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# Employee Benefits and Buyouts

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## Introduction

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Pension plans and group health and welfare plans have significant financial impact on a corporation's financial strength. This is especially true in acquisitions and changes in operations such as plant shutdowns or permanent layoffs. Any reasonably capable employee benefit professional can present either a very positive or negative picture of the pension and benefit programs, depending on assumptions used and the measurement point.

## Employee Benefit, Liability and Cost Issues

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### Overview

Employee benefits are a complex matter in a leveraged buyout (LBO) or acquisition situation. It is imperative to review and evaluate the entire program, find any hidden problems, and decide on a strategy for solving the cost and balance sheet impact—usually all within a short period of time.

For an LBO or acquisition to run smoothly, issues of significant financial impact must be addressed. Improper analysis can lead to improper recommendations. In such cases, a qualified employee benefit consultant can make the difference between a smooth transition and a failure.

### Possible Pitfalls

Areas of particular concern include: unfunded (or unbooked) post-retirement medical or life insurance liabilities and cost projections designed to minimize cost and hidden pension liabilities. These hidden pension liabilities are often associated with future liabilities, resulting from future pay or benefit increases applicable to prior services. Because of the huge financial impact, it is important that the acquiring company utilize specialists who do not represent the selling organization. In our experience, this is evidenced, when an ill-prepared specialist, working for the buyer, has undervalued liabilities by at least 50 percent, or an error of \$137 million on a deal totaling approximately \$500 million.

### Employee Communication

Corporate restructuring is an emotional issue; therefore, after completion of the deal, the announcement to employees is of tremendous importance. It is essential to assure employees of continuity of benefits, i.e., benefits today are the same as they were yesterday. Plain language presentations by senior management are extremely effective. Components of such

communication include: letters, newsletters and presentations to groups of employers.

## Primary Employee Benefit Considerations

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1. Unpaid or Overpaid Liabilities (*at conservative-liberal assumptions*)  
Of special concern are special pensions provisions that may be invoked as a result of layoffs or plant shutdown provision.
2. Adjustments for Understated Costs
3. Allowance for Benefits or Liabilities Resulting from Sale
  - employment/union agreements;
  - creditor/shareholder agreements.
  - executive compensation agreements.
4. Possible Recapture and Creative Use of Fund Assets
  - retirement plans (significant restrictions apply);
  - other employee benefits.
5. Unfunded Retiree Medical or Death Benefits (a gigantic liability in many basic industries) – Liabilities may exceed \$75,000 per active employee and often range between \$20,000 and \$50,000 per retiree.
6. Special Executive Needs and Agreements
  - pre-deal;
  - post-deal.

## Retiree Benefits Have Big Impact

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Retiree benefits, including monthly retirement benefits and post-retirement medical benefits, normally represent the bulk of costs and potential liabilities.

For health and welfare plans, you should consider an estimation of future costs and liabilities associated with retirees on a per benefit basis, *e.g.*, medical, life and dental benefits. Consideration should also include individuals currently collecting disability benefits.

As evidence by recent publicity and increasing scrutiny by the Financial Accounting Standards Board (FASB), the liabilities associated with these benefits can be gigantic; early review of this area, and insertion of

appropriate protective language in preliminary agreements or documents, is *particularly important*.

## Dress It Up For Sale

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Often the selling organization will present cost and liability estimated on an overly optimistic basis; common points of disagreement include:

- Interest assumption rates that are higher than justified on a long-term basis.
- Reflection of retiree medical costs on a pay as you go basis with no reflection of accrued expenses.
- Unrealistic retirement age assumptions, *e.g.*, age 65, when actual pattern may be to retire at age 62.
- Unrealistically high assumed rates of employee turnover.
- No recognition of liabilities triggered by the sale or possible plant shutdowns.
- No recognition of the impact of future pay increases that apply retroactively to presale service.
- Special Considerations – If a facility is moving or work force is being reduced, a partial or total termination may result, thus promoting all benefits to 100% vested status.

For retirement plans, you should consider estimation of liabilities and costs determined on the following basis:

- Accrued liabilities at the date of sale, assuming plan termination.
- Accrued liabilities at the date of sale, assuming an ongoing plan . . . as impacted by future salary or benefit increases applicable to presale service.
- Estimation of current and future recommended contributions, both in dollar amounts and as a percentage of product expenses.
- Estimation of current and future recommended contributions, both in dollar amounts and, if appropriate, stated on a percentage of payroll basis.
- Accountant (FASB) costs as well as cash contributions.

Retiree medical benefits deserve special attention and may be extremely costly. This is particularly true because so little financial information is generally available. It is not uncommon for the unfunded value to exceed \$75,000 per employer, and \$25,000 to \$50,000 per retiree, with related labor costs equaling \$2.50 to \$3.00 per hour.

## ■ Too Late, Too Bad (*or Why Didn't Anybody Tell Me About This Before?*)

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Sometimes a seller is well advised to give away a company. We have seen cases where liabilities associated with under-funded retirement and retire group insurance benefits exceed book value by more than 2 to 1. In some extreme cases, the buyer determines too late that these liabilities made it impossible to continue operation. Unfortunately, if there were other associated companies, the liabilities for these benefits may be transferred to the related companies. Such inter-company liabilities are clearly true for retirement plans; however, the responsibility is not to clear for retiree medical benefits.

## ■ Other Benefits or Related Issues to be Considered

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### **Payroll**

Compensation accrued prior to the acquisition and paid-by-buyer may not be deductible as current business expense if it is included as part of purchase price. If paid by the buyer, the loss of deductible expense should be considered.

### **Vacation Days**

Accrued but not paid, they could be particularly important if unused vacation days are carried forward from year to year.

### **Sick Days**

Particularly a concern if unused sick days are carried forward.

### **Accrued But Not Paid Taxes**

- FICA
- Workers' Compensation (premium and required reserves)
- State Disability
- Federal Taxes
- State and Local Tax

### **Insurance Premiums and Under-Funded Reserves**

- Long-term Disability (examine reserves closely)
- Life
- Medical/Dental, etc. – Reserves for incurred, but not paid claims, should equal approximately three months' premiums or claims. Additionally, if they exist, losses carried forward could be important considerations.

## **Pension Costs Accrued**

- *Defined Benefit*  
Definition of cost is important; FASB required or the actuaries recommended contributions (prior to IRS imposed adjustments) are two reasonable definitions.
- *Defined Contribution*  
401(k), Profit-Sharing or ESOP contributions. Required or normal contributions should be pro rated over the year.

## **Bonuses Accrued**

This includes expenses for the current year as well as those deferred over prior years.

## **Special Employment Agreements**

- Union
- Non-Union (golden parachute)
- Deferred Compensation

## **Tuition Reimbursement**

For courses completed or in progress, but not paid.

## **Special Pension**

- Early Retirement Incentives
- Unfunded or Under-Funded Top Hat Plans
- Deferred Compensation Agreements

## **Multi-Employer Pension Plan (Super big bucks may be involved)**

- *Current Liabilities*  
Have all required contributions been made?
- *Withdrawal Liabilities*  
It certainly is not safe to assume that you can simply cease participating in a plan; there may very well be large unfunded withdrawal liabilities. (Check this one out carefully or get ironclad warranties backed by secured contingencies.)

## **Non-Qualified Salary Reduction Plans**

Pay concessions may be automatically reinstated and immediate payment required in event of sale (*especially important if you bought it*) or higher future profits.

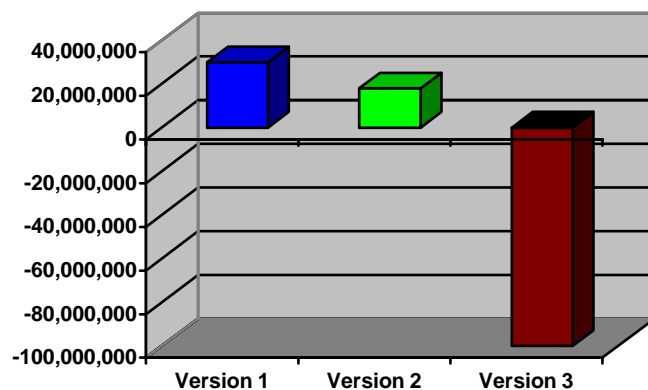
## Layoff or Plant Shutdown Benefits

These benefits are especially prevalent in basic industries and may double the total value of benefits provided.

## Severance Pay Benefits

- Top Executives
- Others

**Assets Vs. Liabilities of One Employee  
Benefit Program**



## Useful Information

Experience indicates that sellers often do not willingly provide information that may prove harmful to their cause. In some cases, we have experienced attempts to mislead, including repeated incorrect verbal warranties.

While a very experienced employee benefit expert, specializing in advising buyers, can provide quality preliminary analysis with minimal information, the better the available data, the better everyone's sense of comfort will be.

In order to answer all of the questions one might ask in measuring plan liabilities and costs, a great deal of information about the acquired company's benefit program is required. It is difficult to obtain such information in the time available, but, in an ideal situation, the following documents would produce most of the necessary information:

- A copy of the sales agreement;
- A list of all plans sponsored by the seller (retirement, group insurance, supplemental unemployment, executive benefits);
- Employee census data;
- A copy of published general information on the company including:
  - annual reports; and
  - 10-K reports.
- Total and complete copies of all collective bargaining agreements;
- Copies of 5500 filings (group insurance and retirement plans);
- Defined benefit pension plan information:
  - Plan documents, employment contracts and deferred compensation arrangements;
  - Trust agreements;

- Employee booklet (Summary Plan Description);
- Latest actuarial reports (three years);
- Trust reports (most recent available);
- Accountant's audits; and
- Firm name and phone number of the plan actuary.
- Group Benefit Information (*Insurance Policies/Contracts*):
  - Complete and current copies of all group benefit policies and contracts for service arrangements;
  - Identification of any benefit changes that have occurred during the most recent three years, and the effective dates of such changes;
  - Copies of any benefit descriptions distributed to employees;
  - For each benefit, a current list of monthly premium or billing rates for each group benefit plan and copies of latest premium statements, if applicable;
  - A list of premium rates in effect for the past three years and effective dates of any changes (*increases or decreases*);
  - List of due or overdue premiums relating to permitted grace periods or premium lags permitted under insurance contracts;
  - Insurance Company Renewals: copies of any insurance company renewal reports for the last three years. If not available, statement listing total premium paid, claims paid, reserves and retentions, by year;
  - Names and addresses of all brokers, consultants and agents for each group benefit plan; and
  - Indication of what, if any, post-retirement coverage is provided, and how funded or otherwise accounted for (a) medical, and (b) life. Make sure these items are clear.

As evidenced by the above chart, the financial view of employee benefit programs may vary substantially. Obviously, the numbers utilized will reflect the bias of the preparer.

## ■ Representations and Warranties Are Extremely Important from Seller to Buyer

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When the buyer is taking over a plan, the new management will want to be assured that it is not taking on liabilities beyond those to which it has agreed. Hence, the acquisition agreement will typically contain warranties from the seller. Some examples of appropriate warranties follow:

1. There are no completed, pending or intended plan termination by seller or other members of the same controlled group.

2. There have been no reportable events other than those disclosed.
3. All plans covering employees in the sold company have been identified and are included in the warranted list.
4. All such plans requiring IRS qualifications are qualified.
5. All plans and trusts have been administered in accordance with ERISA, and each plan funded in accordance with ERISA.
6. All filings, reports and participant disclosures have been made.
7. There are no pending or threatened lawsuits regarding the plans.
8. Warranties and guarantees regarding value assets, contribution levels and present value of liabilities should include specific dollar amounts which are included in a table. (Assumptions identified with each plan would be ideal.)
9. All plan contributions, required by law and union agreements, are current.
10. Contributions have been made to cover all accrued liabilities as of the date of the sale including: retirement plans, medical insurance, SUB plans, workers' compensation and other employee benefit plans.
11. Cost data provided includes reasonable estimates of costs for the next full year. The selling company does have access to recent claims experience and should be able and willing to disclose this information. (Some agreements even contain guarantees by the seller regarding maximum annual costs under a plan for some future period of time based on current levels of employment.)
12. Except as outlined in Attachment . . . , there are no current or future retirees receiving medical benefits under plans sponsored by the employer.
13. Except as outlined in Attachment . . . , there are no life insurance benefits (death benefits) provided to current or future retirees.
14. For the most recent calendar year, medical benefits paid to retirees equaled ...
15. For the most recent calendar year, death benefits paid to retirees equaled ...
16. Asset Values have not declined more than ...% since the most recent full financial report.
17. Plan assets, between most recent published date and the closing date, will be invested in accordance with the Plan's normal investment policy.
18. Employment practices affecting benefit accrual, from today's date to the closing date, will be in the usual course of business.
19. Unfunded liability (difference between liabilities and the assets), as of the closing date, will not exceed ..., or seller will pay the excess to the buyer or contribute the excess to the plan.

It is difficult to get up-to-the minute precise data on plan asset values and accrued pension liabilities. While accrued liabilities can be projected forward to the date the sale is closed (closing date), based on stated assumptions and the last demographic data entered in the actuary's computer system, asset values can obviously change from day to day. These issues may be handled in the acquisition agreement by warranting the accuracy of asset and liability values as of a specific date.

## ■ Warranties and Possible Agreement Language Relating to Retiree Medical, Life, Health and Welfare Benefits

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In the case of retiree medical, life, and health and welfare benefits, most typical due diligence checklists and standard language is very weak. Consequently, preparing representations and warranties in this area may take more time and attention. As a buyer or lender, it is certainly worthwhile to spend the required time. Some of the important points to include are:

### **Warranties**

- All Plans covered have been disclosed.
- Full disclosures of benefits being provided, or required to be provided by the seller to current or future retirees have been made, including post-retirement medical benefits and post-retirement benefits.
- Full assumption of liabilities, relevant to individuals currently not working due to illness, sickness or accident remain with the seller. If not, the present value of all liabilities associated with their employers should be provided in an appendix and should include:
  - Long-term Disability Benefit
  - Life Insurance Benefit
  - Medical Benefits
- Liabilities for retiree medical and life benefits attributable to service prior to the date of sale will be assumed by the seller on a proportionate basis based on service to date of sale divided by all service to date of benefit commencement (this is a very aggressive stance, but worth trying).

### **Possible Agreement Language**

- The selling company agrees to provide, at its expense, medical benefits for all current retirees and upon retirement, all current employees over the age of 50.
- The liability for post-retirement medical and life insurance benefits for current retirees is the sole responsibility of the selling company, the

liability for future retirees will be shared on a pro-rata basis by the selling and purchasing company based on service to the date of sale divided by total service to retirement.

## ■ Communication Among Advisors

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Verbal communications should be summarized in writing and circulated to everyone involved. Very clear communication channels must be established and maintained. When working with advisors in analyzing a prospective deal, or in developing benefit and administrative structures after the deal is completed.

## ■ In The Beginning

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In order to meet employee benefit objectives, it is important that all possible related information is researched. Make sure it is agreed that satisfactory completion of the project is a joint responsibility, and significant time and commitment of resources will be required from all parties. We find it useful to gather pertinent information relating to the buyout. This information includes:

- A list of key contacts, affiliations, titles and telephone numbers.
- Background, including the philosophies of the deal and of the buying and selling companies.
- Special restrictions, *e.g.*, no benefit changes for three years. In the event of termination, excess assets (as determined at the anniversary prior to closing date) revert to participants or prior owner (even if plan is terminated in 15 years).
- Clarify timing expectations and develop a rough schedule.
- Complete a data needs, sources and list of potential roadblocks.

Accurate data, including current as well as historical information, will never be easily available or provided in a timely fashion (and it won't really be accurate).

- By publishing a list of chores, responsible parties and due dates. Clearly establish appropriate roles.

## Employee Communication

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Employee communication is of utmost importance, both initially and on an ongoing basis.

In general, communicate with management and other employees early, often and with candor; don't ignore the important of employee benefits in the communications, and don't over promise.

The employee's list of top concerns include job security, direct pay, work environment and employee benefits. Attention to each of these when communicating, is imperative.

## Summary

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Important employee benefit issues relevant to buyouts include the following:

### **Hidden Costs and Liabilities**

Look closely at hidden costs and liabilities; hidden liabilities can significantly exceed the total supposed value of the deal. Sometimes the best deal is one you walk away from after your employee benefit review is completed.

### **Quality of Advisors**

Make sure responsibilities for due diligence are assigned and carried out by someone with broad knowledge. Understated estimates of liabilities by experts working for the buyer can be very damaging. A good, experienced advisor can provide quality timely advice, which will pay handsome dividends.

### **Communications with Employees**

Pay attention to transition matters and employee communications; delivery of benefits is *extremely important* in maintaining high morale.

### **Representations and Warranties are Extremely Important**

Get as specific as possible and get them in writing.

### **Communication with Management and Other Advisors**

Make sure your employee benefit advisor has adequate contact with other management and other professionals involved in the deal.

### **Early Is Better**

Based on our understanding of specific industries (get us, or another highly qualified advisor involved early, even if it's only for a sniff test). Remember \$10,000 of prevention could easily be worth \$10,000,000 of treatment.