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*Defensive techniques cont'd*

Generally, a corporation makes an annual contribution of stock (or cash, which is used to buy stock) on behalf of each eligible employee. Individual accounts appreciate over time with the growth of share values and dividends received.

In a basic leveraged ESOP transaction, the ESOP borrows money, with a guarantee from the sponsoring corporation, to purchase a block of shares. As the corporation contributes amounts annually to the ESOP (which in turn are used by the ESOP to repay the loan), shares are allocated to participant accounts. Initially, they are placed in a suspense account since they do not "belong" to participants until contributions are made and the debt is repaid.

From a defensive point of view, a key attraction of this transaction is that, while participants receive shares in their accounts over a number of years (as they also do in an unleveraged ESOP), the leveraging results in the entire block being placed in the trust immediately. The manner in which shares in a leveraged ESOP are voted is also an important factor in adopting this anti-takeover posture. Allocated shares are voted by participants while unallocated shares are voted by the ESOP's trustees. The trustees are permitted to vote unallocated shares in the same proportion that allocated shares are voted. Since employee-owned shares are generally regarded as friendly to management, a significant number of unallocated shares in an ESOP with this voting arrangement can be a valuable defensive tool.

A number of public companies recently have sought to structure leveraged ESOPs in a way that does not result in additional costs. While an ESOP that is a new, additional benefit program would clearly have a cost, the new thrust has been to use the ESOP as a replacement for a commitment the corporation has to an existing defined-contribution plan – for example, a company matching contribution to a 401(k) savings plan, which in many cases is already invested in company stock. In fact, due to tax incentives provided to encourage ESOPs (primarily the tax deductibility of dividends used to repay ESOP loans), this structure may allow current levels of benefits to be provided to employees at a substantially reduced cost. In addition to reducing benefit costs, the corporation also strengthens its anti-takeover posture by maximizing the number of employee-held shares.

While most stock acquired by an ESOP is common stock, it is permissible to use convertible preferred stock. Transactions have been structured that include the purchase (by the company with the loan proceeds) and retirement of outstanding common shares with the ESOP purchasing a newly issued convertible preferred stock. This reduces common shares outstanding and can result in higher primary earnings-per-share. Such a transaction can be a valuable part of a defensive recapitalization. In addition, the convertible preferred shares are voted by employees in the same manner as common stock.

As with other techniques, there is a host of issues raised including employee benefits concerns if a leveraged ESOP is established. For example, how will the ESOP interact with existing retirement benefits? The ESOP as a replacement of an existing defined contribution plan is but one option. Financial reporting, tax and legal issues are numerous. It is a complicated transaction but one that can be very helpful to an organization concerned about being acquired.

### Conclusion

All three techniques discussed can potentially contribute to a corporation's overall program to make itself less attractive to an unwanted suitor. Such a program is a very complex undertaking and includes many factors outside the employee benefits arena. It should be emphasized that the employee benefits techniques are complex in themselves and include many financial and legal issues beyond those generally seen in the employee benefits arena.

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# A rare technical slip by the Bureau of the Census

by Robert J. Myers

The U.S. Bureau of the Census has rightfully earned a reputation for technical excellence. However, the author has run across an instance where this venerable, distinguished agency went sadly astray – namely, in connection with the number and proportion of employees of state and local governments who are covered by Social Security (Old-age, Survivors, and Disability Insurance).

Coverage under OASDI is voluntary for state and local government employees (except, in certain designated states, for police personnel covered under a staff retirement system – who cannot be so covered under OASDI).[1] The employing entity must elect the coverage. Under certain circumstances, the employees present at the inception of coverage can opt out individually, even though the entity has elected to participate. In the past, after certain requirements were met, the entity could terminate coverage, but the Social Security Amendments of 1983 eliminated this possibility.

In recent years the Social Security Administration (SSA) has stated that about 70% of all state and local government employees are covered under OASDI. For example, a note in the *Social Security Bulletin* for December 1987 ("State and Local Government Employees Covered under Social Security, 1984") shows an estimated 9.98 million (or 69%) of the 14.53 million state and local government employees in 1984 as being so covered, leaving 4.55 million not covered. The number of covered persons is derived from wage reports submitted to SSA by the covered governmental entities, a quite accurate source of data. The total number of state and local employees, used as a denominator of the ratio, is based on the March 1985 Income Supplement of the Current Population Survey.

In contrast, the Census Bureau reported that in fiscal year 1981-82, among 10.14 million active members of retirement systems of state and local governments, 4.36 million were in systems where no employees were

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*Rare slip cont'd*

covered by OASDI; 3.10 million were in systems where some, but not all, employees were so covered; and 2.68 million were in systems where all employees were so covered.[2] Thus, according to Census Bureau data, the maximum possible portion covered would be 57%, and the minimum would be 26%.

When considered by number of systems (rather than number of active members), the results are even more startling – 79% where none were covered, 6% where some, but not all, were covered, and 15% where all were covered. Thus, even though these data relate only to employees covered by state and local retirement systems – and not to all state and local government employees – they seem to indicate much less OASDI coverage than do the SSA data.[3]

What explains the difference? The problem insofar as the data of the Census Bureau is concerned arises for two reasons. First, there is the statistical-procedural error of assigning all "not available" responses to the "entire membership outside coverage" category. Second, some responses from the retirement systems showed that no members were covered, but other sources indicate otherwise.[4]

The Census Bureau presents detailed information for retirement systems having 200 or more members – 648 systems (or 25% of the total), containing 99.3% of all active members. "Not available" was reported for 28 such systems, involving 2.50 million active members. If these "unknown status" cases were removed from the "no coverage" group, the distribution of the remaining 7.64 million active members in the universe would be 24% in systems with no employees covered, 41% in systems with some, but not all, employees covered, and 35% in systems with all employees covered. Thus on this basis, the maximum coverage was 76% (rather than 57%), and the minimum was 35%.

Although the published Census Bureau data for the total universe of retirement plans did not show how many of the 10.14 million active members are covered by OASDI (a great omission and weakness), such information is available for each of the 648 systems having 200 or more active members, containing in the aggregate 10.07 million active members.[5] If the 28 systems for which the information on OASDI coverage was not available are eliminated, there remain 620 systems with 7.57 million active members, of whom 3.50 million (or 46%) in 221 plans are covered under OASDI. But even this figure, derived for a very large proportion of the universe, is not meaningful – as will be demonstrated next.

Another, and better, way of looking at the matter is to consider the individual listing of the retirement systems with 200 or more members and to examine, on the basis of other information, whether the reporting of "no coverage" is correct – and also to assign the "not available" cases to one of the three categories. It may be noted that several very large systems that have a high proportion (and generally all) covered by OASDI were shown by the Census Bureau as being either "no coverage" or "not available" – notably, Connecticut (general, state; and teachers), Florida (general), Iowa (general), Maryland (general and school), Montana (general and teachers), New York (general and teachers, state; and general, New York City), Pennsylvania (general, state; and school), South Carolina (state), and Wisconsin (general).

Accordingly, the data in the Census Bureau report have been reallocated in those cases where the author has knowledge (from various sources) that the original allocation to "no coverage" was in error. The result is that 6.16 million (or 61%) of the 10.14 million active members of retirement systems are covered under OASDI. This is, of course, a minimum estimate because there are, undoubtedly, many in the "no coverage" or "not available" categories where coverage is present, but the author did not know so.

The adjusted OASDI coverage portion for employees covered under state and local government-employee retirement systems for the Census Bureau data is reasonably close to the corresponding portion derived by the SSA for all state and local government employees, whether or not under a retirement system. Recent data are not available as to whether OASDI coverage is more (or less) likely for state and local government employees not under a retirement system than for those under such a system. However, it seems reasonable to believe that, if anything, the proportion for the former would be somewhat higher than for the latter.[6]

In summary, the Census Bureau data as to the Social Security coverage of state and local government employees who are under a retirement system are significantly flawed, due to incorrect reporting by the retirement systems and to poor statistical procedures of the Census Bureau. In fact, it may well be said that the aggregated data on this subject are too greatly flawed to be of value and should not be used by analysts. Certainly, these data show figures that are far too low as to the extent of Social Security coverage of state and local government employees. Actually, the best indication thereof comes from data developed by the SSA.

1. The tax rate for OASDI is generally combined with that for the Hospital Insurance (HI) portion of the Medicare program. Persons covered for OASDI are always covered by HI, but the reverse is not the case in two instances – (a) all federal civilian employees are covered by HI, but permanent ones hired before 1984 (with certain minor exceptions, such as the president, the vice president, members of Congress, and federal judges) are not covered by OASDI unless they shift voluntarily to the retirement system established for new hires after 1983, which is coordinated with OASDI, and (b) all employees of state and local government entities hired after March 1986 are covered compulsorily by HI whether or not under OASDI (and, further, the governmental entity can cover under HI those employees who, as of March 31, 1986, were not under OASDI-HI).

2. U.S. Department of Commerce, Bureau of the Census, "Employee-Retirement Systems of State and Local Governments" – 1982 Census of Governments, Topical Studies, Vol. 6, No. 1, August 1983 (see especially pages IX, 12, and 22-47). The category of "Some but not all members also covered by OASDI" is not very useful as to the number of members in such systems; what would have been meaningful is the number of members in such plans who were covered, but this statistic is not given (although it is available for individual plans, as discussed later).

3. Even such a distinguished research organization as the Employee Benefit Research Institute (Washington, D.C.) "fell into the trap" of implying that there was little OASDI coverage of state and local government employees. It stated in its *Employee Benefit Notes* for July/August 1985 that "79% of state and local governments did not participate at all, and another 6% limited Social Security participation to less than all employees."

4. Such sources include publications of the National Education Association, various actuarial reports and other material about state and local government employee retirement systems, and the note in the *Social Security Bulletin* referred to previously (with respect to states where there is 100% coverage or virtually so).

5. The report did not give this total, which was obtained by the author from the detailed data.

6. On one hand, OASDI coverage would be more likely, since it would be the only pension protection for such persons. But, on the other hand,

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