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Summary: Come see an actuary on trial for negligence. Could this happen to you? Due diligence is an important part of the consulting process in mergers and acquisitions. Learn from someone else's mistakes rather than your own.

Mr. James A. Kenney: Our vignette is about an actuary who has been called in front of the Actuarial Board for Counseling and Discipline (ABCD) for possible disciplinary action in a spin-off of a pension plan. Ron is going to represent the prosecuting attorney, so to speak, and I'm representing the actuary involved in the transaction.

Mr. Ronald Gebhardtsbauer: The bad guy and the good guy.

Mr. Kenney: I don't think of it like that myself. There's a holding company called Mega Holding Company. It has spun off Blue Bell Mining Company to an entity called Cherry Pie Minerals. Before the spin-off, using my assumptions, the plan was overfunded by $30 million. It had $125 million of liability and $155 million of assets.

If you were to use the Pension Benefit Guaranty Corporation (PBGC) assumptions, however, this plan would have been overfunded by only $5 million. Using my

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assumptions, the transaction involved spinning off $75 million in liability and $105 million in assets, thereby transferring $30 million in excess assets to the purchaser's plan. This left behind an accrued liability of $50 million and $50 million in assets.

On the PBGC basis, however, the accrued liability left behind is $60 million, and the resulting plan is $10 million underfunded. The PBGC has intervened in this transaction. As the actuary involved, I've been brought in front of the ABCD to defend my practice in this matter.

Our panelists are Ron Gebhardtsbauer, who is senior fellow of the American Academy; Max Schwartz, a partner with Kramer, Levin, Naftalis and Frankel; Hector Mislavsky, who is a principal with Mercer; and I'm with Coates Kenney.

Mr. Gebhardtsbauer: As you know, something like this already happened. There was an actual spin-off case where the parent plan was well-funded, even on a PBGC basis. Part of the plan was spun off and was underfunded on a PBGC basis but not on a *Financial Accounting Standard (FAS) 87* basis.

Maybe you saw the note that was sent around to all the actuaries saying the PBGC is putting us on notice. The PBGC didn't take this first actuary to the ABCD. But it is going to take the second actuary to the ABCD. That's James Kenney here, and you are all on the ABCD. I'm going to quiz him.

First, he used the 1951 Group Annuity Mortality (GAM) table. That table is older than I am. Why did you use this table? Is it appropriate? Did you look at mortality improvements in the future? Are there any insurance companies that would use this? Did you do a gain and loss analysis in your valuation? Have you done an experience study on this?

Mr. Kenney: I used 1951 GAM because I thought it was the best table to use for this purpose. These are mining employees. They work in a relatively rough environment and are exposed to all sorts of particulate matter during their working career. Their life expectancy is not nearly as great as that of the general population.

In the aggregate for the last several years our evaluation has been very close to the actual experience of the plan. And so I feel very comfortable with using this mortality table. I think it's a very good table to use.

Mr. Gebhardtsbauer: Is it your best estimate? Couldn't you have chosen anything better than that?

Mr. Kenney: I think in combination with the other assumptions, yes, it is my best estimate.

Mr. Gebhardtsbauer: And did you do a gain/loss analysis?

Mr. Kenney: Well, I haven't actually done a gain and loss analysis on the mortality. The number of lives involved in this transaction is not such that that really would be statistically significant.

Mr. Gebhardtsbauer: But you said in aggregate your assumptions are good. But, of course, in the aggregate you're only looking at the past few years. Mortality is constantly improving. In fact now, when actuaries put together mortality tables, they include a mortality improvement scale. With the 1994 GAM it looks like they're going to use an improvement scale as part of the table. I think they're encouraging us all to use it and to realize that mortality improvement is going to continue happening.

In the past, actuaries would always say, well, we know this improvement has happened already, but we don't know if it's going to continue on forever. Now we're saying that maybe it is going to continue on forever. We should be a little conservative if anything. Make sure that you're covering yourself, especially since this calculation is supposed to be done assuming there's a termination of the plan. If you're terminating the plan, you have to buy annuities, and the insurance company is going to be conservative.

Mr. Kenney: I'm not sure what you're asking here. Did I use a projection? No, I didn't.

Mr. Gebhardtsbauer: You didn't project mortality?

Mr. Kenney: No. I realize that life expectancy has been improving over the last 40 or 50 years. But personally, I think that is slowing down. And there are already signs that it may have come to a halt.

I don't know if you're aware, for example, that bacteria are mutating in ways that make antibiotic drugs less effective. It's quite likely that many of the antibiotic drugs that are now very powerful will cease to be effective in the next 20 years.

I think its quite possible we've reached the point where improvement in mortality may not necessarily continue in the future.

Mr. Gebhardtsbauer: How about your interest rate? The PBGC interest rate is pretty close to Treasuries now, under the new basis. In the old days, PBGC interest rates were pretty conservative, but they've updated them and they're a lot better. Your interest rate was 8.12%?

Mr. Kenney: That's correct.

Mr. Gebhardtsbauer: And the PBGC's interest rate was nearly 200 basis points less than that. What kind of a difference in results would you have if you calculated it at 8.12%?

Mr. Kenney: I think that if we had done the calculations using the PBGC interest rate, you might expect the liability to be 15% or 20% higher. I personally do not feel that the PBGC interest rate is a reasonable rate to use. It's certainly not reflective of what the fund has been earning. It's not reflective of the current investment strategy of the fund. Finally, it's not reflective of annuity purchase rates.

The rate I used was in the interest rate "corridor" published by the Internal Revenue Service (IRS). In the Gray Book of the 1994 Enrolled Actuaries meeting, the IRS was specifically asked, did it feel an interest rate that was in the corridor could be used for this purpose? The IRS indicated in the answer to that question that it thought a rate in the corridor could be used.

This rate is squarely within that corridor. Moreover, it is the rate that we were using for our Financial Accounting Standard Board (FASB) disclosure, which under the Securities and Exchange Commission (SEC) letter is supposed to be indicative of the annuity purchaser rates. The accountants accepted it for that purpose. Therefore, I feel very comfortable using this rate.

Mr. Gebhardtsbauer: From what I've heard about the Gray Book, the IRS doesn't feel that the rates were properly recorded there. The current liability corridor has a four-year lag in it. When interest rates are coming down from a period of being very high, the current liability interest rates can be much higher than what insurance companies are using in annuity purchases.

So I don't think that the current liability corridor is an appropriate place to be choosing your interest rates. I think you need to find an interest rate that an insurance company would be using to settle these liabilities.

Mr. Kenney: Well, speaking of lump sums, one of the things you're not taking into account is that, before the plan was spun off, we amended our lump-sum limit to be $20,000. This would cover roughly 45% of the participants.

Over the next 15 years or so, as people terminate from this plan, they're very likely to take lump sums. Those lump sums would be considerably lower than the liability we calculated because they would not include the early retirement subsidy.

Mr. Gebhardtsbauer: Is the lump-sum provision in the plan as it's currently written today?

Mr. Kenney: Absolutely.

Mr. Gebhardtsbauer: Do people take lump sums?

Mr. Kenney: Absolutely.

Mr. Gebhardtsbauer: Are you sure most people will take them?

Mr. Kenney: I think virtually every person eligible to take a lump sum of up to $20,000 will do so.

Mr. Gebhardtsbauer: Can you prove it?

Mr. Kenney: No, I can't. Can you prove they won't?

Mr. Gebhardtsbauer: No, but the PBGC won't believe that anybody is going to take a lump sum.

Mr. Kenney: I think it's a reasonable assumption that these people will take lump sums. But that's not how I valued it. I valued it under the assumption that they would take the early retirement subsidy. Therefore, the liability that we transferred over was conservative in nature.

I believe that you could buy an annuity based on these assumptions. This was our basis for our *FAS 87* disclosure. It was based on corporate triple A bonds. We developed a hypothetical portfolio to immunize the liabilities. I can document that portfolio if you would like.

Just because the interest rate we used was higher than the PBGC's doesn't give you a reasonable basis to overturn this transaction or to bring me in front of this board.

Mr. Gebhardtsbauer: You mentioned a little bit earlier, that you think it's a good approximation of what annuity purchase rates would be. You know the PBGC does the same thing. The PBGC gets its interest rates by getting information right from the American Council of Life Insurance (ACLI) saying here's what the purchase price is for annuities from these 16 companies.

The PBGC takes that information and, in fact, averages it. The PBGC doesn't take just the company selling the safest annuities.

Mr. Kenney: Of course.

Mr. Gebhardtsbauer: The information is for all 16 companies. The PBGC figures out what interest rate and mortality table together would produce a good approximation of what the annuity purchase price would be.

Mr. Kenney: No. That's a good approximation of what the average bid would be on this business. But we're not going to take the average bid.

We're going to get a group of bids from safe companies. And then we will pick the lowest naturally.

There is usually a significant spread among the bids. Naturally we will only select reputable, safe companies. But among those companies, there's a spread of as much as 10% or 15% in the purchase price.

So when you do this on an average basis, of course, you're going to wind up with a conservative approach. This is a transaction that was intended to be economically neutral. It is not to feather the nest of the pension plan that is being left behind.

Mr. Gebhardtsbauer: One other thing I noticed here: you didn't use any expense loading. If you're going to purchase annuities, you're going to have a 5%, 6%, or 7% loading for expenses.

Mr. Kenney: Well, we did not put a loading for expenses in here. I personally don't think that one is necessary. I think that the important issue is, am I going to be able to calculate an amount that would be similar to the premium I would be able to find in the marketplace? And I believe I've done that. I think whether I have an explicit loading or not is immaterial. It's the combination of the assumptions that I use that is the important issue.

Mr. Gebhardtsbauer: Did you also do a calculation with each individual assumption being your best estimate? How do you know that in the aggregate you were getting close to the insurance companies?

Mr. Kenney: I know that it's reasonable in aggregate for several reasons. One is that for the last three or four years we've had insignificant gains and losses from experience, relative to the size of the plan. I've also had considerable experience in purchasing annuities. It's my belief as an actuary that what I used for this particular case is reasonable.

Mr. Gebhardtsbauer: Also, I notice your retirement age is 62, and I think that's the same one that you've been using in your valuation.

Mr. Kenney: That is correct.

Mr. Gebhardtsbauer: It may have been reasonable in the past but considering what this company is going through in this transaction, there's probably going to be much higher rates of retirement in the future. You have heavily subsidized benefits available at age 55. I think you failed to take that into account in your valuation.

Mr. Kenney: We do have subsidized benefits at age 55. Some people may take them. Some people will work beyond age 62. We did a study of the last five years' retirement experience, and concluded that age 62 was the average age of retirement.

My understanding is that Cherry Pie Minerals is a very good place to work. It has very liberal benefits. These people are just doing the same job they've always done. I don't expect that there will be any significant changes in retirement rates. Why should there be?

Mr. Gebhardtsbauer: Let's look at the big picture. Didn't you choose these assumptions so that you could put most of the surplus assets where you wanted them? So you could transfer as much money as possible with the spin-off plan that goes to the buyer? How much did you get for them in the purchase price? Is it 80% or 90%?

Mr. Kenney: Well, it turned out that way in this transaction. My job as an actuary was to evaluate the accrued liability as best I could. What the plan sponsor did with that is up to it. Are you saying plan sponsors shouldn't transfer excess assets in a spin-off?

Mr. Gebhardtsbauer: If you move all those assets with just one group, then the other participants are in a more precarious situation than before. Don't you feel you have a responsibility to those participants? What about your responsibility to the PBGC? If that company is not strong enough and the company goes under, the PBGC will be left holding the bag. And the plan participants may not get all their benefits because they'll only get up to the PBGC maximum.

As a professional actuary, do you have any responsibilities to those participants or to the PBGC?

Mr. Kenney: My attorney advises me not to answer that question.

Mr. Gebhardtsbauer: Yes.

Mr. Kenney: The most important thing is that, if the interest rate climate that exists now maintains itself, there will be sufficient assets to pay all benefits, according to my calculations.

I felt that the participants were well-protected and the PBGC was protected. We have a fully funded plan here. What more can you ask?

Mr. Gebhardtsbauer: Fine. That's all. I think you did a good job, James. I just want to mention that someday the PBGC is probably going to want to make an example of somebody. So when you do get involved in these areas, make sure you're ready to answer all those questions that James was just answering because I think the PBGC does want to make an example and send someone to the ABCD. Have your answers ready.

Mr. Kenney: If the transaction is at all sizable and is of a nature where it might come to the attention of the PBGC (for example, if the excess assets are being transferred), it would be very wise to have a good documentation on how you selected your assumptions and why you selected those assumptions. Then you can defend yourself.

Mr. Max J. Schwartz: Clearly this was a transaction designed to siphon off the surplus to the buyer and to get the seller cash indirectly for the value of that surplus. So I suspect the buyer here was paying something in the neighborhood between 50 cents and 80 cents on the dollar for the surplus, which is not an unusual range.

If you're involved in a transaction of that nature, one of the things that you have to be concerned about is the fiduciary liability issues involved. There are cases that would impose some fiduciary responsibility here, particularly if you're in Texas.

If you're an actuary helping this fiduciary extract money from the pension plan, you know that the *Mertens* decision was good for the actuaries. You never know how the law is going to evolve. There may be some cofiduciary liability here or something like that. Remember when he asked if you felt any responsibility to anybody? That's why I advised you not to answer that question.

Mr. Kenney: Max, you were going to give a presentation on stock versus asset transactions.

Mr. Gebhardtsbauer: I just wanted to say one thing. The views that I expressed were not those of my current employer, nor my former employer, the PBGC. And they weren't my own views either. He told me to be rough on him. So I did, but it was tough.

Mr. Kenney: All the views expressed are not those of the speakers, their employers, or, in this particular case, not even their own.

Mr. Schwartz: As a lawyer I have no views. It just depends who retains me to represent them. I'm going now into a more general discussion of dealing with mergers and acquisitions from the benefit side.

First, I want to set up a legal framework, that is, what lawyers might look to. And the key issue from a lawyer's perspective is, what kind of corporation transaction is going on? Is it a stock purchase? Or is it an asset purchase?

What is the difference? Let me liken it to a cup of coffee. Turkish coffee is like cowboy coffee only it's a lot stronger.

To make cowboy coffee, you pour all the grinds in the coffeemaker, put it on the fire, and let it simmer for however long you want. When you pour it out, you get lots of grinds in your coffee. That's the image you should keep.

When you're dealing with a stock purchase, you are buying the whole cup. It has the coffee in it, but it has all the grinds. It has the works. You're picking up all the impurities in the coffee. If you're dealing with an asset purchase, you can pour the coffee out of the cup through a strainer and just take the clean coffee. That's Turkish coffee. You get to pick and choose what you want to take as a buyer in terms of the assets and the liabilities of the company.
So in the stock purchase what I am concerned about as a lawyer are all of the different contingent liabilities, all the undisclosed liabilities, that I may be picking up with this company. You could think of them as all the coffee grinds at the bottom of the cup.

And those liabilities can be enormous. You can categorize them. You have the liabilities associated with having been part of the control group of companies, so you can pick up contingent liabilities to the PBGC. If there were a prior plan termination by a member of the control group, if it was underfunded or a sale to another company, where the purpose of the sale was to unload an underfunded plan, the PBGC can come back at me and say, I'm liable for the underfunding in the plan that I sold.

There could be contingent liabilities or withdrawal liabilities from a multiemployer plan. When I buy a company, I can pick that up. And obviously there are the ongoing funding liabilities that I could pick up. There are also the fiduciary liabilities that I can pick up if I'm buying a company.

In the course of the transaction, the target company may be creating fiduciary liabilities right and left. Suppose the company miscommunicates to the participants. You can have fiduciary liabilities associated with implementing a window program a year or two years prior to the deal, if you didn't communicate in advance to people that you were setting up windows.

People who have already retired come back and sue you saying you should have told them that you were putting in a window program because they would have had enhanced benefits. You have prohibited transaction liabilities that you could pick up. You have liabilities with suspected plan investments, imprudent investments. And you have liabilities associated with benefit cutbacks and compliance issues. So these are the kinds of liabilities that I get very worried about in a stock transaction, when I'm picking up the entire cup.

If all I'm buying is the strained coffee, then I can be much more comfortable because I know what I'm buying pretty well. There are certain liabilities that I cannot escape as a successor employer. I have to try to figure out what those are. But for the most part, I can leave the seller with a lot of these contingent-type liabilities that I talked about.

So if you know ahead of time what kind of transaction you're involved in—asset purchase or stock purchase—you can be sensitive to the kinds of things that you as actuaries and benefit consultants are looking for if you're representing the buyer. You can be very helpful to me as a lawyer by bringing to my attention things that you think may be issues in terms of contingent legal liabilities.

As a general matter, as a lawyer, representing a buyer, my preference is for the buyer to leave all of the seller plans alone. If it is consistent with the structure, with the economics of the transaction. I would just rather the buyer starts all benefits from scratch. That way I'm not inheriting any of the problems of the seller's plans. Nor do I have to deal with any of the transition issues associated with getting the seller's plans. I would much rather put the new employees into my plans and leave the seller to deal with his problems. That would be my general approach.

Mr. Hector H. Mislavsky: I agree.

Mr. Schwartz: Now what ends up happening sometimes is we can't have our own opinions. What happens is that sometimes our opinions don't matter. The deal will dictate whether we have to take on the seller's plan, or whether we can put the employees in our own plan. Or maybe we will have a hybrid of the two plans. So while we may have our own preferences, the deal will often dictate what the actual outcome turns out to be.

Mr. Mislavsky: An example might be if there are more assets in the plans than liabilities, I guess the sale price goes up. So the seller gets more money that way, I guess.

Mr. Kenney: But is that a reversion?

Mr. Schwartz: Well, one would hope that's not a reversion. I think there's some IRS or DOL rulings that would suggest that it's not a deemed reversion for purposes of the reversion tax at least. But again you know, there are potential fiduciary issues associated with those kinds of transactions. And you have to be sensitive to them.

The one thing to stay away from, if you're dealing with surplus asset transfers that may or may not affect the purchase price, is not to build into the purchase documents a mechanical formula under which the purchase price is mathematically adjusted, based on the amount of pension surplus transferred. That's a no-no, at least if you're in Texas.

You will get stuck with fiduciary liability in Texas. So it's best for the parties to negotiate the deal based on whatever knowledge they have regarding the pension surplus. The parties need to cut a purchase price and that's it. That way nobody can pinpoint what portion of the purchase price, if any, was attributable to the pension surplus. That would be my recommendation involving that transaction.

Mr. Kenney: What is the fiduciary concern there? It is that this company would be using surplus assets to its own benefit?

Mr. Schwartz: Technically there may be a prohibited transaction here, although I don't believe there is. There's a use by the sponsor of the assets of the plan for its own benefit because the sponsor is now transferring those assets but getting cash in exchange. So there's both a prohibited transaction and a fiduciary breach.

Mr. Kenney: So you're essentially selling these assets. And that is the basis of a fiduciary challenge?

Mr. Schwartz: Some would have you believe that after some court decisions, yes. There are decisions that go both ways. There are decisions that suggest that, as long as you have satisfied the requirements for 414(l), that's it. There's no issue of fiduciary breach or anything else, but again, the courts are divided on the issue. I would not have a formulaic approach to the purchase price to deal with the one circumstance where a court has held that there is a fiduciary breach.

Mr. Kenney: But you don't see anything inherently wrong with structuring those kinds of transaction, where you take all of the excess assets of a plan and spin them off along with a portion of the participants in the plan, as long we've satisfied 414(l)?

Mr. Schwartz: As long as the actuary has put his or her signature on that.

Mr. Kenney: As long as I'm willing to sign that 414(l) has been satisfied, you do not see anything wrong with that kind of approach. Even where, although there may not be a formula in the purchase agreement, there has still been a negotiation on the purchase price?

Mr. Schwartz: Right. Those deals are still doable.

Mr. Gebhardtsbauer: But as you know the PBGC might be a little bit concerned about that because you sent all the excess assets one place, so then the other plan might be underfunded on PBGC assumptions. So if the PBGC learns about that, it may try to become involved. Now normally the PBGC only becomes involved if it has enough power to change something.

For example, if you have an underfunded plan and you're spinning off another underfunded plan to a weaker buyer, the PBGC definitely wants to become involved in there. And the way it gets involved is it can use the atomic bomb. It can terminate that plan before the spin-off. The seller, who still has the plan, is liable for the whole underfunding in that plan using PBGC assumptions.

Mr. Schwartz: Let me just correct that statement. The PBGC can threaten to terminate the plans, but as to whether it would actually prevail in doing so is a different matter.

Mr. Gebhardtsbauer: When the PBGC threatens to do that, usually it's at the last minute. The negotiations are almost all resolved. Now PBGC becomes involved at the eleventh hour and says, we don't like that, don't do that spin-off. The PBGC may want the seller to remain on the hook for any future underfunding by the buyer. If the buyer goes under, the seller is still on the hook. Or maybe the seller needs to post some security. Or maybe it ought to just keep it itself so that the PBGC is still happy. The PBGC wants most of the underfunding to stay with the stronger company instead of going to a weaker company.

Ms. Heidi Rackley Dexter: I have a question on fiduciary liability. We're focusing more on the large plan area. I've never been involved in these transactions. I'm not sure how they work.

I understand that in the small-plan area you get these plans that have been over-funded because of asset gains or whatever and because of the 415 limits. The principal owner can't get the money out of the plan. One strategy is to find some nonprofit with an underfunded plan and go through this merger. Then the owner gets his cash from the nonprofit. And how does that play into this scenario?

Mr. Kenney: I do some of the small-plan work. I've never actually tried to do this. I do have some overfunded small plans. I've heard that people do this. I think it's one of those things that sound more clever than it might actually be. And I wonder about the amount of time involved. I wonder about the real economic value of trying to do this, in comparison with the time involved, the fees involved, the hassles of finding somebody like that, that is, getting the transaction actually accomplished. You're talking about a small plan here.

Typically the amount involved is maybe $200,000 or $300,000. The plan sponsor in the small-plan arena is typically impatient. Once the sponsor has made the decision to terminate that plan, it typically does not understand why we have to wait so long to get the IRS approval.

Now if I tell the sponsor not only should it wait for the IRS' approval, but also let's go hunt for a small nonprofit—

Mr. Donald J. Segal: I have two quick comments and then a question for Max. Transferring the surplus to a not-for-profit, and letting the not-for-profit terminate it doesn't get you out of the excise tax because the exception for not-for-profit says it is for a plan that has always been exempt from taxes. This plan obviously wasn't.

Ms. Dexter: In this situation Don, the nonprofit isn't terminating its plan. It has an underfunded plan.

Mr. Segal: Oh, they were merging plans. The second point was addressed in the Gray Book at the 1996 Enrolled Actuaries meeting.

There's something that says, if you can't bump the benefit all the way up by 20%, because you've run into 415 limits, you can still reduce the excise tax to 20%. As long as it's 415 that's limiting you.

Mr. Kenney: Which year's Gray Book?

Mr. Segal: That's in the 1996 Gray Book. This question has been discussed at length as a matter of fact. Because there have been people speculating, "well, if my limit is the 415 limit minus a dollar and I increase it, does that get me around the 50% excise tax?"

I don't think the IRS would look kindly upon it. But I wanted to comment on Max's point about certifications from the actuary and all that.

When you're talking a 414(l) transaction, there's no legal requirement for the actuary to sign anything. Even in the instructions to the 5310 and the 5310A where they're looking for the 414(l) statement, it says this statement does not have to be signed by an actuary.

So you might ask, where's our liability?

Mr. Schwartz: I noticed it's right in these instructions that you don't have to sign it, but I just was looking through the Code of Professional Conduct, because I'm giving a speech soon on ethics. In the Code of Professional Conduct it says that actuaries are responsible for their work and have to sign it.

Mr. Kenney: Don, I was confused by that answer in the Gray Book. What I hear you saying is, I may have an overfunded plan, typically a small plan, and the major participant is not yet at the 415 limit. Suppose she's 5% away. So I bump up her benefit and the benefits of the other people in the plan, and that uses up 5% of the excess assets. Are you telling me, under those circumstances, the Gray Book says I can go for 20% instead of 50% on the excise tax?

Mr. Segal: The interpretation that has been applied apparently is, if you run into limits that prevent you from increasing everybody's benefit by 20%, then you have satisfied the conditions, and you can have the 20% excise tax, not 50%.

Mr. Kenney: That's what it says in the Gray Book?

Mr. Segal: Yes, and that's what it says in the code. I mean that's the interpretation of what it says in the code. So as I said, this led to some theories about gaming—is your benefit defined as 100% of final pay minus a dollar? Therefore, when you terminate the plan, you kick it up a dollar. If you run into the 415 limit, I don't think you have a 20% excise tax. I could see where the agencies might have some problem with that.

Mr. Kenney: On the other hand, suppose the plan participant is already at the 415 limit, and I can't bump up the main participant. But I could bump up some of the others.

Mr. Segal: I think that might satisfy it because the original example in the Gray Book was, "I'm at the 415 limit. I can't take any increase. Therefore, I've satisfied the condition. Therefore, I have a 20% excise tax." The IRS response was, you have to have some increase. If there was no increase, you haven't satisfied the provision of the code.

Mr. Schwartz: Let's come back to the question for a minute. I'd rather have no excise tax than even the 20%, so I could see how these transactions would get done. All I'd have was the ordinary income tax, or, if I'm lucky, perhaps there's only capital gains tax on the amount that I get from the buyer.

To answer your question, I don't think these transactions should work unless there's another business purpose in connection with this transaction. One might view a pure sale of surplus assets as abusive and subject to attack on various fronts.

I've not been involved in any of these transactions, so I haven't had a chance to think about it. I think you'd need some other business purpose.

Mr. Kenney: Well what business purpose could you concoct for selling an over-funded defined-benefit plan to a nonprofit entity that has nothing to do with you?

Mr. Schwartz: I think I should extract a fee before I answer that one.
Mr. Richard Daskais: I was amazed to hear James and Ron talking about that hypothetical case, and to bring out all of the salient arguments.

There was a trial in Washington, which I just attended, that began on June 11, 1996, and I've testified just recently involving precisely the same issues. It involved a government contractor. The government is alleging that the pension plan was overfunded. The contractor alleges that the pension plan was underfunded. It took about a 150 pages of expert reports and what will probably turn out to be 400 or 500 pages of trial transcript to raise the issues that the two of you raised. Of course, Mr. Kenney is right.

Mr. Gebhardtsbauer: I'm sure he will agree with that.

Mr. Kenney: Do you want to go into your presentation?

Mr. Mislavsky: I would like to have a quick show of hands of those who have worked on, say, at least five merger and acquisition transactions in the last two years? Five of them at least in the last two years? Good, a few of you.

I've worked on 30 or 40 of them in the last two years. Most of my experiences are on the buyer's side. Much of what I'm about to tell you on the buyer's side can be generalized from the seller's side because they're just the mirror image of one another.

What I'm going to try to cover is really just the process for working on a due diligence transaction.

As Max was saying earlier, there are many types of transactions. We have the mergers, acquisitions, dispositions, divestitures, spin-offs, recapitalizations, leveraged buyouts (LBOs), management buyout, stock, and asset sales. And they can be friendly or they can be hostile.

Clearly a merger is when two companies decide they want to get together and do business as one company. But then the kind of work that we do also deals with recapitalization, for example.

I worked on one a few years ago where a large investment banker was looking to land a large organization. This involved a substantial amount of money in excess of a billion dollars. And this is about the time that *FAS 106* was just coming on board.

The investment bankers had asked us to help them understand what the *FAS 106* liabilities were with as little information as possible, i.e., only information that's publicly available. What was *FAS 106* going to do to this particular organization's income statement? And their balance sheet?

We did the due diligence with very little information, and it was not your classical merger and acquisition situation.

When you have an LBO or a management buyout, the thing you need to be concerned with is cash. Cash is king when an organization is leveraged to the hilt. The organization needs to use a lot of the cash to pay down on debt, and it's usually some very expensive debt.

Max already covered some of the differences about stock and assets, though, and I'll need to remember the reference to Turkish coffee.

In mergers and acquisitions, there are a number of parties involved. First, of course, there's the client. Then there's the buyer, and the buyer could be either a strategic buyer or a financial buyer.

Strategic buyers are those who have two organizations that are just typically in the same or similar line of business. They feel that, if they get together, then they will be a stronger player in the market. You see a lot of that in telecommunications. You're seeing it in the drug industry where many companies are just getting together to be stronger worldwide competitors.

A financial buyer is one who has an organization that is interested in buying a company for the sole purpose of turning it around within a period of three or five years and "flipping" that company and getting a substantial rate of return. The buyer will either take that company private and then five years later, after a possible downsizing, the buyer will sell it for more than it paid for the company.

What happens here is you have a venture capitalist that will buy a division or a subsidiary of a much larger organization. It may be perhaps a subsidiary that's no longer in the main line of business of that larger multinational organization. The venture capitalists will come in, they'll buy that organization, and they'll flip it over to make more money.

Mr. Schwartz: In a financial transaction, because of the objective, the buyer is going to be interested in knowing not only the cash flow associated with the current benefit programs, but also in cutting back on that cash flow. So the buyer will be looking for advice on whether to terminate these plans or reduce the benefits. What's involved? This raises a whole series of different issues in looking at the benefit picture as it exists.

Mr. Mislavsky: And it's also the classic situation of the sum of the parts being greater than the whole. This is what we're talking about here.

Know the other parties that you're involved with. On your side you have outside counsel, and you have the independent auditor. There are the investment bankers, and there may be other advisers involved. And the other side that you're dealing with, of course, will have similar parties on its side.

Mr. Kenney: How do we know who we can talk to? I have a lot of trouble finding that out sometimes.

Mr. Mislavsky: Good question. Yes, this is what I call protocols. That is, who should be kept informed? Obviously for whatever organization you work for, whether it's a consulting firm or an accounting firm, you want to make sure that the lead person on your side is absolutely and continuously involved in everything that you're working on.

On the client side, you need to deal with the people there, but you have to be very careful who you deal with. There may be several clients within the client. I'll put it that way. There may be people you want to deal with or you may want to ask questions of, but your true client within an organization may want to keep it hush, hush. And therefore, you're going to be restricted as to who you can speak to.

The key here is to know whom you're allowed to talk to. That is very important. Certainly when talking to anybody at the target, you want to make sure you obtain permission to call them. Often the transaction may be either secretive or semi-secretive. And if you go ahead and initiate a telephone call, you may be tipping off something that the target doesn't want you to tip off. And that, of course, can create a great deal of aggravation for many people.

In terms of protocols clearly there are attorneys involved. You want to make sure that they're apprised of what's going on. Especially make sure of that as you get to the negotiation phase of the process, be sure that what you've negotiated or what you've extracted from the target is correctly interpreted in the legal document. This is really a communication issue.

What often happens is that what is obvious to us may not be obvious to Max or some other attorneys. And I've been involved in many situations where what ends up being printed is not close to being what was actually negotiated. And then you basically have to start the negotiations all over again.

One thought I had is that maybe it's important for you to have not only a good relationship with the human resources side of your client, but also a good relationship with the top financial people in your client company.

This goes back to knowing the protocols and who to talk to. It's always the financial people who are driving this bus. It would not be unusual for the human resource persons, at least at the beginning of the process, to not even be aware that there are any transactions going on.

So you have to be very careful that you don't go talk to your contact in human resources and say, "I hear that you're working on this transaction. How can I help?" That person will say, "Tell me more because I haven't heard anything about this." Then you're going to put everybody in a predicament.

Mr. Schwartz: I have the same problem from the legal side. Often the benefits are not the first thing that people think about, unless you're dealing with a specific surplus transfer transaction. But at least I've educated my corporate partners to involve me sooner rather than later in the transaction. And if I happen to know who the outside consultant is for that client, and often I do, I'll pick up the phone and call them right away and say, "You know, this is confidential. Don't talk to anybody at the client until we get clearance."

But I want to know what's going on, because I'm going to need your help. Typically, in a corporate transaction, there's going to be representations made with respect to benefits, and if you have a defined-benefit pension plan, there can be representations regarding the funding level. And I'm going to want to make sure that if we make the representation, we do it right.

There's going to be communication with respect to what's going to happen to the benefit plans. And I'm going to want to draft that correctly. And there has to be coordination between human resources and the outside consultant and us. I mean it just has to be, and the sooner the better, otherwise things don't get done right.

Mr. Mislavsky: So that brings us to due diligence, which is the bulk of the work that we do. And what is it?

Well, in short it's information gathering and analysis. What we want to do as actuaries is to evaluate the transaction and quantify the risk and to help our clients make informed decisions.

Now different transactions proceed at different speeds. And more often than not, you only get one bite at the apple. So you basically have to know what it is that you're looking for, so when you go in, you can ask all of the appropriate questions, get out, do your analysis, and then report back to the client.

Now, to demonstrate the process of due diligence, I put together what I call the "M&Ms" dilemma. I have a one-pound bag of M&Ms. I'm going to ask this audience to pretend this is a due diligence assignment. A client is paying us a lot of money to tell it how many pieces of candy are in here. Here's a product that we're all familiar with. Now we have to take a guess, and the client is going to make a business decision based on what we tell it.

So this is the audience participation part of the show. I'd like to take one guess from the audience as to how many pieces of M&Ms you think are in this one-pound bag? How many?

From the Floor: Three hundred and twenty-five.

Mr. Mislavsky: I have 325. Is there anyone here who thinks there are more than 325. And I have to believe there's one person that thinks there's more than—yes?

Mr. Kenney: Four hundred and fifty.

Mr. Mislavsky: We have 450. Is there anyone here who thinks there's more than 450? Nobody. Well then everybody must think that there are less than 325. Can somebody tell me how many less than 325. Or a guess?

From the Floor: One hundred and seventy-six.

Mr. Mislavsky: One hundred and seventy-six.

From the Floor: Three hundred and twenty-four.

Mr. Mislavsky: Three hundred and twenty-four. Anyone less than a 176?

From the Floor: One hundred and sixty-nine.

Mr. Mislavsky: One hundred and sixty-nine. Well, we can continue, but I've made my point. Here's a product that we're all familiar with. Most of us have probably consumed it. And the client is going to hear from different people in this room that there is 176 on the low end and 450 on the high end. And in fact, if we continue this exercise, we can probably even stretch this further.

The question is, how do you make a quick decision? We also have to learn how to ask questions because one of the questions that should come to mind is, "Mr. and Mrs. Client, are you sure you mean chocolate M&Ms?" They could be talking about peanut M&Ms. Or they could be talking about peanut butter M&Ms. Or they could be talking about almond M&Ms. And for all I know there's a different amount of M&Ms in each of those one-pound bags. So make sure you understand what your client wants you to measure.

What I'd like to do is tell you how I proceeded to answer his particular question. I got myself a little pack of M&Ms. I can count these real quick, and then I extrapolate.

I can tell you that in this one small bag of M&Ms there's about 53 pieces. Which means if I extrapolate correctly there's 530 pieces of M&Ms in the big bag. So, our client just wasted a lot of money on consulting services, because they received the wrong answer.

All kidding aside, what I'm trying to show is that in the due diligence, you have to make some very quick and important decisions given very limited information. Very often you are working with information that we work with every day. And we can literally come up with some very different answers, depending on how we approach things.

Also in due diligence it is important to understand the transaction. What is the nature of the transaction? We talked earlier about mergers and dispositions. What is the structure? What is the purchase price? What is important? What is the materiality level?

As actuaries we have a tendency to try to get down to the last nickel in measuring things. But I've worked in a transaction where the level of materiality was $400 million. The client just didn't want to know about anything less than $400 million.

Now the flip side of that is, we don't walk away from stuff just because it's less than $400 million, because the sum of a lot of little things can actually add up to a big number. I think it behooves us to still bring up to the client's attention that we did a $50 million variance. Then I let the client make the decision whether it wants to deal with that size of variance.

The time frame is also important. Obviously and in the example that I gave you, I'm asking you to make a split-second decision on how many pieces of M&Ms there were here. If you had enough time you would actually open up the bag and count all the pieces and get to the right answer. Very often we don't have that luxury. So the time frame will be important.

Related to that is the budget. How much does the client want to spend to have us count the M&Ms? We can always go back to our clients and say, "Sure we'll do evaluation, but it will cost you X thousands of dollars." And then we find out that the client is unwilling to pay that much money. They want us to work with the existing paperwork.

The bottom line is, this is about negotiations. Once you calculate how many pieces of M&Ms there are—one person says 450, another says 176—the negotiations come in.

The other thing that we need to understand is the client and the target background. What is the business activity? What does the client plan to do? I think Max was alluding to that earlier in the discussion.

Are we going to not provide defined-benefits plans anymore? I had a client in the high-tech industry. It has bought any number of firms over the years. It has a very simple mantra that it follows. If this client buys any company that has a defined-benefit plan, this client terminates the plan. The client only provides defined-contribution plans. No ifs, ands, or buts about it. That's just the way it does business. All employees go into this defined-contribution plan. End of story. So you need to understand the business activity.

We talked earlier about whether it's a strategic or a financial buyer. What is the buyer going to do with this company down the road? If the buyer is going to flip it over in three or five years, chances are that the financial buyer is not going to want to get too involved in much planning and taking care of the retirees because the financial buyer is really in this for the money.

There are other issues to keep track of. Somebody in the audience mentioned earlier about government contractors. We need to be mindful of that. We need to be mindful of regulated industry.

We need to be mindful of certain industries that are undergoing a lot of change like the pharmaceuticals, the banking, and the telecommunications industry.

When I go into a transaction, I assume that everything is wrong. Really you have to go in that way. More often than not, you're dealing with people's opinions. Much of the work that we do is just giving opinions. Oftentimes there are things that are wrong. That's not to say that 50% of the time or 80% of the time things are wrong. You need to know which transaction you're working on is going to be the one that's wrong.

I was involved in one situation where, just based on rules of thumb regarding *FAS 106* I said, "I just don't feel comfortable with what you show as the effect of a 1% change in the health care cost trend rate." The answer I received was very disappointing. The answer was, "The numbers came out of the computer." This is to imply that therefore they must be right. And I said, well, with all due respect, would you mind going back and checking the numbers in the input? Sure enough there was a computing error. And the number turned out to be more in line with what I had expected versus what was actually reported.

The point is that we're humans and humans do make mistakes. It's our job to uncover as many of these as possible when we're working on these transactions.

Mr. Schwartz: Sometimes the mistakes aren't mistakes.

Mr. Mislavsky: You just reminded me of something else I wanted to mention. It's a good segue.

This past Sunday the business section of *The New York Times* talked about a Truth or Consequences party. It talked about annual financial reports, and whether you should believe everything that you read. And this is exactly what I'm talking about. Some of the quotes here are, "Companies do it all the time." "You can't believe lawyers." "It's not material." "It's all hocus pocus anyway." One of the things that was highlighted later on in the article is a restructuring at IBM in 1991. It was about how companies use restructuring to basically cleanse their balance sheets so it looks better. AT&T in the past (I forget the number of years), has had something on the order of every year taking a restructuring charge. But over the same period of time AT&T's earnings were $10 billion.

So the question is, what do you believe? Again my advice is, approach the due diligence by assuming that some of the information given to you is likely to be incorrect.

Now tools that we easily use in due diligence are the so-called check lists. Most checklists what I call the "all-you-can-eat variety," long multiple pages of things to ask clients.
Now, the checklist is just a wish list of everything that you'd want to read if you had time to read it all. It doesn't prioritize the information. The most minute thing that's on a checklist appears equally as important as the most important thing on the checklist. So you need to prioritize the information.

The checklist doesn't do the analysis for you. Once you receive boxes and boxes of paper, you still have to do the analysis. So, a word of caution here is, be careful what you ask for, because you might get it, and then you'll have to deal with it. You have to have a sense for what's important and what's not. Then deal with it accordingly. A checklist is nothing more than a road map.

When should a buyer be concerned with benefit issues? I believe that almost in every transaction a buyer should be concerned with benefit issues, because most companies have employees. Also, the benefit issues do not depend on the size of the transaction.

While at some level large transactions are very complex (because you might have multiple locations and subsidiaries), I also have found that the smaller transactions can be even more complicated because the reporting and the collection of data, can be more sloppy and more lacking which means they need to do even more digging than you might in the larger transaction.

Certainly you want to avoid surprises. In an asset sale, for instance, the buyer is not taking over all the liabilities. Suppose an employee has 29 years of service and could have gotten out with a 30-and-out benefit the next year. The service in the next year for that employee who is still working at the same desk, is not going to count towards the 30 years that the employee has in the seller's pension plan.

So there's going to be a surprise for that employee. He or he was hoping to get that 30-and-out benefit; now he or she can't get it. However, on a stock sale, the employee would get it. On a stock sale another thing can happen. Suppose the employee is 65 now. Under an asset sale, he or she could have retired and started benefits. The employee is not going to be able to retire under a stock sale, because he or she is still working for the successor employer, which is the employer that maintains the plan. So the employee would have preferred an asset sale.

From the Floor: Could you give an example of an actual case?

Mr. Mislavsky: In this one particular transaction, the actuaries for the sellers were very up-front about what they've done. I'm going back about four years, before the adoption of *FAS 106.*

The targeted company did what I would call a "back of an envelope" evaluation of their postretirement medical liabilities.

The actuaries were very much up-front as to what they did value and what they didn't value. But the executives at the targeted companies saw what they wanted to see, and said "this is our entire liability."

By the way, the liability was shown to be $60 million. The actuaries weren't happy with the data that they had. They said that the liability only included medical but not life insurance liabilities. And there were any number of other caveats, some of which don't come to mind right now.

We came in and said, "Well, this could be a problem, so let's find out how dirty the data really are." And we find out that the data that the actuaries obtained were different than the data that we obtained. And these data that we obtained were more recent than the data their own actuaries obtained.

We found out that the life insurance benefits were quite substantial. To make a long story not so long we stopped counting liabilities at $200 million, and we were still just dealing with retirees.

At that point the buyers say, well we're not going to bother even trying to estimate what the active *FAS 106* liability is going to be, because there's obviously going to be no deal here. So we need to be careful about everything that we read.

Some issues that need to be addressed are obviously actuarial and financial. There are going to be some technical tax and compliance issues. And again, this is where we worked particularly together with the attorney. There are the plan design opportunities and challenges that we've mentioned earlier, as well as, of course, some of the international situations.

If you have a multinational company, I'll give you a quick example of an international situation that we were involved with. The company wanted to become a public company and register in the U.S. with asset valuation reserves (AVRs). The company had a huge pension plan. In this one particular country, you're allowed to have your own debt in the pension plan. Let's assume that the assets of this company were about $1 billion. And approximately $800 million of those assets were in company debt.

So while the company showed a fully funded pension plan, for *FAS 87* purposes, it was very underfunded to say the least. So you have to be mindful of what's out there in some of the international arenas.
Briefly let's consider some of the actuarial and financial considerations. We've talked about some of the *FAS 87, 106* and *112*. You know I mentioned the *FAS 106* example. For those of you who haven't worked with *FAS 112*, there are probably as many organizations that disclaim any *FAS 112* liability as there are that have claimed an *FAS 112* liability. In fact there may be even more of them that disclaimed it.

So you're going to have a lot of varied practice here. Your job, if you're representing a buyer, is to nevertheless find out if there are indeed any *FAS 112* liabilities because they can, in fact, turn out to be material after all.

The other thing is that the assumptions can, in fact, be particularly aggressive. You have to be mindful of what has transpired since the last valuation was done. For example, the last valuation may have been done as of January 1, 1995. Actually, January 1, 1995 may be the last valuation that would be available to you if you were doing a transaction, if the client or the target is still working under 1995 valuation.

You have to find out how the economic environment changed in the last year and a half? How has the company changed in the last year and a half in terms of work force? And then you have to extrapolate.

The other thing that we're finding in practice is that a lot of companies no longer want to do annual *FAS 106* valuations. They roll forward their *FAS 106* or *FAS 112* results and then you need to make sure that nothing major has transpired that will cause those roll-forwards to go awry.

What I want to talk about as a last point right now is the changes in the work force, which is what I was saying previously. A company over the course of its last evaluation may have had several programs, such as window programs. You want to see that all of that is properly reflected in the company's financial results.

I was dealing with one situation, a Fortune 500 company, that had a huge deferred compensation plan. This company was not accounting for the plan properly under *FAS 87,* and the *FAS 87* liabilities turned out to be about twice as large as the liabilities that the company was showing on its books.

The difference was from about $15 million to about $30 million. I don't care how big the company is; there are going to be variances almost anywhere. Our job is really just to find them.

The last point is one of documentation of work. Some believe that everything must be documented and that you must leave a good paper trail. Others that I've worked with believe that none of this should be documented, so they don't leave a nice paper trail. You need to decide what situation you find yourself in.