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Defensive techniques using employee benefits programs

by Larry S. Schumer

In response to the large volume of acquisitions in recent years, many corporations have implemented defensive measures to make themselves less desirable acquisition targets. A number of techniques involving employee benefits programs can be part of a corporation's anti-takeover posture. These techniques generally attempt to accomplish one or more of the following:

- impose a new, significant liability, or cash commitment, on the hostile bidder,
- place a block of stock in "friendly" hands, or
- increase earnings per share.

Three specific techniques are discussed in this article. The first two impose a significant additional obligation on the acquiring party and involve defined-benefit pension plans and retiree healthcare programs. The third technique is the establishment of a leveraged employee stock ownership plan (ESOP) to accomplish all three of the desired results.

Pension parachutes

Due to extensive press coverage in 1985 and 1986 when several large public companies used it, the pension parachute technique is perhaps the best known employee benefits defensive measure for averting takeovers. Essentially, under the pension parachute concept, a corporation amends a defined-benefit pension plan to provide that, upon certain events, the surplus assets (the amount by which plan assets exceed the value of benefits accrued through a certain date) would be used to provide increased benefits to participants. The amendment's purpose is to prevent a new owner from making use of the surplus through a plan termination and reversion of the surplus. Surplus assets can revert to a company only following termination of a plan and settlement of the plan's benefit obligations through purchase of an annuity contract and/or lump sum payments to participants.

Pension parachutes have taken various forms. One approach automatically triggers the increased benefits following a change in control. This approach does not provide the board of directors with great flexibility but appears to be a stronger deterrent than a second approach where the board can, at its discretion, increase benefits. This second approach may not work if the hostile acquirer gains control of the board.

A third, more drastic approach is to automatically increase accrued benefits. Future benefits would accrue under the prior, lower-benefit formula. This provides a windfall to employees, particularly those who retire or terminate soon after the date benefits are increased. This approach may be appropriate only in limited circumstances when it is very clear that an acquisition will take place and the board has decided that the surplus "belongs" to plan participants.

Adopting a pension parachute involves complex legal issues, including shareholders' rights and employee concerns. Actuarial and accounting issues also exist. While the purpose for adopting one is clear, its effectiveness as an anti-takeover measure is less certain. While these measures have probably been part of lawsuits filed against a company's overall defensive strategy, the courts have not specifically addressed the validity of pension parachutes.

Retiree health benefit parachute

While its name implies similarities to the pension plan arrangement discussed previously, there are significant differences between a retirement health benefit parachute and a pension parachute.

Unlike pension plans, retirement health benefit programs usually are not prefunded. (While prefunding is possible through an Internal Revenue Code Section 501(c)(9) trust known as a VEBA or through a separate account within a pension plan under IRC Section 401(h), tax incentives are limited.)

Therefore, the obligations are likewise unfunded, since benefits are paid for and expended on a "pay-as-you-go" basis. For large companies with large numbers of current retirees and mature active workforces, the unfunded accrued obligations can be staggering.

As a defense against a hostile acquisition, a corporation could amend its health benefit plans (this could also apply to retiree life insurance benefits) to require a cash contribution to fund all or part of the obligation if unsolicited takeover activity reached a predetermined threshold. The contribution could be made to either an existing health benefit trust or a newly established one. Under the Employee Retirement Income Security Act of 1974, amounts contributed to such a benefit plan trust generally would not be recoverable by the contributing company. Since the contribution could be very material relative to some measure of a company's value (for example, net worth or available cash), the deterrent effect could be significant.

We believe this is a new concept, and we are not aware of its adoption as yet by any major corporation. It raises a number of tax, legal, financial, and management issues, including:

- What employee groups would be covered? What benefits would be included? And what assumptions would be used to calculate the potential contribution?
- As for the pension parachute scenario, would the required contribution be automatic upon satisfaction of specified conditions or left to board of directors' discretion?
- If the hostile attempt were defeated, would it be possible to use the funds contributed to the trust for other purposes such as active health benefit costs?
- What are the tax implications of the amount contributed and the trust's investment income?
- For companies that have stressed the discretionary nature of post-retirement health benefits, would the event of funding a portion of or the entire obligation "lock" in the commitment for all participants?

Leveraged ESOP

An employee stock ownership plan (ESOP) is a defined-contribution pension plan with benefits based on the value of shares of company stock held in individual employee accounts.

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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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