SOCIETY OF ACTUARIES

Article from:

International Section News

October 2004 – Issue No. 34

Aquiring a U.S. Operation—A Primer

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When an international parent company purchases its first U.S. operation, the international parent is also likely to be faced with the responsibility for U.S. retirement programs for the first time. The buyer, along with executives of the U.S. operation, also must survive the transition and move into operational efficiency at break-neck speed.

As M&A activity increases worldwide, scenarios such as this are becoming more commonplace, and the special considerations involved are complex. There are five critical stages of M&A activities: due diligence, effecting the transaction, understanding the complex transition issues, designing retirement programs after the sale and management after the sale. The first stage often gets the most press. Due diligence is critical, but a company's first step into the U.S. retirement arena should not be taken without a solid awareness of all the stages.

This article provides non-U.S. corporations with an overview of the issues to consider at each stage when they buy a U.S. operation. Though we focus on qualified pension plans, we also recommend a similar rigorous understanding of issues related to nonqualified pension plans (which often benefit executives) and postretirement medical benefits.

Due Diligence

The objective of due diligence is to identify, quantify and obtain coverage for all risks and liabilities associated with the people aspect of a target company. Beyond these objectives, it's also important to gain a full understanding of the benefits and compensation programs, human resources (HR) structure and culture of the target company.

Appendix A provides a general checklist of materials that an interested buyer should collect to gain a comprehensive understanding of a targeted U.S. company's benefit arrangements. By reviewing these materials, benefits experts can identify and quantify potential pitfalls. These include noncompliance with local standards, hidden subsidies, benefits triggered upon the sale and undocumented promises. An actuarial analysis will alert the buyer to the financial impact of the target's benefits programs. This analysis should precede the negotiating stage and can be crucial in creating the sales agreement.

Due diligence also identifies the actions required for the post-acquisition integration of the target business. If at this point the buyer foresees a low probability of integration, the company could walk away from the transaction.

Effecting the Transaction

Once the buyer thoroughly understands the human capital issues, risks and obligations of the target company and is willing to proceed, the buyer and seller are ready to move into the next stage of the acquisition: the sale.

Advisors representing the seller and purchaser help to shape the sales agreement. An actuary can help ensure that the design, administration and financial aspects of retirement programs are appropriately reflected in the formal sale agreement. Elements of the ideal sale agreement that specifically apply to retirement programs are summarized in Appendix B.

In the United States, an acquisition may involve the transfer of retirement program assets and liabilities, though this does not have to be the case. As with any sales transaction, the seller aims to sell high, while the purchaser aims to buy low. In all cases, the buyer expects that the assets are sufficient to cover the benefit obligations of the transferred participants.

Ideally, the sale agreement will specify the criteria by which assets and liabilities will be measured. Most transactions are based on ERISA §4044, typically referred to as "PBGC Assumptions." This is the standard in the United States set by the Pension Benefit Guaranty Corporation, a government-sponsored insurance company for privately sponsored defined benefit plans. The valuation of assets/liabilities is based on very detailed assumptions that leave little room for interpretation. The liabilities could also be measured using FAS, a measure used for financial statement purposes. There is far less guidance for this liability determination than for an ERISA §4044 determination.

The amount of assets transferred depends on whether the plan is funded on a PBGC basis. If the plan is sufficiently funded, the assets transferred will equal the amount of liability (measured using ERISA §4044 assumptions) associated with the participants being spun off. Otherwise, participants must follow a complex allocation that will parse a transferred participant's total accrued benefit into priority categories. If the assets do not fully fund all priority categories, an allocation is performed to fund as many of the categories as possible. For the buyer, there is a real risk that, after the allocation, the assets calculated for transfer are insufficient to fund the obligation of the transferred participants.

The calculations to determine the amount of transferred assets following a sale are so complex that many calculations are not

Appendix A—Materials to Collect for Due Diligence Stage in the United States

PLAN DOCUMENTATION	
• Retirement plan documents • Summary plan descriptions • Summary of material modifications • IRS determination letter	• Union Arrangements • Undocumented promises • Owner data
DETAILED COMPLIANCE TESTS	
• Nondiscrimination testing results	• Top-heavy testing results
ADMINISTRATIVE REPORTS	
• Financial statements • Actuarial reports • Administrative procedures • Trust statements • Census data	• Employee reports • Employee communication • IRS Form 5500s • PBGC filings
MISCELLANEOUS REPORTS	
• Reportable events • Litigation history • IRS Voluntary Compliance Program filings • IRS, DOL or PBGC audit information	• Funding waiver requests • Service contracts • IRS Form 5330—Return of Excise Taxes Related to Employee Benefit Plans Service Contracts

completed for as long as six months after the closing date. It is typical to adjust the value of the transferred assets from the closing date to a later date. This date would be when the seller's trustee actually transfers the assets to the buyer, to account for the time value of money or monthly benefits paid by the seller until transfer date.

Before, during and after a corporate transaction, the buyer and/or the seller may be subject to reporting requirements to the main governing bodies of U.S. pension plans—the IRS and the PBGC. Also, regulatory bodies impose a number of participant communication requirements, but the buyer may want to supplement these notices with additional communication.

Understanding Complex Transition Issues

The processes of due diligence, effecting the transaction and understanding the transition issues often become one and the same for the purchaser. Transition issues are critically important as the purchaser moves into "after-sale" mode.

One of the challenges for the buyer during the transition is to ensure a full understanding of the processes in the benefits spectrum—from administration and regulation to communication and disclosure. For someone who is well versed in benefits management, this should be a manageable task. However, if the purchase represents the buyer's first foray into U.S. retirement program management, information overload will occur quickly.

The line between fiduciary responsibilities and governance duties can be blurry, especially for a new HR manager. The simplest explanation of the distinction is that fiduciary responsibility is typically defined, managed and regulated under ERISA (the major legislation governing pension plans) and is limited to retirement programs. Governance operates at a much higher corporate level, but may include behavior related to retirement programs. To address any questions that come from the corporate officers, the HR manager must understand the responsibilities at both the fiduciary and the governance levels.

As long as the sponsor satisfies the qualification requirements under ERISA, the sponsor can maintain the pension trust as a tax-exempt fund. These enjoy several tax advantages in the United States, including:

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Appendix B—Critical Retirement Benefit Elements in a Sale Agreement

- Name of each retirement program offered by the seller, including:
  - Qualified pension plan(s)
  - Nonqualified pension plan(s)
  - Postretirement medical plan(s)
  - Postretirement life insurance plan(s)
- Name of each retirement program that the purchaser agrees to sponsor as a condition of the sale transaction (transferred plans)
- Name of each retirement program that the seller agrees to sponsor as a condition of the sale transaction (retired plans)
- Description of which participant's obligations will remain with the seller and which will be transferred to the buyer, divided into the following categories at a minimum:
  - Active participants, including information about whether service after the sale date will be transferred
  - Terminated vested participants
  - Participants in payment
- Stipulations regarding ongoing coverage under the retirement programs transferred to the buyer
- Description of the remediation process in cases of disputes in benefit amounts for benefits earned prior to the closing date
- Basis by which the value of each retirement program to be transferred will be measured with reference to the governing ERISA Code section or Financial Accounting Standard (FAS)
- Basis by which the value mentioned above will be adjusted for the transfer of assets occurring after the effective closing date

- Tax-deductible employer contributions
- Tax-deferred investment earnings
- Tax-deferred benefits

If the purchaser maintained a pension fund before the sale, a review is needed to determine whether a change is needed in the nature of the investments held by the pension fund, its investment policy and/or its asset allocation.

After the Sale—Designing the Buyer's Retirement Programs

If the buyer has the luxury of creating retirement programs that are tailored to the new workforce following the sale, then the next step is to explore the range of options and design the retirement package.

Under less stressful circumstances, this planning can be complicated. Its complexity is heightened when the very corporate team that must define the objectives is overwhelmed by the acquisition details. The senior team members play an absolutely critical role in the design of retirement programs. This is because the design is often shaped by the attitudes toward nonbenefit issues that derive from an understanding of the overall business strategy that led to the acquisition.

After the Sale—Management of the Buyer's Retirement Programs

After the sale, there will be a great deal of focus on financial management, as the plan sponsor will need short- and long-term financial projections to minimize the chance of unpleasant financial surprises. In addition, the myriad administrative, reporting and compliance requirements may seem overwhelming. But, with a solid team of benefits advisors, the plan administrator will become accustomed to the requirements in short order.

Entering the U.S. benefits market as a result of an acquisition is no small task. The buyer must get through five critical stages: due diligence, effecting the transaction, understanding the complex transition issues, designing retirement programs after the sale and management after the sale. Once the parent company has successfully navigated all five stages, it can more quickly focus on implementing the business strategy that brought it to the negotiating table. ☐

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