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Session 14IF
Corporate Reorganization: What Does it Mean for Pension Plans?

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Summary: Corporate sponsors have seen significant changes in their organizations: acquisitions, divestitures, downsizing and "re-engineering." All have become a part of our everyday vocabulary.

As pension consultants, how can we better serve corporate sponsors undergoing these changes? How should these organizational changes affect the design and funding of pension plans? This session addresses these questions and provides information that will help you when these situations affect your clients.

Mr. William Daniels: I will identify some of the major programs we're going to discuss and then give some perspective on the merger and acquisition (M&A) activity over the last 18 months. Joan will explain some of the due diligence activities that are involved in M&As and the transition approaches that are often employed when you're moving employee benefit plans out of an organization or, of course, bringing them into an organization. Finally, we will present some checklist items that you may find very valuable.

We plan to emphasize the area of defined-benefit pension plans and the retiree medical plans. In the area of pensions, we'll touch on both qualified and nonqualified plans. We'll also discuss, in some measure, the family of defined-contribution plans 401(k), and employee stock ownership plans (ESOP). We'll briefly discuss active health and welfare. We won't talk at all about non-U.S. plans.

There has been an awful lot of activity, certainly over the last five years, but particularly in the last 18 months. I have summarized some of this activity to help give you a feel for just how busy things have been. For worldwide activity in 1996, the value of the deals total a trillion dollars. The U.S. accounted for two-thirds of that. There were 10,200 deals; six of them were involving amounts above $10 billion and 100 of those deals were over $1 billion. Does that surprise anyone?

That information was in a 1996 *Wall Street Journal* article. The Securities Data Company is in New Jersey. For many of you, this M&A activity comes very close to home. Marsh McLennan bought Johnson & Higgins recently; AON bought A&A. I was touched very personally by Mellon Bank buying Buck Consultants. Coopers & Lybrand bought Kwasha. Watson Wyatt formed a joint venture with State Street which was probably not as meaningful to most consulting actuaries working at Watson Wyatt as the other deals are, but nevertheless I thought it was interesting. I'm sure there are more. Going back to 1995, Hazelhurst was acquired by Northern Trust.

It's not just the employee benefit industry that has been involved in M&As. The telecommunication industry had a big deal involving MCI and British Telecom. In transportation, Conrail, CSX, and Northern Southern merged. That was a break-up and then recombination. I didn't put specific hospitals down, but many of you are involved in that segment of industry. There are many hospitals trying to come together; as well as health maintenance organizations (HMOs) and insurance companies. I found that because of the activity in health care that there's a great deal going on with the physician plans as well. In the past you had the small market activity, individualized plans for old proprietorships. Currently, physicians are coming together and often becoming employees of hospitals. In the next year, I'm sure we're going to see more in the utilities area.

Even though M&As have been going on for years, it seemed to me that there ought to be some good explanations for the increased activity level. Regarding the employee benefit industry, there’s just a fundamental change in business economics. We are no longer just being asked to consult and tell companies how to run their employee benefit programs. They say do it. Figure out how to deliver the benefits directly. Take all these calls and shuffle all that paper. From our perspective at Buck, we found that those challenges, both in technology and skill set, were things that were too hard to develop internally. That was a big part of why Mellon acquired Buck, and that's probably some of the case with the other consulting firms as well. It's not just employee benefit consulting. A company as big as IBM believes it needs to get into the software business quickly, so they buy Lotus. Another key reason for an increase in activity is the strong stock market.

We're trying to emphasize the business issues behind these deals. There are a lot of very interesting questions and analyses associated with the legalities of the employee benefit plan combinations, the funding implications, and so on. What are some of the major factors that drive the deals, and how do they play themselves out in the employee benefit arena? Focusing from that perspective on what the consultant should be looking for and the alternative transaction approaches. Do you want to do a spinoff? Should you keep the assets with the plan liabilities? This is dependent on what you want to do.

Ms. Joan Boughton: I have a lot of material and I'll try to go through it quickly. There is more than a slight difference in the perspective of the buyer versus the seller. After the buyer acquires the company and perhaps assumes some of the liabilities of those plans, he doesn’t want any surprises down the road. In the due diligence process there’s an attempt to unearth those things that might be surprising if you didn't do the process. You want complete administrative records, they want all of your compliance stuff in a row and then no deal breakers. Obviously everyone wants the deal to go through. They don't want to assume known, or more importantly, unknown commitments that will cause them to commit big resources such as time or money.

The sellers don’t want surprises either. In many cases, a smooth transition for employees is a key point. They also want all the ducks to be in a row and they want no deal breakers. On the financial side, the seller doesn't want to be left with any residual liabilities that they either didn't expect or are more expensive than what they want. They generally want employees to be treated fairly.

What is the due diligence process? Basically, if you're on the buyer's side, the first thing you must do is collect papers and documents and fill up your office and conference room. The next thing you do is what I call go on a treasure hunt. Some of the things will be easier to find than others. I'll get into these more specifically in a moment. Then you say, “What's the weather like? What did the plans look like financially? What sort of condition are they in?” Then you say, “After this sale happens, what will the weather be like? What will the plans look like financially after this deal goes through?” Finally, “Show me the money.“ Typically through the due diligence process you will identify liabilities or amounts that may even impact the sale price. You write a report telling your client what they will want to do perhaps with the actual sale agreement language to help your seller provide what they need to through the buyer.

Whether you're the buyer or the seller, there is a due diligence checklist of the information that needs to be covered. If you're the buyer, you're going to be looking to collect all this information. If you're the seller, you're going to be asked to provide this information. There are some big categories—a list of all the retirement programs and plans such as pension, deferred compensation, profit sharing, retiree medical and life, employee stock ownership plans (ESOPs), and multiemployer plans. From the buyer's perspective, you want to collect financial statement information. All the *Financial Accounting Standard (FAS) 87* results, multiemployer and defined-contribution plans, contributions, *FAS 106, FAS 112,* costs, liabilities, the executive compensation nonqualified arrangements, deferred compensation and the like must be provided.

You may ask for a list of employees for the division to be purchased or maybe an age/service charge. Then you'll get more documents including plan documents, insurance contracts, trust agreements, summary plan descriptions (SPDs), determination letters, Form 5500s, etc.

Mr. Daniels: Joan, on that list of employees, the definition of an employee and, of course, those that potentially get into the plan varies quite a bit. Have you found that you often miss people, such as part-time employees or groups of people who get special treatment because perhaps they are laid off. You go to the human resource system or the payroll system and get employee information, but it doesn't include layoffs, but yet they're eligible for the plan. What kind of ideas or tools have you employed to try to make sure you get all of that kind of stuff?

Ms. Boughton: You do see that problem. Those are the little sorts of unhappy surprises that occur after the sale. Usually, it might be leased employees or part-timers who did work enough to get eligibility in the plan.

Mr. Daniels: You could be dealing with pension plans where you have deferred vested participants and the benefits aren't yet calculated so you're left to try to guess what the benefits might be. I was also wondering about the deferred compensation programs, the kind of documentation that's out there on either 415 or 401(a)17 plans. That sometimes is overlooked or not well documented.

Ms. Boughton: I agree that's not always well documented and sometimes, especially if there's an individual executive agreement involved, there's a little bit of reluctance to hand over that information even with existing clients. Sometimes even getting the individual agreements for the very top people at your client's organization is getting hard for the consultant. They're either not measuring their liabilities on an ongoing situation or they're trying to measure it themselves.

Mr. Daniels: Of course in the public companies you have another resource—financial disclosures.

Ms. Boughton: You often want to go much deeper than what's in the proxy or the annual report—but yes, I have seen that. That's why I put it on the due diligence checklist. This is something that's very important to get. It's real easy to get a valuation report for all the qualified plans and typically everything is in there that you need to know and it's really these unknown things that you really need to plumb the depth of the company acquiring and get the information you need to measure these liabilities.

To continue with the checklist, you get your actuarial report, the contribution amounts, Pension Benefit Guaranty Corporation (PBGC) forms (those can be very important if there's anything like funding waivers or reportable events you want to learn about that), nondiscrimination test results, and then participant data, which somewhat overlaps with the employee list.

In the nonqualified deferred compensation plans, you're going to want to get change of control agreements. You want to get the documents for these and the individual agreements. Sometimes they're not even written up. They're typically one or two pages, noncompetition arrangement, severance, supplemental plans—try to get all of that. Then collective bargaining agreements are also important to get. If there a multiemployer plan involved, get the history of contributions. If there are any bargained increases that are going to become effective after the sale occurs, you're going to need to learn about that as well.

You have all this paper—what are you going to do with it? These are plans that can be unknown or unwritten so you're attempting to understand what plans are there. Find out what the provisions of those plans are. They might be documented through a plan document or some other agreement. Then you're going to want to find out the unofficial provisions. I'm sure none of you have a client like this and I'm sure I had only one along the way. Often clients administer their plans differently than how the plan is written either in the document or the summary plan description and that could actually cause liabilities for which you would be on the hook. Here's an example. I had one client and it came to light after a little while that they were allowing certain employees who terminated with less than five years, to come back and be rehired for a day at age 55 in order to become vested. Then they could retire early with subsidized early retirement factors. Let's say they had done that broadly. Then that would really be a provision of the plan even if it wasn't written in the plan that they were administering it that way. That would be one of those administered provisions that you might have to worry about. That could be costly.

Then there's compliance. There's more legal and less legal approaches. You'll want to unearth those. What do the plans look like before the transaction? What will they look like after the transaction occurred? I'm not just talking about the ongoing measures of contributions, expense, funded standards, it's also some of these messier things—the unfunded liabilities and the transactions for book liabilities. I'll go into a little detail on that through an example later.

Let's start with the qualified pension plans. What are you going to look at? Are you going to look at the level of contributions in dollars and at the percentage of pay? That will give me an indication of how rich the plan is. What are the minimum and maximum? What's their funding policy? Is it different than that? What's the actuarial liability funded status? What's the current liability funded status? You might not only worry about the current liability funded status which is driving your full funded limitations. What if there's volatility release issues or things like that. You want to look at the assumptions and methods. What are they relative to norms? Are they appropriate for the plan? Would you use different assumptions after the sale—such that some of these results, contributions, and funded status will look different after the sale occurs? Then are there any special items on the Employee Retirement Income Security Act of 1974 (ERISA) side?

FAS 87 is similar. What is pension cost in dollars as a percentage of pay? What's the service cost amount? Is there a transitional asset, for example, that you're amortizing and that's a credit to your cost which is going to drop off two years after the sale? You're going to want to know that you're going to see that hit two or three years down the road. What are you amortizing? Are there prior service costs or credits that will also drop off in the future? Are there any additional minimum liability or equity issues? I have an example that shows a situation where there was this hit to equity. It was not occurring before the sale, but once you spun off the plan, it didn't look too good. Also, in *FAS 87* you would look at the assumptions, the expense allocation methodology, and if there's any special charges under *FAS 88*.

Mr. Daniels: I was confronted with a situation of a severely underfunded plan where the deficit reduction contributions weren't phased in because there was a plan once sponsored by this company. The deficit reduction contributions phase in when you put a new plan in, but if you once sponsored a pension plan, and you're trying to put a new plan in, then they aren't phased in. There's a big funding requirement because of the heavy funding associated with deficit reduction.

Ms. Boughton: Here's an example of another unhappy surprise that occurred in a spinoff situation I worked with. Before the sale, the seller sponsored a single plan that covered Divisions A and B. The expense had been allocated to Divisions A and B on a historical basis. The plan in total had no hit to equity. As of the sale date, Division B was sold and the plan for Division B—part of the total plan covering Division B was spun off and sent to the buyer. All the assets/liabilities were transferred. After the sale, you have the buyer sponsoring a new separate Plan B. The seller is maintaining the Division A plan and the buyer's Plan B had a very large hit to equity. There was no hit to equity for either division before. This was a big surprise that was unearthed by doing the due diligence. I'll show you how it works in Table 1.

TABLE 1
AN *FAS* EXAMPLE OF HOW THINGS CAN CHANGE IN ONE DAY

	Before Sale **One Plan with "Allocated" Balance Sheets**			**After Sale** **Two Separate Plans with Their Own Balance Sheets**	
Plan	**A**	**B**	**Total**	**A**	**B**
ABO	(1,000)	(250)	(1,250)	(1,000)	(250)
PBO	(1,050)	(260)	(1,310)	(1,050)	(260)
FVA	950	250	1,200	960	240
FS	(100)	(10)	(110)	(90)	(20)
UTO	(50)	0	(50)	(50)	0
UPSC	70	5	75	70	5
U(G)/L	80	20	100	80	20
P/(A)	0	15	15	10	5
AML	N/A	N/A	65	50	15
Int. Asset	N/A	N/A	65	50	5
Equity Hit	**N/A**	**N/A**	**0**	**0**	**10**

These are not the real numbers, but it does give you kind of a flavor for what they looked like. Basically before the sale, this is a reconciliation of funded status. You have A, B, and the total plan. This is what went on the balance sheet. What has been allocated to A and B as individual divisions? They didn't have to worry about whether they had a hit to equity. After the sale, because B was spun off, B historically had carried more than their fair share of the assets on this historical basis. That's because the company, when they had previously acquired B, had brought with it a plan with some surplus and they carried that along. It was a better funded division on this allocation basis than Division A. When they went to spin off the plans, they had to spin off assets and liabilities under 414(l) which meant that B only got its pro rata share of the assets. They ended up with only $240 million, rather than the $250 that had been historically carried. Nothing else changes except that $240 million asset figure. What happens is that B had a hit to equity of $10 million. That was an unpleasant surprise. This is just an example of what can change. Nobody was expecting it.

I would like to go over some ideas as to where you might see potential unfunded liabilities. These would typically be for compensation earned or benefits accumulated but not yet paid before the closing date of the sale. Under the retirement plans, the premiums and contributions due, you could have receivable pension contributions. Let's say the sale occurs in March and there are receivables as of January 1. They weren't planning to make them until September. The buyer doesn't want to have to be responsible for PBGC premiums, matching contributions, profit sharing, etc. There are also benefits for currently retired employees. Under pensions, this could be the underqualified or the nonqualified plan. If someone is retired and they're receiving an annuity, all those benefits that have already been earned haven't been paid out yet. Essentially those are unfunded liabilities that you have to make sure are taken care of. You also can see them under *FAS 106* on the medical and life insurance side.

You have the same types of issues for active employees. There are the transaction-triggered benefits and liabilities. These could be accelerated retirement. If Company A sells a division and there are people at that division who are eligible to retire, they might choose to retire rather than work with the new company. That means they're retiring earlier than expected. That might cause a loss to the plan and typically would if you have subsidized early retirement.

If you're not careful in the way you write the sale agreement language, you could have people who would be terminated vested, take retirement earlier than they would, and perhaps early retirement subsidies might be triggered. You also have post-retirement medical plans where people will retire earlier and begin to draw benefits sooner, which could also be expensive.

Sometimes with accelerated terminations, you could have severance benefits. If you have collectively bargain plans, planned shutdown benefits, etc. it might be triggered in the event of a sale.

Other things you might see are multiemployer plan issues, withdrawal liabilities, and/or future withdrawal liability. On the nonqualified side, there could be issues for changing control provisions that you'd need to be worried about.

After a division from a company is sold, all the nondiscrimination could be thrown out of whack if the characteristics are a certain way in the spunoff group. You have to be careful about that because that means you might have to increase benefits for the lower paid or cut them back for the higher paid.

There are a few ways to make this happen with regard to a pension plan when you have a sale. There are basically three approaches. One is retention, where no assets or liabilities go. The benefits are frozen on the sale date. You can have a spinoff which is like the example I showed you before where you have a single plan, division B, being sold. You actually spin off a portion of that plan to the buyer. The assets/liabilities go to the buyer and it could be for actives only or for actives and inactives. I think it's predominantly actives.

Then the benefits for those employees could continue under the seller's formula if the buyer chooses to do that or they could change with the buyer's new program. If you have such a spinoff, what assumptions do you use to determine the assets to be spun? You can get in a tussle that may flow through to the sale agreements over what assets are going to go through the buyer for this plan.

I found when I first started in the business that the first item, the accumulated benefit obligation (ABO) was the commonplace measure of funded status. It was almost as if there was a rule book somewhere. I've also found that recently the rule book says the projected benefit obligation (PBO) is the measure of funded status. I find that interesting to see that occur and yet nothing in the economics behind it has changed, except the accounting standard. There are legitimate arguments that would still have you back at the ABO level. The projected benefit obligation is surprisingly more common.

Mr. Daniels: I have an example that is similar to that situation. Teledyne Corporation was in the press a few years ago with a billion dollars of surplus pension assets. That was a trend that I wanted to comment on. Related to that, of course, is what interest rates do you use? I'm struck by the fact that the discount rate that the accounting standard put in effect is very frequently the accepted basis for determining the ABO. Even though the underlying assets that will serve to meet the benefit obligation will have a return that is certainly better than that fixed income settlement rate. The rationale and the logic behind using the PBO and the discount rate is unsupported and yet it's commonplace. I think it would be useful if we were to think more carefully about those and articulate some arguments as to what the right level should be, but the accountants have taken this one from us.

From the Floor: You're saying that the discount rate is used to measure 414(l) transfer amounts?

Mr. Daniels: No. The PBO measurement and the *FAS 87* discount rate is used. The resulting number is usually bigger than the current liability or the ABO at an interest rate that would meet 414(l) requirements.

From the Floor: Is that acceptable?

Mr. Daniels: Yes, but the point is that you're sending more assets than what typically would be required under the ERISA required calculations.

From the Floor: Isn't that also acceptable?

Mr. Daniels: Yes, and that's exactly my point. There's room to negotiate the amount to be transferred. It should be negotiated. It should be supported by strong arguments that fit in the whole context of the deal and not that the accounting standard says the number is this.

Ms. Boughton: As the consulting actuary, you can really add the value and say, here are the assumptions we ought to be using, and here's the liability we ought to be using, as long as you're meeting that minimum requirement. You help them work through that and you actually get that language into the sale agreement.

Mr. Daniels: The starting point, the minimum is the way the world was ten years ago. It almost was without debate.

From the Floor: You have a plan with surplus assets and you are the actuary of the organization that may be transferring more assets; therefore you may want to transfer more assets. You're trying to make use of surplus assets by the transaction.

Mr. Daniels: Clearly that's rationale. You have a good business reason for moving some assets to another organization where they can be used more effectively. It's legitimate and well conceived. It doesn't make sense when you send more assets simply because the PBO is bigger than the ABO.

Ms. Boughton: We've touched on some of the issues. The last idea is to just handoff. You're showing Division B, and there is a plan that covers just that division. Pass the assets/liabilities off to the buyer.

For defined-benefit plans, there are three main categories of approaches to use. First will be the trust-to-trust transfer where the account balances for this whole group of employees are basically transferred from the seller's plan to the buyer's plan. This is not typically used unless the buyer is going to maintain the plan on an ongoing basis. It won't be a frozen plan. It's nice because it preserves all the tax advantages and also prevents people from taking distributions from the plan. If you're a paternalistic employer you might be thinking along those lines.

Then there's distribution rollover where the seller says “We're going to distribute the account balances for all the employees who work for the operations that are being sold. You can either roll over to your individual retirement account (IRA) to the new company’s plan or just take the distribution.” That can be used no matter what the buyer’s plans are doing. It's nice for employees because they can decide where the money goes whether they take the distribution and pay all the excise taxes or whether they roll it over. They also have the flexibility if they put it into an IRA to invest it the way they want and not just the way the buyer will let them.

The third approach is retention where the seller keeps all the account balances until the employees retire or terminate from the buyer. That's a pain for the seller because they do have administrative burdens until all those people are retired or terminated.

For retirement welfare plans, I would say what happens to the plan is done more by employee category. For those employees who are already retired, typically the seller retains the liability for the payments made to those folks in the future. The buyer could assume the liability for adjustment in the purchase price. I would say that's less typical.

For actives who are eligible to retire on the sale date, there are a couple of options. The seller could treat those as retiring at the point of sale and continue that coverage even if those people remain active with the buyer. The seller could keep the retired medical liabilities, but not pay any benefits until they actually do retire from the buyer. Finally, the buyer could provide benefits once the employees retire, again in return for a purchase price adjustment.

Those are the general issues to be worried about depending on what you do. There's coordination with the buyer's plan and that could be for actives or retirees. There might be differences that develop between the seller's and the buyer's plans over time. There could be purchase or settlement accounting that you have to do which would require gain or loss recognition. If you do have a purchase price adjustment, what are the methods and assumptions that you use for that? That's similar to some of the pension issues we were talking about. How do you actually measure those liabilities. What assumptions do you use?

Bill is going to walk you through some case studies on plan design, but I’ve outlined just a handful of basic ways for treating plan design when you have this sort of a transaction. One would be to continue the programs as they are currently written for a certain period of time. Next would be to continue most of the programs with some changes by the buyer, such as in the level of benefits. More typically post-retirement medical or flexible benefits would have a change in the form of benefits. Maybe they're coming from a strictly defined-benefit environment and they go to a more defined-contribution plan, defined-benefit blend, or a hybrid plan. More substantial changes could be made to most of the programs. The buyer could replace all the plans with its plans or start entirely new plans. Finally what is probably least used would be the best of both worlds. Other people who are transferred would get the better of the two. That could be expensive.

Mr. Daniels: Related to the arguments around the economic assumptions are discount rate and rates of return. There are some demographic assumptions that would probably change. Have you employed similar kinds of thinking for the anticipated change in a culture; have you brought the two organizations together? There's going to be some turnover. Let's just say you have two organizations that are coming together where you don't think you're going to downsize. Instead, you're just bringing them together and they'll be natural cultural changes. One organization tended to have high turnover for lots of reasons; maybe it’s because pay policies and personnel policies versus another organization where you don't see that as much. Do you employ assumptions for the organization that previously had lower turnover and change it to higher?

That's what I'm talking about. Did you see a significant change in the measurement of, for example, the ABO or the accumulated benefit liabilities when you employed that? You changed the plan provisions. That certainly is going to cause you to reevaluate. Even if the plan provisions aren't changing, I think there are some good arguments to be made whenever you bring two organizations together that have very different view about whether they want to keep employees for a longer period of time or promote turnover.

That brings us to point out the relationship of the *FAS 87* and 106 assumptions. I have found that whenever you get some information in the due diligence process, you can get a report dealing with the retiree medical obligations and a report dealing with the pension obligations for the same class of employees. You'll have different assumptions about the way in which they retire—it’s probably for reasons that are pertinent to the specific valuation, but it's dealing with the same class of employees. They obviously can't retire differently. That sometimes happens because one consultant does the *FAS 106* work and another does the pension work. Whenever I've seen that, I was able to negotiate a better deal for my client because you can pick the one that serves your purposes. How can they both be right? The seller obviously has little to say. One of them has to be right—or at least the one that you're going to go with.

From the Floor: A little variation on that theme, we had a situation where the mortality assumption came up where they wanted to buy out the life insurance of their prior company and since everything was based on the *FAS 106* assumptions (mortality, etc.) they would have to pay much more if they went to the marketplace.

Mr. Daniels: When we started to measure the retiree medical obligations under *FAS 106*, more consideration had to be given to mortality because it's certainly more significant there than it is in a pension plan where the duration of liabilities are longer. There was more thought given to mortality, but clearly that same thing holds on the pension side. It's probably a fair statement to say that the pension actuaries don't really wait for the mortality improvement to occur, even though we know it's out there; conversely the other side anticipates it a bit more. What's the right approach? Is the pension mortality table right because it waits to see the improvement or is *FAS 106* correct because you tend to anticipate it? I did some work in the insurance company and projecting mortality improvements is commonplace there. I always wondered why it is that the pension plan valuations didn't try to do something similar.

There was a business where a pension plan was underfunded and they were going to split the underfunded plan into two plans. The seller who was sending an underfunded plan to the buyer argued that the operations of that company being sold were going to be the means of funding the underfunding. Therefore, a purchase price adjustment was required. It didn’t work, and it did show creative thinking.

When I deal with plan design issues, I have found it useful to think about these things in the following terms and convey this thinking to my clients. It seems to be useful. The fundamental viewpoint of these programs that we are providing are current compensation that we are providing in a tax favored way, and if we could, we'd just give you the money. However, because there are beneficial ways of delivering retirement benefits in the tax code, we're willing to do that, but for the most part, this is just current compensation.

The other perspective that I think captures a great number of plans is that they are intended to achieve a retirement resource objective. We don't approach this from the perspective that it's simply compensation. There's a broader goal being served. Those two perspectives help you think through different plan designs. There are characteristics that flow from these perspectives. The first one really conveys a year-to-year economic relationship. It tends to encourage or is supported by defined-contribution plans in all their varieties. There are typically no retiree medical benefits under the defined-contribution perspective. If you can accumulate retirement benefits through defined-contribution plans, then a similar concept is certainly applicable in Retiree medical. There's a notion of lump sum resources that a person can draw upon in a tax-favored way. Actually, I have designed a plan like that for a company. We create an account balance that is just a lump sum IOU to the people involved.

The consequence of defined-contribution approaches is that you have more certain cost for employers, but less certain benefits for the employees.

The retirement resource perspective takes on a longer term viewpoint. This is a partnership relationship between the employer and the employee. The employer is simply not happy giving the employee the money for the year. They see themselves having more of a commitment to the employee. They see that perspective as having a benefit to themselves because it won't serve them well if the employees have insufficient retirement resources at a point when it would be good for the organization if you could retire. The first perspective can really cause problems in retirement resource accumulation. So many organizations say, it's a partnership and we're going to do our part. In that framework, you would have defined-benefit plans with traditional retiree medical plans and the consequences of costs and benefits to employees and employers.

This framework will help a little as we go through the specific examples that I'm going to cover because typically when you bring organizations together, it's typical that only one of those perspectives continues, and it's not a discrete choice. There's proportions of each that often show themselves, but one perspective will emerge. Clearly the trend is towards the deferred-compensation perspective. Anytime you bring the two perspectives together, it's particularly difficult for the mid-career employee.

Ms. Boughton: Bill, when you say the defined-contribution approach, I assume you're also talking about the cash-balance plan.

Mr. Daniels: I think we're now moving to the plan design as seen from the employee's viewpoint. What do I as an employee see as opposed to the financial infrastructure that delivers that benefit. I would include cash-balance plans, the retirement bonus, or perk pension equity. There's a couple of names for the lump sum variety of the final average paid defined-benefit plan.

Ms. Boughton: When you say defined-contribution approach, do you mean to include all these types of plans?

Mr. Daniels: Yes. Here are a few case studies I wanted to share. First are two organizations which have the retirement resource perspective. They both have defined-benefit plans. Company A's plans tend to be skinnier. It was final average pay program where the pay is base only. Compare that to the Company Bs plans where you have total compensation as the definition of compensation. It also happens in this case to be a bit front loaded. The retiree medical programs are similar. We had some retiree medical in Company A, but it was small. Company B was fully paid for by the employer for a career employee.

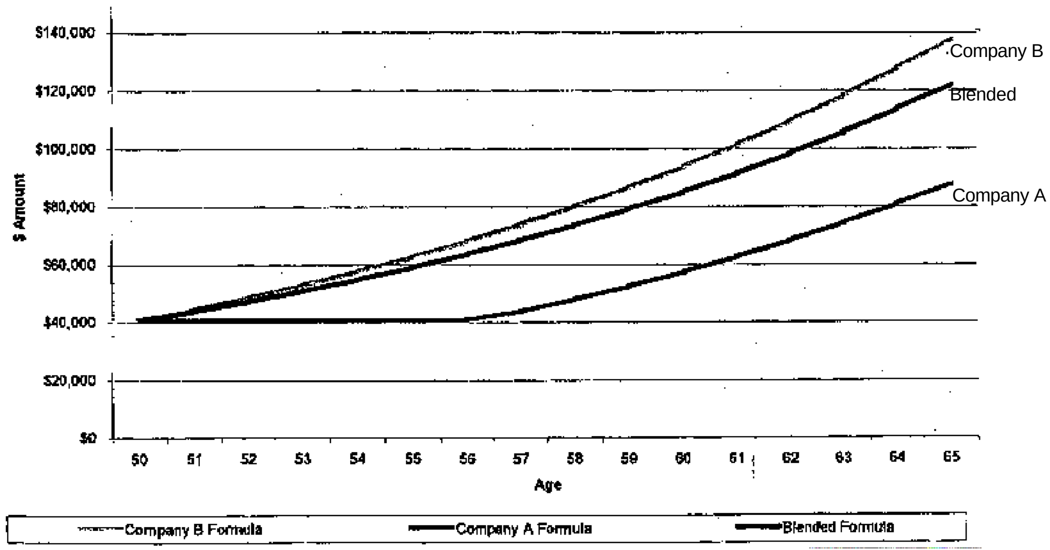
When bringing them together we have the merger issue that Company A's perspective was going to be the surviving perspective. That is, we have that retirement resource view, but we don't think that we should deliver as much as the Company B program is doing. By doing that, you have the losses that those employees will incur.

In this case, the design that emerged was one that was attempting to blend in a smooth and fair way to the employees. I don't see this design very often, but in this case we've employed a PBO approach to delivering the benefits. What I mean by that is, if I had a certain accrued percentage under the Company B benefit program (let's call it 20% of pay) at one point in time and this change occurs at another point, that 20% applies to my pay—whatever it grows to. The accrued benefit I earned is updated for the inflation or growth in the pay. This provides for a more fair approach especially because there were different definitions of compensation in the two programs. If incentive compensation were a significant component of my pay, then you have a real cutback issue. That was a solution that emerged in this case which I did a really nice job of blending.

The consequences from the financial perspective is that the benefit change is quite gradual and the program from the acquirer's perspective was already funded for, or at least expensed because what we are really delivering is the benefit design underlying the PBO. Since the PBO was already accrued on the balance sheet, there was no change. There was a prospective change for profit and loss purposes but there was no change for the balance sheet. I think it's a bit of an administrative burden, but the great systems that we now have to calculate these things helps mitigate that.

What I've shown in Chart 1 is the way benefits would accrue for a person under three approaches. First is if this employee had continued on as a Company A employee. Remember Company A had a better formula that was front loaded; it had a better definition of compensation. The top line describes the way the benefits accrue. Remember Company A's perspective is the survivor and to get to that benefit formula as quickly as possible. The traditional approach would be to protect the accrued benefit based on current pay and then count all service under this new formula. Doing that would produce no benefit accruals for quite some time, although this is the way it would look if you were to achieve the Company A perspective as quickly as you could possibly do it.

CHART 1
COMPARISON OF ANNUAL BENEFITS PAYABLE AT RETIREMENT
UNDER ALTERNATIVE BENEFIT FORMULAS



The middle line represents what that person actually gets if they had accrued a 20% of pay benefit as of age 50. Pay, at that time, totaled $200,000, which consisted of $150,000 of base and $50,000 in bonus. Then the benefit would grow as the base and bonus grows. After that, the new formula would drive on base pay only. You're adding up two pieces, and conceptually it simply says that as an employee you were reserving for a PBO level benefit. That benefit is whatever the pay would grow to in the future. I'll accrue some more in the future under this new formula.

In this first case, all benefit accruals prospectively are on the same plan. It addresses in some measure that concern that sponsors often have when they are side by side. I want them to be accruing the same benefit. Do they get the same benefit? It's different because of historical consequences but prospectively they do. The example would fight with that if that were an objective.

The next example is the typical perspective clash. I have a division of a company where before the divestiture of that division, you had a final average pay to fund benefit plan, and you had the retiree medical plans paid for by the employer. In this case, the buyer is adamant that they can have no employee benefit liabilities. They cannot have *FAS 106* and we cannot have *FAS 87*. “I just want to keep my balance sheet clean of all that stuff. It's very important to me. I like this division. I want to bring it into my structure with no material reductions in benefits. I want the employees to come over and feel they are not harmed by what's going on. I need to be able to make some statement about the value of benefits being comparable to or equivalent to what they currently have." The classic response to that would be, "If you want to give them retirement benefits, the only way to keep the balance sheet clean is with the defined-contribution plan." Because we had a defined-benefit plan, we went to an age-weighted, defined-contribution plan.

The seller provided retiree medical, so there was more added—the retiree medical value was rolled into the defined-contribution plan. That produces no balance sheet liabilities and the benefits turned out to be approximately equivalent. Chart 2 shows how the benefits compare for a younger, 25-year-old employee. This comparison is in a lump sum. You can see that in this case the defined-contribution plan turned out to be a bit more than the defined-benefit plan at most ages and that better be the case, because we had intended to roll in retiree medical value.

You do have problems if it's not a new hire. If I'm mid-career and you make this change, it's deadly. The age weighting can help only a little. In a projection, they tend to lose a lot, but the person who has one year of accrual left before they retire doesn't lose as much. For the year, they lose a lot, although their total benefit isn't much different because they've accrued quite a bit already under the old plan.

Ms. Boughton: They'll also lose a lot if they're one year having a total retirement subsidy. There's a blip at age 55 and they can lose big at that point.

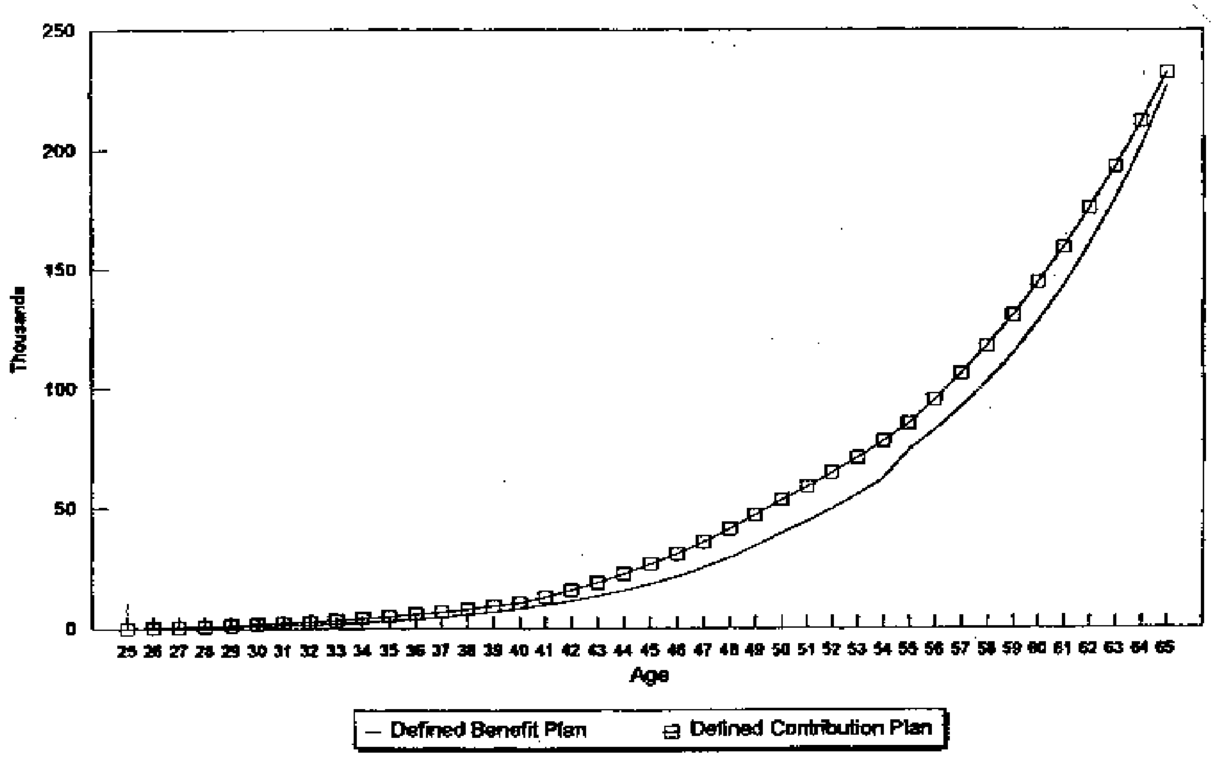
Mr. Daniels: You're talking about a plan where that feature wouldn't be a protected benefit.

If you are being constrained by the balance sheet issues, then there isn't much that can be done. If there are certain people who hurt and if you wanted to do something, you could get away with it from a discrimination perspective. You could give them more defined-contribution money. You'll often run into 415 problems with that. The first level of solution is, can I shift more defined-contribution money to certain people for a temporary period because they are unduly harmed by this transition; and the answer is, I'll try. When you hit 415 problems, you could have an excess plan that produces balance-sheet liabilities—even if it's a defined-contribution plan. The other solution after that would be just give them cash. However, it's not deferred compensation anymore.

In Chart 2, we used a 7% interest rate, both preretirement and postretirement. I don't recall what the mortality table is. This works well for the 25-year-old person. The beauty of that is the power of compounding. We also employed a salary scale.

If it were 7% interest then we were probably using 3–4% on a salary increase assumption.

CHART 2
COMPARISON OF VALUE OF ACCRUED BENEFIT FROM DB PLAN VERSUS DEFINED-CONTRIBUTION PLAN ACCUMULATED BALANCE



Ms. Boughton: I would also challenge your client. If they want to put in a defined-contribution plan that, for the career person, gives you a defined-benefit line, then why are you going to a defined-contribution plan? You can put in a defined-benefit plan and it will be cheaper than the defined-contribution plan because the employer can achieve investment returns higher than the individual typically will. You're saying you want a defined-contribution plan, but if you're really trying to get a defined benefit out of it, then why are you going to a defined-contribution plan? You have to kind of go back to the objective.

Mr. Daniels: Interestingly enough, because this is an age-weighted plan, if you have a younger group, the defined-contribution plan looks cheap. In your statement, I think you were presuming somewhat level funding or expression of cost under the defined-benefit plan as opposed to perhaps a unit-credit valuation.

This is totally unrealistic and furthermore, even if they keep the money in the plan, how many people are going to work 40 years with the same employer? I would submit that 1 out of 50 people will have this path.

From the Floor: Your balance adds up at $230,000 or so, and you're going to end up with a range between maybe $100,000 and $300,000, depending on the actual adjusted returns if everything else works. That's totally idealized. The real endpoint depends on the market when they retire.

Mr. Daniels: On that point, I did some work through stochastic modeling. Instead of saying deterministically we'll have $250,000, I said, "What's the chance that this won't measure up to at least 75% of the defined benefit?" The analysis isn't refined yet, but that chance turned out to be about 40%. There's a 40% chance that under the defined-contribution plan, even if I go into equities as I should, because there is a mortality risk, we are just getting unlucky. You're into the markets just the way you should be, but the markets aren't kind to you. You just were born in the wrong year, so there's a significant chance that a person won't make it. Here's the average, and when you're doing retirement planning, you're going to give away on the upside to protect the downside. I want an adequate retirement income. I don't need to know that I'll have twice as much if I'm lucky. If I have half as much, that's deadly. I have to compromise my lifestyle in that outline. I think these are really important issues.

Let's forget about retirement design. This was more of a plan where the pension plan drove the deal, and this is where it went bad. This is a company that sells a subsidiary where the consideration is the assumption of unfunded benefit liabilities. I get real hard assets of a business, but I also know there are employee benefit liabilities. I pay nothing for that. I promise to pay off the unfunded benefit liabilities. The thing went bad because the pension plan's unfunded liabilities were anywhere from $35 to $60 million. Can you imagine buying a business not knowing whether the purchase price was $35 or $60 million?

One thing that went wrong was a discrepancy in how to value a dedicated bond portfolio. We don't see those as much any more, but certainly in the early 1980s that was very common. This one happened to be at a 14% interest rate. Some segment of the total plan liabilities were discounted at 14%. Then there was a change in the interest-rate environment. The discount rate for the liabilities still stayed at 14% and the assets were revalued, so that more unfunded liability was created and nobody noticed. Roughly, $5 million of that difference was just simply because of an oversight. There were collective bargaining agreements involved where they didn't fully understand some provisions. The union's point prevailed and so they couldn't look at it the way it was originally valued. Good records weren't maintained with respect to prior compensation. When computing the accumulated benefit obligation, they used a salary scale to get prior compensation. It was a high salary scale which normally is good. You're not underestimating the liability, but everyone knows that when you have a high salary scale and you go backwards, it produces a lower definition average pay at that time. At least some part of the discrepancy was accounted for in that way.

The company is naturally downsizing—efficient uses of the surplus are pretty limited. It can't be used to pay for future benefit accruals. Along comes Company B, the investor company with unfunded pension liabilities. The new company has a big appetite for surplus pension assets. The solution is, put them together. You put Company A’s surplus together with Company B’s appetite to use that surplus. You end up with unfunded pension liabilities which become fully funded. The retiree medical benefits are funded through asset transfers and nothing has really changed in the benefit structure. You had many different benefit structures before and you still do, but they are all under one legal entity. This is the situation where it went well. It was an appeal for a significant merger of two big companies.