



ABC Company

Compensation and Benefits Issues Arising from Divestitures, Mergers and Acquisitions

First Discussion Draft

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Introduction

ABC Company is interested in identifying issues that arise surrounding compensation and benefits in divestitures, mergers and acquisitions. While the outline that follows focuses mostly on mergers and acquisitions, the issues explained are applicable to any situation that may involve a change in ownership of a corporation.

OVERVIEW

Too often when completing the arrangement for sale or divestiture, companies have been astonished by the magnitude of the unfunded and unrecorded liabilities attributed to the post-retirement medical, active health and welfare, executive compensation and pension plans of the target company.

These liabilities may be the result of (but not limited to)

- The selling entity not fully reflecting on their balance sheet and/or income statement the liabilities or expense items associated with their employee benefit programs. The failure to represent these programs can result in dramatic differences between pre- and post-transaction accounting. In fact the amount of goodwill included in a purchase price can be significantly affected by these unrecognized benefit liabilities.
- Certain benefit obligations (e.g., severance programs, early retirement programs, golden parachutes etc.) being triggered thereby increasing liabilities due to a change in corporate structure.
- Withdrawal liability claims pursuant to the divestiture of a division or post-sale closing of a facility which participated in a multi-employer plan. This liability can be very substantial if the plan is not well funded, and many plans are not.
- Claims runout, benefits for former employees and COBRA (the Consolidated Omnibus Reconciliation Act of 1985) coverage under the sellers employee health and welfare programs.
- The differences from one company to the next of benefit levels and retirement income philosophy. As a result of a corporate merger or acquisition, benefit disparities may arise which will have to be resolved to maintain employee satisfaction with the benefit programs of the post-transaction organization.

- The implementation of performance driven benefit and compensation designs to promote the business goals of the new organization.

Companies considering a buyout or divestiture typically go through a planning process with regard to the successful operation of the post-transaction entity.

A. Buyer's Objectives

1. Quantification of benefit and compensation liabilities that have an impact on the value of acquired business.
2. Allocation of pre-transaction benefit and compensation liabilities to Seller, to limit financial burden on post-transaction business.
3. Specificity of language in Purchase/Sale Agreement
 - Warranties and representations from the seller that, up to the date of acquisition, all ERISA requirements have been met
 - Clarity with regards to assumptions and methodologies
 - How previously retired and terminated employees will be handled
 - Potential withdrawal liabilities
 - Purchase price adjustments due to employee benefit liabilities

- Avenue of resolution of post-closing disagreements

B. Important Distinctions

1. Four Types of Employees

a) Collectively Bargained Actives

- Single employer
- Multi-employer
- Acquisition agreement must address treatment of labor agreement. (Pre-transaction discussion with union may be necessary)
- Generally less flexibility for Buyer in post-transition benefit design

b) Non-Collectively Bargained Actives

- Generally more flexibility for Buyer
- Broader variety of special programs may be in place, requiring specific analysis

c) Retired

d) Inactives

- Disabled

- Laid Off
- Leave of Absence
- Vested Terminations

2. Two kinds of Benefit and Compensation Liabilities

a) "Accrued" Liability

- Liability for benefits and compensation earned, in whole or in part, prior to transaction, but payable after transaction.
 - e.g.,
 - "past service" component of pensions
 - post-retirement health benefits
 - incurred but unpaid health claims
 - change in control agreements with key executives
 - non-qualified deferred compensation arrangements
 - stock options/equity-linked promises
- Area of confusion in the definition of accrued liability can lead to “imaginary” surplus.
 - actuarial accrued liability as determined by a particular actuarial cost method; also known as accrued liability, actuarial liability, actuarial reserve.
 - accumulated benefit obligation (ABO) as determined in accordance with FAS 87.
 - PBGC Title IV Liability if the plan terminates, the PBGC may assess the employer up to 30 percent of its net worth, or 75 percent of the unfunded insured benefit (excess of the value of insured benefits over pension assets). The actuarial assumptions for

PBGC purposes may be different from those used under the plan's normal valuation and accounting requirements.

b) "Post-transaction" Liability

- Liability for benefit and compensation claims that will be incurred and paid after transaction.

e.g.
 - future active employee health claims
 - "future service" component of pensions
 - severance payments

- Cash flow and operational impact, after acquisition.

RETIREMENT BENEFIT PROGRAMS

A. Background

1. Types of Retirement Plans

(a) Defined Benefit Plans*

- pay related benefits
- flat dollar benefits

*** including terminated plans**

(b) Defined Contribution Plans

- Profit Sharing Plans
- §401(k) plans
- ESOPs

(c) Multiemployer Plans

2. Funding Arrangement

(a) Trust Fund

- Dedicated assets

(b) Ongoing Contribution Requirements

- Mandatory: generally for defined benefit
- Discretionary: generally for profit sharing

3. FAS 87

(a) Covered Plans

- Single employer plans
- Multiemployer plans
 - cost and liability based on current contributions
- Multiple employer plans
 - considered single employer plans
- Non U.S. Pension Plans

(b) Accounting Treatment

- Annual expense
- Balance sheet recognition

- Disclosure
- (c) Impact of purchase accounting rules
 - unfunded projected benefit obligation must be booked

B. Pre-Transaction Issues

1. Warranties and representations

- Up to the date of acquisition all ERISA requirements have been met
- PBGC premiums have been paid by seller
- Seller pays contributions due up to the date of closing

2. Quantification of Liabilities

- (a) Funded status of defined benefit plans
 - Termination basis, Valuation basis, Accounting basis
 - imaginary plan surplus
 - Projected basis: "maturation problems"
 - Importance of actuarial assumptions

-- alternative assumptions and liability measures

(b) Impact of funded status

- Purchase price adjustment
- Transfer of plan sponsorship
- Difficult if plans are underfunded

3. Allocation of Liabilities: Disposition of Seller's Plans

(a) Buyer seeks to avoid liability for

- retirees' benefits
- active employees' benefits, to the extent accrued at acquisition

(b) "Mirror" Plan vs. Plan transfer

- Legal and tax requirements
- Treatment of subsidized benefits
- Problems with pay-related plans: "backfill"

C. Post-Transaction Issues

1. Design Options for Ongoing Plans

- Union plans subject to bargaining agreement
- Change in salaried plan may be appropriate
- Cash flow considerations vs. expense

2. Compliance and Administrative Issues

- Timing of Plan implementation
- Resource requirements
 - internal vs. outsourced
 - scope
 - cost

D. Special Issues

1. Multiemployer Plans

- Quantifying withdrawal liabilities

2. Defined Contribution Plans

- Vesting transition

- Treatment of prior company stock in 401(k) plans
- Outstanding Loans

3. International Programs

- Identifying material foreign benefit commitments

POST-RETIREMENT BENEFIT PROGRAMS

A. Background

1. FAS 106

- Scope
 - Primarily health
 - Life insurance
 - Tuition assistance
 - Day care
 - Legal service
 - Housing subsidies
- Covered Plans
 - Single employer
 - Multiemployer (remains pay as you go)
 - Multiple employer (plans considered single employer plans)
 - Individual contracts
 - Non U.S. plans
- Unfunded "Past Service Liability" to be booked on acquisition (offset by Goodwill)
- Ongoing expense to reflect accruals over working lifetime
- Future inflation to be reflected in current liability

2. Companies becoming aware of significant liability

- Unfunded promises
- Extremely high medical inflation
- Demographic changes: ratio of actives to retirees deteriorating
- Prior accounting was "pay as you go"

B. Pre-Transaction Issues

1. Quantification: What is magnitude of liabilities?

- Important for purchase price adjustment
- Actuarial basis is critical
 - discount rate
 - medical trend
 - retirement rates

Under most retiree life and health plans, an employee retiring at age 55 receives a much greater total retiree benefit than an employee retiring at age 65.

- Extreme uncertainty in estimates

2. Allocation: Who is responsible for liabilities?

- Buyer often does not take liability for current retirees
- Difficult to divide active liability into past and future service portions explicitly
- Typical approach: buyer takes liability for all actives with purchase price adjustment reflecting imputed past service liability
- Benefits can be changed for actives after transaction (more difficult for employees eligible for retirement and union employees)

C. Post-Transaction Issues

1. Future impact on Company Financial Statements

- Company's ability to control
 - Medicare Risk HMO
 - Defined Contribution
 - Employee Contributions
 - Voluntary Insurance
- Sensitivity to economic environment

2. Reservation of design options

- Section 402(b)(3) of ERISA

- danger for buyers with respect to the ability of the company to reduce benefits under all ERISA-covered plans (particularly significant for welfare plans)
- provides that one of the requisite features of any ERISA plan is to provide a procedure for amending the plan and for identifying the individuals who have the right to amend the plan
- Different groups of employees
- Bargaining issues

WELFARE BENEFIT PROGRAMS

A. Background

1. Highly visible to employees

- Wide utilization
- Third party administrator/payer

2. Significant P&L impact

- 15% to 20% medical plan cost inflation
- Significant administrative and compliance effort

B. Pre-Transaction Issues

1. Allocation: Liability and cost problems

- When does claim liability cease?
- Who is responsible for employees not working on closing?
- Adequate cost and reserve recognition
- Identifying potential sources of cost containment/efficiencies of scale

- Legal compliance

2. Operational Considerations: Providing continuity of coverage

- Old administrator/New administrator
- Is funding method appropriate?
- Time extensions of seller's program
- Effect of bargaining and purchase agreements

C. Post-Transaction Issues

1. Reservation of design options and impact of financial structure of program

- Do plans meet objectives of new ownership?
- Can plans be made more cost-effective?
- Competitive bidding
- Future cost patterns

2. Plan operation

- Financial reporting and control
- Claim processing

- Continuing legal compliance

D. Other

1. Impact of Health Care Reform

- Pre-Transaction
- Post-Transaction

POST-EMPLOYMENT BENEFITS

A. Background

1. FAS 112

- Recognize liabilities for post-employment benefits provided to former and inactive employees who are not retirees, and their dependents
- Scope
 - salary continuation
 - severance pay
 - disability and workers compensation
 - supplemental unemployment benefits
 - continuation of life and health care coverage
- Impact may be significant

B. Pre-Transaction Issues

1. Quantification: What is magnitude of liabilities?

- Important for purchase price adjustment
- Accounting basis is critical
 - cash-basis accounting employers experience the greatest increase since terminal accrual accounting generally applies to most post-employment benefits covered under FAS 112

2. Allocation: Who is responsible for liabilities?

- Important if employer expects significant cutbacks in the work force

C. Future impact on Company Financial Statements

- assess current accounting procedures for reporting the expense of offering these benefits
- Examine which accounting alternatives (as allowed under FAS 112) and strategies are appropriate
- Consider plan redesign if necessary
- Determine the timing of adopting FAS112

EMPLOYEE COMPENSATION PROGRAMS

A. Nonqualified Executive Compensation Arrangements

1. Types of Programs

a. Deferred Compensation

- Individual contracts
- Plans for classes of senior management/bonus & salary deferrals

b. Equity-based Compensation

- Stock, Performance and Premium Options
- Stock Appreciation Rights
- Restricted Stock/Dividend Investment
- Dividend Equivalency Programs
- Other in tandem grants/awards

c. Golden Parachutes

d. Possible earnings charges or disclosure under FASB rule

- e. SEC Proxy Disclosure requirements, if public
- f. Possible target ownership concerns.

2. Funding Arrangements

- a. General Assets
- b. Earmarked Assets
- c. Rabbi Trust
- d. Secular Trust
- e. 403(c) Annuity
- f. COLI
- g. Surety Bond

3. Impact of Transaction on Nonqualified Programs

- a. Trigger for golden parachutes and special deferred compensation provisions
- b. Effect on stock options, SARS, and other equity-based compensation

4. Post-Transaction Plan Design

- a. Ongoing role of pre-transaction management
- b. Importance of incentive compensation
- c. Attracting, retaining and motivating executives
- d. Linking all plans to the new business and operating strategies including appropriate performance measures.

B. General Employee Compensation Programs

1. General Employee Compensation Programs

- a. Method of job evaluation
- b. Job descriptions
- c. Salary Structure
- d. Pay Practices and Policies

2. Salary Management

- a. Performance Evaluation Guidelines
- b. Geographic Differentials

- c. Salary Management Policies and Practices

3. Relocation Policies

- a. Moving Expenses
- b. House Hunting
- c. Temporary Living
- d. Purchase/Sale Assistance
- e. Mortgage/Cost-of-Living differentials
- f. Loans

4. Post-Transition Issues

- a. When and if to merge policies and programs
 - 1. Similarities and differences between business lines
 - 2. Geographic locations
 - 3. Common Labor Markets
 - 4. Transfers of employees between units
- b. Severance Policies
 - 1. Pay continuation
 - 2. Outplacement Services

CHECKLIST FOR EMPLOYEE BENEFIT AND COMPENSATION DUE DILIGENCE

The following items would be requested by ERL Consulting in order to initiate the review of existing benefit liabilities and projected future costs of employee benefit and compensation plans for any entity that is to be the subject of a restructuring.

I. PURCHASE/SALE AGREEMENT

- 1) Sections pertaining to employee benefit plans.
- 2) Sections pertaining to Buyer's obligations to employees at Closing Date.
- 3) Sections pertaining to disposition of collective bargaining agreements.

II. SINGLE EMPLOYER DEFINED BENEFIT PENSION PLANS

- 1) Plan documents and amendments to date.
- 2) Trust Agreements or Insurance Contracts.
- 3) Summary Plan Descriptions.
- 4) Most recent IRS Determination Letter.
- 5) Form 5500 filing, including Schedule B, for last two years.
- 6) All Form 5310 filings for prior plan mergers, consolidations, or spin-offs, for last five years.
- 7) Actuarial valuation reports for last two years.
- 8) Statement of required disclosures under FAS87, last three years.
- 9) Audited, financial statement of Plan assets, for last two years.
- 10) Trustees or Insurance Company reports for last two years.
- 11) Statement regarding pendency of any issues before IRS, DOL or PBGC.
- 12) Collective bargaining agreements relating to plan participation, if any.

III. MULTIEMPLOYER DEFINED BENEFIT PENSION PLANS

- 1) Plan documents and amendments to date.
- 2) Trust Agreements.
- 3) Summary Plan Descriptions.
- 4) Collective bargaining agreements.
- 5) Calculation of potential withdrawal liability, pursuant to ERISA §4221(e).
- 6) Statement regarding pendency of any claim against the employer for complete or partial withdrawal.
- 7) Actuarial valuation reports, last two years.
- 8) Record of employer contributions, last three years.
- 9) Audited financial statement of Plan assets, last two years.

IV. DEFINED CONTRIBUTION PLANS (INCLUDING PROFIT SHARING PLANS, §401(k) PLANS AND ESOPs)

- 1) Plan documents and amendments to date.
- 2) Trust Agreements.
- 3) Summary Plan Descriptions.
- 4) Most recent IRS Determination Letter.
- 5) Form 5500 filing, last two years.
- 6) Audited financial statement of Plan assets, last two years.
- 7) For §401(k) plans, records of Average Deferral Percentage and Average Contribution Percentage tests, last two years.
- 8) Collective bargaining agreements relating to plan participation, if any.

V. ACTIVE EMPLOYEE LIFE AND HEALTH BENEFIT PLANS (WELFARE PLANS)

Items below are requested for each of the following plans:

- a) Health Insurance (Medical, Hospitalization, Major Medical, Dental, Vision, etc.)
 - b) Life and Accidental Death & Dismemberment Insurance
 - c) Short- and Long-Term Disability Insurance
 - d) Business Travel Accident Insurance
-
- 1) Plan documents or insurance contracts, including §125 arrangements.
 - 2) Summary Plan Descriptions.
 - 3) Collective bargaining agreements relating to plan participation, if any.
 - 4) Form 5500 filings, last two years.
 - 5) Description of basic funding method for each coverage - i.e., insured, minimum premium self-insured, 501(c)(9) trust.
 - 6) Description of any special insured arrangement - e.g., retrospective rating agreement, premium delay, claims stabilization reserve, pooling arrangement, individual or aggregate stop-loss coverage.
 - 7) Financial experience by coverage for most recent two years:
 - i) premiums paid;
 - ii) claims paid;
 - iii) claims incurred;
 - iv) administrative expenses;
 - v) changes in reserve;
 - vi) other retention;
 - vii) dividends.

- 8) Statement of all reserves and by whom held - e.g., contingency, catastrophic, premium stabilization.
- 9) Census of covered employees, including relevant coverage data - e.g., number of dependents, salary levels.
- 10) Specification of employee contributions.
- 11) If funded through 501(c)(9) trust VEBA:
 - i) Most recent Form 1024 filing;
 - ii) IRS Determination Letter;
 - iii) Audited financial statement of plan assets, last two years;
 - iv) Actuarial certification under IRC §419A, if any, last two years.

VI. POST-RETIREMENT LIFE INSURANCE AND MEDICAL BENEFITS

- 1) Plan documents and amendments to date.
- 2) Summary Plan Descriptions.
- 3) Form 5500 filings, last two years.
- 4) Description of funding arrangement, if any.
- 5) Financial experience, last two years. See Item V (7), (8).
- 6) Census of covered retirees.
- 7) Specification of employee contributions.
- 8) Description of accounting treatment and any quantification of liabilities under FASB 106.
- 9) If funded through §501(c)(9) trust, see Item V (11).

VII. NON-QUALIFIED (EXECUTIVE) BENEFIT PLANS

- 1) Plan documents, descriptions, or contracts.
- 2) Description of funding arrangements - e.g., "rabbi" or "secular" trusts.
- 3) Actuarial valuation reports, last two years.
- 4) Statement of required disclosures under FAS87, last three years.
- 5) Census of covered employees.

VIII. EXECUTIVE AND NON-EXECUTIVE COMPENSATION

- 1) Name, current title, job description, salary grade and location.
- 2) Current base salary.
- 3) Most recent salary/merit increase percent and effective date of increase.
- 4) Most recent bonus and effective date of bonus.
- 5) Current salary structure(s) and salary increase policy/guidelines.

- 6) History of all stock options, SAR's, restricted stock and other equity-based compensation including:
 - number of shares granted;
 - Grant date;
 - Grant price;
 - Fair market value on grant date.
- 7) Type and annual cost to the company of each perquisite (cars, club memberships, etc.)
- 8) Current performance appraisal program description and sample completed appraisal forms.
- 9) Communications to executives regarding incentive goals (letters, documents, etc.)
- 10) Most recent performance reviews for key executives
- 12) Copies of annual incentive plan documents and long-term incentive plan documents (stock option plans, restricted stock plans, cash performance plans, etc.), for current plans.
- 13) Examples of stock option/SAR/restricted stock/equity-based compensation agreements.
- 14) Copies of employment contracts, change of control agreements and non-qualified deferred compensation agreements.
- 15) Relocation policies and procedures.
- 16) Severance policies and procedures.

Note: Above list is intended to be illustrative. In any given case, initial review could warrant requests for additional information.