would be the resulting funded status in spin-off situations or if there is no asset transfer? How would our books look? How will the expense be adjusted to reflect the funded status of the pension plans? How will our expense be different from the expense we've seen in the P&L.

I also like to show a buyer how the seller might account for this same transaction? I think if you as the buyer or you as a seller understand what the other party is going to do, it's a lot easier to find that middle ground and reach an agreement. And I think a lot of that can be done by just eyeballing an actuarial report and some basic demographic data.

MR. TORMEY: Okay. I just want to also point out that as to financing arrangements, maybe perhaps on a secondary level, make sure you review whatever investment management contracts there may be out there and other financing arrangements, in order to facilitate or ease any transition, depending again on how you decided to do this transaction.

Perhaps we can discuss nondiscrimination testing and the problems that we can encounter there.

On the nondiscrimination side, at least in terms of qualified plans, there's good news and bad news. The good news is that there are no real hard and fast rules, and that's also the bad news. There's a lot of flexibility and a lot of uncertainty. You're all familiar with the rules in Section 410(b) that basically give you a pass for the year of the transaction and the following year. Essentially then for coverage, you don't really have to worry. And you say, well that's great. I have anywhere from a year and a day to almost up to two years. If I was passing before the transaction, I'll continue to pass after the transaction.

I think in practice you'll find that that's a rather short period of time. How exactly the transition relief operates and what your risks are of losing that relief are rather uncertain. For example, it's unclear how the relief that's provided under 410 is coordinated with 401(a)(4), the general nondiscrimination test. I think under one reading you could argue that I automatically pass 401(a)(4) during the transition period, if I can restructure my plan in any fashion that I choose. And if, for example, I were to calculate an accrual rate, I don't want to get too actuarial here, but if I were to calculate an accrual rate, and it turns out that the highest accrual rate under the plan was the accrual rate of one highly compensated employee, well I would say that would normally be a problem. But if I have my rate group with that one highly compensated employee and then I apply the transition relief provided by Section 410(b), I can very well argue, well, I passed 410 automatically, and, therefore, I don't have a problem on the discrimination side, since everyone in that plan has the same accrual rate, i.e., the one person. But it's a little unclear how that's intended to operate.

There are also some restrictions on the transition relief. First of all, you have to satisfy 410 immediately prior to the transaction. It's a little unclear to me, exactly what immediately prior means. Some would say immediately prior means right before. But what if I'm already passing quarterly? Is that good enough? We like the position that that is good enough. But it's an area that is not entirely clear.

Also, if you're dealing with a fairly sizable company, chances are that they're going to have an acquisition or divestiture perhaps once a year, or maybe more often. And how does this transition relief apply for future years? Arguably, it's available for each transaction. What happens though, in year two? I've done a transaction in year one and I passed 410. In year two, I now have another transaction, and one of the conditions to getting the relief provided under 410 is that I pass 410 immediately prior to the transaction. Well, how was I passing 410 immediately prior to that transaction? Was I relying solely on the transition relief? Or do I actually have to do some sort of testing to demonstrate that I passed 410 without regard to the transition relief? If it's the former, well then this could go on indefinitely. And so that doesn't really appear to be the right result. If it's the latter, on the other hand, I can argue that I'm not really getting the full benefit of the transition relief I thought I had. If I do have to actually pass coverage to get the additional relief, my relief from the first transaction may be short cut.

And depending on the size of the first or second transaction, I may be very unhappy that I had either one of those. You may have a very small transaction in year two that would require a large restructuring or redesign of the programs because of the earlier year's transaction.

There are even more basic problems with the 401(a)(4) regulations and the 410 regulations. I'm on an American Bar Association's Joint Task Force that submitted about 100 pages of comments to the Internal Revenue Service (IRS) with regard to these issues. The problems begin with the basics; who are the highly compensated employees? When I'm using a look-back year, and I acquire some employees in an asset transaction, to me, as to the buyer, they have no prior year. They weren't my employees. If I acquired the stock from the seller, then there is past service. Should the form of a transaction drive these discrimination results when these employees are coming over and possibly the same benefits that they had before? Should that be the driver? The corporate form of the transaction?

Similarly, if I'm a seller, am I losing all of my low-paid employees that I needed to pass coverage? Or am I losing the "wrong" high-paid employees -- the group of high-paid employees who maybe weren't getting great benefits? Do I have to go back and redetermine who the highly compensated employees are? I think our recommendation on the issue, I don't know how the IRS will react, is to provide employers with the greatest amount of flexibility on that issue and let them choose among a number of alternatives, provided of course, that there is some consistency and reasonableness to their methodology. This can have an effect not only on the defined-benefit plans, but also on thrift plans doing Average Deferred Percentage (ADP) and Average Contribution Percentage (ACP) testing. All of this has to be taken into account. In a transaction where you're losing a group of employees, and assets have been transferred out of your thrift plan, all of a sudden the end of the year comes and you find,

"oops," I failed the test. And when you look at it further, you determine and say, Well gee, you know, it wasn't my remaining employees that caused me to fail; it was all those employees who left in the sale.

There are a number of strategies that you can use to try and minimize hard feelings in that regard, but I think this illustrates again the importance of doing due diligence and doing the groundwork upfront. If you're the seller and you know your plans, you know who's contributing and who's not, and perhaps there are certain things you can do before the transaction. Perhaps you could cut back the contributions of those highly-paid employees before the transaction. Or you could not agree, for example, to transfer assets until after the end of the plan year, until after the math has been done and all the testing has been done and so, if in fact money has to be refunded to employees, it perhaps can be refunded to those employees who are going with the sold business.

Now, it's not just a given that you're going to get the buyer to agree to those things. The buyer, at that point, has very different concerns than the seller. There is, however, some commonality of concern. Everyone wants a viable business. The seller wants a viable business, it wants the best purchase price, and the buyer has ongoing concerns with the operation of the business. So the buyer may not be terribly thrilled with, but may accept, cutbacks or refunds to those who are now its employees. But again, that's something that will be worked out in the bargaining. I wouldn't expect too much in the regulations as to how to deal with this type of testing.

I think that's about all I want to cover for 401(a)(4) and 410(b), but there's a lot more there. For example, looking at benefits rights and features under a plan, seeing how they mesh with what's covered under your plan. Looking at how the plan passed testing before, whether it was on a separate line of business basis. How is that going to be continued? There are separate transition rules available under the separate line of business rules. They don't provide you quite the relief that is provided under the regular transition rules under 410.

There are just many traps and many inadequacies in the "final" regulations regarding nondiscrimination, particularly in safe-harbor plans and the general testing – how we recognize past service, and so on and so forth. All these things have to be taken into account before you can properly evaluate whether you're going to go forward with the transaction. But more likely, evaluating coverage and nondiscrimination in benefits will affect the design, and therefore the cost, for the programs that you're going to be willing to offer.

I want to talk for a while about some hidden liabilities. A few of the more obvious hidden liabilities, of course, are things like accrued vacation pay and accrued sick leave. Perhaps a little more difficult to get a handle on are things like taxes and contributions due. Not merely the more obvious ones of PBGC premiums or any potential liens that may have arisen with regard to other members of the seller's controlled group, before this transaction for which you may or may not be liable in the future, but also, things like the deductibility of your contributions to provide the benefits that you're going to agree to provide after the transaction. And you know, a number of years ago there was a case that involved an unfunded liability of a

company to provide a spousal benefit. Basically, the decision in that case, this was the Webb case, was that the acquirer (buyer) was not entitled to a deduction for those benefits. In fact, this had to be added to the purchase price and amortized so that if there was any tax benefit at all, it would only be recognized or realized by the buyer, if and when, it sold the assets that it had acquired. The IRS has ruled, at least in the defined-benefit area, that ongoing contributions for past service and so forth, will be deductible. In other areas, that may not be so clear. So, for example, if you're acquiring significant retiree medical liabilities or any of these other types of liabilities, whether they're under formal plans, individual arrangements, or otherwise, it would be very important to determine what you think your chances are of being able to deduct those contributions. That would then factor into the offer that you make for the company and your assessment of how much money you think you're going to be able to make from that acquisition. You can't really go in and say, well I think we're going to make so much per share on this deal, and then find out that all of the items you had taken into account as tax deductions are now not going to be deductible. So this can be a significant item and something that bears a lot of scrutiny. Bill, did you want to talk a little bit about medical and dental?

MR. GULLIVER: I think most of these items are self-evident. I would like to comment on what you are likely to see in terms of a conversation between the buyer and the seller. Many of these items are accounted for on a pay-as-you-go basis. Some companies, but not all, will build up an accrual for unused vacation time. If a company hasn't built up that accrual, a buyer may come in and say, all this unused vacation time is a liability and I want some recognition of that in the sale price. Companies have varying practices in self-insured medical plans for measuring the reserves during a year for incurred, but unpaid claims. At the point you buy a company those reserves may not be an accurate measure of the incurred, but unpaid claims that exist.

From the buyer's view, you will argue that those are real liabilities that you're taken on, they've been incurred prior to sale and you should be compensated. If you're the seller, your position is going to be, "I account for this business as an ongoing operation. That's the way I've always run my books. If I were to compensate you for those kinds of liabilities, I'd be selling you a company that was in a lot better shape than the way I've always measured it. That was never contemplated in this letter of intent." So expect, even on these minor items, some give and take. You can argue these things a lot of different ways, as to whether it's necessary or proper to make adjustments to the balance sheet or expense. I think what's really important is getting this kind of information into the hands of the people that are negotiating the deal. They can evaluate what's significant and what isn't.

One thing I would like to point out is that the acquisition or divestiture itself can have an impact on cost allocations. Let me give you an example. Very often the group of employees you will be acquiring as a buyer will participate in a medical plan. Let's say that the medical plan of the parent covers both active employees and early retirees. If you carve out a group of actives, and if that group of actives is much younger than the total pool, guess what? Your medical costs are going to be a lot lower than you would have guessed by just looking at the cost allocation which might have been assessed by the parent. You'll find a lot of cost allocations are done in less than precise terms whenever a group of employees being acquired is participating

in a larger pool. You'll be asked to come in and evaluate what the ongoing costs might look like on a stand-alone basis.

Other things that I've seen come up are leaves of absence, layoffs, recall rights, and the like. These can be important to understand for the potential impact they have on your plan. What kinds of liabilities exist that aren't anywhere on your financial statements? These people may not even be showing up in demographic data, but they do have certain rights to be recalled to work which may trigger some additional benefits that you're not even evaluating. So you want to ask those kinds of questions.

Also, an acquisition or divestiture can trigger certain events that generate liabilities. It can trigger early retirement. It's important to ask questions like, As a new company, will I continue all the operations that I am buying? Will a certain operation be shut down? If you take over pension plans, will a shut-down benefit be triggered or will early retirements be accelerated? And will that affect the cost of the plans? So even if you've measured the cost of plans very accurately, it's important to have some idea of what the business plans are and to see if they will trigger some liabilities that may not be in those measurements. When you look at the impact of acquisition and divestiture on the actual obligations you're assuming, I think those kinds of things are important.

Just as is done with pension plans, it's good to look at both the assets and liabilities of welfare plans. Here I think it's important to note that you will not likely get up-to-date information in the middle of a year on the funded status of any given program. You're going to have to do some massaging of the numbers to move them forward from the last time things were measured to get a fair representation of the funded status today. In both the welfare plan area and, more importantly, in the pension area, you probably will be working with some dated information and it's important to update it. Remember to keep your eye on the capital markets and understand where the money is invested. You can find that the funded status has changed dramatically in a very short period of time, and you want to make sure that message has gotten out to both the buyer and seller.

MR. TORMEY: I just want to finish up here talking about the benefits or obligations that can be precipitated by the sale. A few of them are obvious. You should examine any severance plans or policies that could inadvertently be triggered by the transaction because, clearly, neither party wants to be in a position of having to pay severance benefits – particularly to employees who are going to continue with the buyer. So a review of those plans is important. Those plans have been written to reserve to the seller the right to make modifications to those plans, so that even a few days before the transaction those plans could be modified, if need be, to make it clear that no severance would be payable in the event of this kind of transaction.

There are issues concerning shutdown benefits and layoff benefits that you should be aware of when trying to determine the funded status of the plan. There are other things. For example, there is one statute that basically says that if you're planning a shutdown of a facility, you have to give a 60-day notice to employees and also to state and local governments regarding the potential shutdown or the planned shut-down of a facility.

There's an issue with partial plan terminations. You may be familiar with the Gulf Pension Litigation. This had to do with a spin-off transaction in which there were substantial employee contributions. The court was not at all pleased with how the spin-off calculations were done, particularly because they didn't allocate what the court felt was a substantial or an appropriate amount of assets to account for the fact that they were employee contributions. So when you're looking through your plan document and it says all contributions will be made by the employer, then you look at the 5500 and you don't see anything on the line that says employee contributions. That doesn't mean there hasn't been any. Again it's important to go beyond that and look a little further, because if there were employee contributions, that may affect how you structure the transaction and what you feel may be an appropriate amount of assets, if assets are going to be transferred, or if they're not.

MR. GULLIVER: Let me make a point here. If you have contributory pension plans, I think it is unclear as to what the spin-off rules require in the way of an asset transfer. It is clear that if a contributory plan is terminated and there is a surplus, that surplus must be shared with employees. It's also clear that your minimum spin-off calculation is done so that spin-off assets equal the present value of accrued benefits, measured, on plan termination benefits. I don't believe it's clear that the present value of accrued benefits necessarily includes surplus sharing that would be triggered by a plan termination. That's certainly not an accrued benefit in the traditional sense of the word. I've been involved in a couple of these situations. It is very common to hear an attorney suggest that the minimum transfer should include surplus for those employees who have contributed because they have a right to share in surplus if the plan is terminated. There is a problem with that argument. Suppose the buyer terminates the plan right after you transfer the employees' share of surplus. If your purpose in transferring that surplus was to protect the employees, guess what? The employees wouldn't get all that surplus. They'd only get a small portion of it and the buyer would get the rest.

This is a very unclear area and if you happen to have a contributory pension plan, I'm not convinced that there is a shining light guideline that you can look to, as to how to handle this situation.

MR. TORMEY: I agree, Bill. I think there are two other things to keep in mind, in addition to the fact that nothing is terribly clear. Perhaps as a seller if you are concerned about that issue, you will maybe want to try and retain some of that surplus. I think you can do so. And second, if you're a buyer and you have your eyes on that surplus for one reason or another – whether you have underfunded plans of your own or whether you now want to charge administrative expenses against the plan – you need to be aware that all of that surplus may not be available.

MR. GULLIVER: Well just to pick up the pace a little bit, let's close the discussion on benefits and obligations. We mentioned layoff and shutdown benefits. Keep in mind if a buyer tells you, I might shut an operation down, or there may be layoffs, that can trigger additional entitlements. You also better make sure you're familiar with the deficit reduction contribution requirement, and unpredictable contingent of event requirements under minimum funding standard accounts. The ongoing cash flow to support this plan can change dramatically when those arise. Cash flow is usually very important to a buyer, particularly if it's a leveraged buyout situation. You want to

make sure they're familiar with those concepts if they apply because they will not show up in the ordinary minimum funding calculations. Settlement and curtailment accounting under Financial Accounting Standard (*SFAS 87*), and now *SFAS 106*, will also be an issue that arises with early retirement windows or layoff and shutdown benefits. This too may or may not be a subject that's familiar to a buyer.

The last point I have on my list is one you will rarely come across, but I have come across pension parachutes in plan documents. This is a plan provision which states that if there's an acquisition and the plan is in surplus, the accrued benefit of employees will be increased so as to use up that surplus. The provision became a popular thing to do when merger mania was around and companies were using pension surplus as a financing mechanism for acquisitions. They're still out there. And so if they exist, you want to make sure you're not pulling the trigger unintentionally on the parachute. I've only seen one pension parachute actually open, and I'll tell you it's ugly. When the provision was put into the plan, back in the early 1980s, 10-year phase-in rules on 415 limits did not exist. When the parachute opens, there's a huge increase in accrued benefits and virtually everybody in the plan is now being subjected to phase in limits on 415 calculations for this big increase in accrued benefits. It's a mess. Usually acquisitions turn friendly. There's usually a "double trigger" in those kinds of provisions which state that the surplus may get used, but it's subject to board discretion or board approval. You want to be careful if you see those kinds of words so that nobody is pulling a trigger that will generate some kind of pension parachute.

MR. TORMEY: Did all the employees retire?

MR. GULLIVER: No.

MR. TORMEY: No, they continued?

MR. GULLIVER: Many of them did terminate shortly after, and those pension calculations were onerous.

I look at a pension entitlement as sort of a big pie. There are certain accrued, nonforfeitable benefits. These are benefits which are subject to the anti-cutback rules. And obviously, employees have a right to these benefits whether or not a buyer or seller tries to change entitlements in an acquisition.

There are also certain forfeitable benefits that go with that accrued benefit. Disability benefits and temporary security supplements are two examples of entitlements which can be forfeited. They're not subject to the anti-cutback rules.

It's possible to structure a deal if you were taking a minimalist point of view, to eliminate those entitlements for the affected group before the sale, and then transfer just the accrued nonforfeitable benefits. But in essence, I view the bottom half of the pie to be benefits that people have earned even on an employment termination basis, and a portion of those benefits are forfeitable under ERISA. On the left-hand side of the pie, just above the midpoint line, is the effect of future service on accrued benefits ("other future benefits"). For example, it's very common to have early retirement subsidies put into a pension plan, which employees will have the right to age or

service into down the road. A clear example would be an unreduced pension benefit available after 30 years of service at any age. An employee who has 29 years of service is one year away from an extremely valuable benefit. Some minor future service is required to earn the benefit, but it can add significant value to the accrued nonforfeitable benefit.

The top of the pie is the effect of future pay increases. This basically is the effect of future earnings growth on the benefits that have been earned to date under a final-pay formula. The last piece of pie is things that will be earned in the future. If you think of pension benefits as being represented on the pie, we can turn our attention to how these deals structured. First and simplest is an arrangement in which the seller keeps all assets and liabilities. As a minimalist approach, the seller can freeze its pension plan and treat the employees as though they're terminating. The buyer could start an entirely new plan and there could be virtually no recognition of service with the seller. Rarely do you see a deal structured this way, and it raises some significant issues in my mind with respect to benefit adequacy. In essence, the employees will be left with a small piece of the pie. The piece called "other future benefits" is subject to whatever the buyer will provide. Employees could have lost all the other pieces of that pie.

Well, since that rarely is the deal, an employer who does not wish to transfer pension funds to a buyer may nevertheless strike a deal which requires the buyer to continue the plan and coordinate total service -- that is, provide a total service benefit under the existing plan and simply offset by any benefit that the seller will provide from its plan. So, in a sense, the seller is providing the benefits that are the bottom half of that pie. He may possibly even be responsible for the effect of the future service on the accrued benefit, i.e., the early retirement subsidy. The buyer provides a total service benefit and just reduces its benefit by whatever the seller will provide. This brings with it, of course, the need to coordinate pension payments from two different sources and raises some significant administration issues. It also requires the buyer and seller to consider total service so they both need service records for these employees. It can get awkward, but it does avoid issues of discussing what the amount of the asset transfer might be.

A third arrangement is for the seller to recognize service and earnings with the buyer for the purpose of determining benefits in its plan. It's very common, I think, for a seller to agree to allow employees to age and service into their early retirement subsidies. It's not at all common, but I've seen it done, for a seller to recognize future pay growth with the buyer under its pension plan. By this I mean the seller will ultimately provide a benefit based on service prior to the acquisition, and also based on final average earnings, including earnings with the successor employer.

MR. TORMEY: I think we want to point out that while we see that occasionally, there are significant questions as to whether that can actually be done under the 401(a)(4) rules and it also poses 415 problems and other exclusive benefit problems. In order to try and solve some of those problems, people have proposed using a proxy for actual salary increases, for example, shoehorning some increases in terms of a cost of living adjustment (COLA).

MR. GULLIVER: Among the significant issues that it will raise are, if these are not my employees any longer, am I increasing the accrued benefits of "former employees." Anybody who's taken the time to look at the testing of benefit accruals for former employees will immediately recognize a significant nondiscrimination issue.

What happens if there is an asset transfer? As a minimum, the transfer amount must be sufficient to cover the value of an accrued benefit on a plan termination basis. Of course, a buyer will argue for larger asset transfers, and a seller will argue against larger asset transfers. One possible basis we've seen for larger transfers is to request assets equal to the accrued benefit liability, plus an allowance for future pay growth, Projected Benefit Obligations (PBO) in accounting terms, actuarial liability in funding terms.

A second common deal is to transfer a pro rata share of the assets. The concept here is that the pension costs shown in the P&L statement reflect a plan's funded status. If the spin-off plan is funded to that same level, my cost recognition should be consistent with preacquisition cost, if measured on the same basis, because the plans are equally well funded.

The cleanest approach is to transfer sponsorship of the entire plan. Now that may be practical only in a situation where you're acquiring the stock of a company or the employees are covered under a stand-alone plan. Where the employees are participating in a larger plan of a parent or if you're just acquiring assets of a division, it may not be a practical alternative.

Let's talk about some other benefit plans. Without going through any of the details, I think we just want to comment that all those other plans that we inventoried need to be reviewed in terms of the buyer's ability to continue those plans, and particularly, to administer and finance those plans. You have to ask who does the benefit calculations? Who does the medical claims? If there are trusts in place, who runs them? And you have to understand if this deal is struck, can those same financing mechanisms and administrative techniques be continued by a buyer?

I'm going to go on to purchase price considerations because that fits nicely with the discussion we just had. Inevitably, if you get into a discussion of the assets and liabilities of the plan, you'll get into a discussion of whether the sale price should be adjusted to reflect the underfunded or overfunded status of plans being acquired.

In the pension area, I think it gets into a discussion of comparing how much of that pie you transferred, comparing it with the assets you transferred, and deciding if, within the context of a letter of intent, that necessitates a sales price adjustment. The other area in which potentially large sale price adjustments will emerge is retiree medical.

MR. TORMEY: Bill, I don't want to interrupt, but just before we get off the pension issue, I just want to make you aware that I mentioned the case before the IR Gulf Pension Litigation. It has some rather unfortunate and disturbing language regarding fiduciary duties and purchase price adjustments. So that I just caution you that if you're in a transaction where there is going to be some sort of adjustment to the purchase price, that it not be terribly direct.

MR. GULLIVER: I don't know if anybody from the Department of Labor is here, but that case basically suggests that if the parties make too direct a link between the asset transfer deal and the sale price, that could, in effect, raise issues with respect to self-dealing or breach of fiduciary conduct. It could be viewed as an indirect reversion of any pension surplus. For example, if a seller negotiates a better sale price which does not subject him to excise tax in exchange for transferring pension surplus, is that an indirect reversion? Does it require plan termination requirements to be invoked?

This is an area where the Department of Labor has just recently raised its eyebrows a little bit, and so it's important to at least keep that in mind as you get into discussions on sale price adjustments.

MR. TORMEY: The decision flies in the face of reality in many respects, and there were a lot of bad facts in the decision, but nevertheless, it's there.

MR. GULLIVER: Now in the medical area, where these adjustments can be significant, the first question you have is, Is there a pie? I mean, do these employees have any retiree medical entitlements? And if there is a pie, is any piece of that pie nonforfeitable? Have those future entitlements to medical benefits been communicated in a way in which they can be eliminated or modified by a new employer?

Just to size the potential sale price adjustment, it's not all uncommon for the pie for an active employee group to be one times pay, or more, in the pension arena. In the medical arena, that pie might be 50-75% of payroll. But in the medical arena, there is a very broad range of assumptions one could call reasonable in measuring lifetime, postretirement medical benefits.

And there is no ERISA protection, nor is there any funding for those benefits. While the medical benefits may have smaller value for an active group than the typical pension entitlements, the range of potential sale price adjustments with unfunded, unprotected benefits, subject to a broad range of measurements, may be much bigger than you see for pensions. So in the postretirement medical area, we're seeing more and more attention paid to those obligations and more and more pressure being brought to bear in terms of the actuarial measurements of their value and how they might affect the sale price.

MR. TORMEY: I just wanted to add one small word of caution. When you're structuring your transaction in terms of medical benefits you are going to be providing, if you're a seller, the buyer will frequently ask you to allow these employees of the sold business to continue in the seller's plans, for a period of time, while the buyer gets his plans up and running. Just so that you're aware, there is an issue if you're a seller whose plans are self-insured that the arrangement is a Multiple Employer Welfare Arrangement (MEWA). Those arrangements do not get ERISA preemption protection. Therefore, you may find yourself inadvertently in an arrangement that's subject to a variety of state law mandates that you would not otherwise be subject to. So just be careful how you structure those arrangements.

MR. GULLIVER: Said another way, if you put something in the sale agreement that says the seller will pay the retiree medical benefits for everybody in the early

retirement zone, even though they're no longer the seller's employees, watch out for those multiple employer welfare rules.

MR. TORMEY: There are ways to structure around it, but it's something you do need to be aware of.

MR. GULLIVER: And it's not uncommon for buyers and sellers to make arrangements in which one party will pay the medical costs of another.

Flipping to pension implementation considerations, just a couple of very quick points that I wanted to make. The funding standard account can get kind of tricky. If a seller retains assets and liabilities within its plan, you can basically treat this as a termination of a large group of employees. You might call it a gain or loss, but if there's some formal plan amendment that describes how the deal was done, you can argue it is a plan amendment. There are a variety of approaches that would appear to be acceptable for assessing the impact on the minimum funding rules. Where there is an asset spin-off, if life is good, it's diminimus, or else the plan is in surplus, so there are no amortization bases and the like that have to be allocated between the buyer and the seller. But if this is not a diminimus transfer and if there are minimum funding standard account bases being kept intact, there is a very complicated process described in two revenue rulings, as to how to allocate amortization bases, credit balances and the like between a buyer and seller in a spin-off.

The guidance that exists with respect to allocating old liability amounts and new liability amounts that can be important in deficit reduction calculations, and the reconciliation account that keeps track of amounts paid above the regular minimum funding standard account, is at best fuzzy. You're going to have to put your actuarial thinking cap on in terms of how to structure the minimum funding standard account and split it into two pieces if there's a spin-off in those situations.

I think those are the key points I wanted to make on pension implementation that were largely actuarial in nature. As far as miscellaneous points, maybe you want to make a quick comment, Doug, and then we'll take some questions.

MR. TORMEY: Okay, you're probably all aware there's a case that's going to be heard by the Supreme Court involving an actuarial firm. Basically the case involves the fact that the plan did not have sufficient assets to provide. I believe it was shutdown benefits. And it is alleged, among other things, that the actuary involved was, in fact, a fiduciary with respect to this plan and breached its duty to the plan. The lower court, of course, held for the actuarial firm, following a long line of decisions that under ERISA, actuaries are not fiduciaries. They may have the power to persuade, and employers may accept the advice without too much questioning, but as a matter of fact, they do not have discretionary authority with regard to the administration or operation of the plan. The employer is the one who, in fact, acts on those matters. The actuary merely provides the professional advice.

Nevertheless, in all these situations, and we've seen it with regard to other professions, particularly the accounting profession, when something goes wrong and people are injured, they look around for people to sue. They look around for people they think may have money. Any people they can find that they think have money, are

the people who are going to be named in the lawsuit. For example, in the S&L situation, very often you find law firms and accounting firms sued. Frequently, in the securities area you'll find accounting firms being named as party defendants. So, it's not unusual, I think, to see that an actuarial firm has been sued. Hopefully, we'll get a favorable decision from the Supreme Court on the issue, one that will be clear and clearly define the actuary's role in these matters. So we'll be eagerly awaiting the result of that case.

In two other cases, both involving law firms, we have received good results. The IRS tried to disallow deductions for pension contributions, asserting that the actuarial assumptions were unreasonable. There's some very good language in those cases, upholding the actuary's authority and judgment to set those assumptions. So I think these are very favorable decisions.

In the merger and acquisition area, some decisions that may be of interest have to do with the requirement that a buyer or acquirer grant continued service credit to employees in order to determine eligibility for early retirement benefits. So far the decisions have been favorable, but we probably haven't seen the last of it.