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Report to the Chairman, Subcommittee on Oversight, Committee on Ways and Means, House of Representatives

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PENSION PLANS

Terminations, Asset Reversions, and Replacements Following Leveraged Buyouts

GAO

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Human Resources Division

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The Honorable J.J. Pickle
Chairman, Subcommittee on Oversight
Committee on Ways and Means
House of Representatives

Dear Mr. Chairman:

In this report, we respond to your request for information on what happened to the pension plans of companies acquired in leveraged buyouts (LBO). As agreed with your office, we focused on whether (1) pension plans were terminated after the LBOs, (2) companies recovered excess assets from terminated plans, (3) terminated plans were replaced, and (4) the financial condition of continuing plans changed after the LBOs.

An LBO involves the purchase of a company with mostly borrowed funds, using the company's assets as collateral. From January 1982 through March 1990, 345 publicly traded companies became privately owned through LBOs, at a total cost of about $150 billion.

We reviewed a sample of 121 public companies whose LBOs were announced from January 1982 through December 1987. We identified 558 defined benefit plans[1] sponsored by the companies before the LBO and determined what happened to the plans after the LBOs were announced. For each terminated plan, we obtained financial data for it at termination, as well as information on any asset recovery and replacement plan. For plans that continued, we compared the ratio of assets to liabilities before and after the LBO.

Results in Brief

Twenty percent of the defined benefit plans sponsored by the companies that we reviewed were terminated after the LBO. Most plans that were terminated were overfunded, and the terminations resulted in a reversion of excess assets to the company. Most terminated plans were replaced, and most active participants were to be provided replacement defined benefit plans. We could not determine if participants received the same benefits from the replacement plan as from the terminated plan. Information about the financial condition of plans that continued

[1]In this type of plan, the company promises a specific benefit that is generally based on a worker's years of service and earnings. The company is responsible for funding the plan sufficiently to pay promised benefits.

was limited, but when available, showed that the financial condition of most plans did not deteriorate after the LBO.

Background

From January 1982 through March 1990, 345 publicly traded companies became privately owned through LBOs, at a cost of about $150 billion. In some LBOs, up to 90 percent of the acquisition price was borrowed, leaving the company with a significant amount of post-LBO debt that in some cases could not be paid off without selling corporate assets or reducing other expenditures.

As LBO activity increased, several concerns were raised about the ability of LBO companies to meet their pension obligations. One concern was that companies would terminate overfunded pension plans and use the excess assets to help finance LBOs and would not replace terminated plans. Another concern was that, to conserve funds to pay interest on the debt, companies would reduce funding for continuing plans.

The Employee Retirement Income Security Act of 1974 permits a company to terminate an overfunded single-employer defined benefit pension plan. After the company has satisfied the plan's obligations to all participants, remaining assets may revert to the company. The company is under no obligation to replace terminated plans.

Before 1986, a company could also voluntarily terminate a defined benefit plan that was underfunded. Since January 1986, however, an underfunded plan termination is permitted only (1) if the company is undergoing bankruptcy proceedings and has court approval for the termination, (2) if the termination is required to allow the company to pay its debts and continue in business, or (3) to avoid burdensome pension costs caused solely by a decline in the company's work force. When a plan terminates without enough assets to pay benefits, the Pension Benefit Guaranty Corporation (PBGC) acquires the plan's assets and assumes responsibility for paying the benefits, up to certain guaranteed limits.[2] The company, however, remains liable to PBGC for the full amount of any underfunding.

[2]PBGC is a federal government agency established under title IV of the Employee Retirement Income Security Act of 1974 to insure the benefits of participants in private sector defined benefit pension plans.

Scope and Methodology

LBOs are used to acquire all or part of either publicly traded or private (not publicly traded) companies. We focused on LBOs in which entire publicly traded companies became privately owned. We did this because these LBOs accounted for over half the value of all LBOs, and more information was available about them than about LBOs involving private companies or parts of publicly traded companies. We focused on LBOs announced from January 1982 through December 1987 because they had been identified by the chief economist of the Securities and Exchange Commission (SEC), and most of the information required for our analyses was available from the Internal Revenue Service (IRS). We excluded defined contribution plans from our study because a company generally cannot obtain a reversion of assets from this type of plan.[3]

From SEC's chief economist we obtained the names and LBO announcement dates of 244 publicly traded companies whose LBOs were announced from January 1982 through December 1987. We eliminated 22 companies because required information could not be obtained. We identified subsidiaries for the remaining 222 companies and determined the number of employees for each company and subsidiary in the year before the LBO was announced from a directory of corporate affiliations.[4]

Our review focused on the 121 companies with the most employees in the year before the LBOs were announced. Together, these companies represented 95 percent of the employees of the 222 companies whose LBOs were announced from January 1982 through December 1987.

Using employer identification numbers provided by IRS, we identified defined benefit plans sponsored by the selected companies and their subsidiaries in the year before the LBOs were announced. We obtained information on assets, liabilities, and participants for the identified plans for the year before the LBOs were announced and for each subsequent year for which data were available. This information was obtained from IRS's computerized file of pension plan annual reports (form 5500).

At PBGC we determined which plans were terminated after the LBOs and obtained information on (1) why the plan was terminated; (2) plan

[3]In this type of plan, a formula specifies the rate at which the company makes contributions to each participant's account. The retirement benefit consists of the contributions and the investment earnings of the account. If the plan is terminated, each participant receives the amount accumulated in his/her account. There are no excess assets that could revert to the plan sponsor.

[4]Directory of Corporate Affiliations: Who Owns Whom, National Register Publishing Company (Wilmette, Ill., 1981-86).

assets, liabilities, and participants at termination; (3) whether there was an asset reversion; and (4) if a replacement plan was to be provided. For most terminations we verified the information in PBGC's computerized file with termination documents filed by the companies with PBGC.

To determine how the financial conditions of an individual plan that continued changed after the buyout, we compared a plan's funding ratio in the year before the LBO was announced with the ratio in the last year for which financial data were available, 1986. The funding ratio[5] was calculated by dividing the plan's assets by the actuarial value of participants' accrued benefits.[6] Because 1986 was the last year for which financial data on plans were available, this comparison could only be made for plans of companies whose LBOs were announced in 1982 through 1985.

We also computed weighted average funding ratios for all other defined benefit pension plans with 100 or more participants using form 5500 data. We compared the changes in the funding ratios of these plans to the changes in the weighted average funding ratios of continuing plans of LBO companies for the same years to determine whether funding trends differed.

We also reviewed the results of studies of LBOs and pension plans made by PBGC, the Congressional Research Service, and private institutions.

Our work was done between July 1989 and September 1990 in accordance with generally accepted government auditing standards.

Twenty Percent of Plans Were Terminated After LBOs

Before the LBO announcement, companies in our sample sponsored 558 defined benefit plans. After the announcement, 114 of these plans were terminated. Terminated plans represented about one-fourth of plan participants.

As shown in table 1, we identified 558 defined benefit plans sponsored by 107 of the 121 companies in our sample. Fourteen companies did not

[5] A ratio greater than 1.0 indicates the plan may be overfunded or may have more than enough assets to cover obligations to participants. A ratio of less than 1.0 indicates that the plan may be underfunded or may not have enough assets to cover obligations.

[6] Accrued benefits consist of the vested benefits earned by plan participants and the benefits earned by participants who have not yet met the plan's vesting requirements. These benefits are based on the assumption that the plan will continue.

sponsor any defined benefit pension plans in the year before the LBOs were announced.

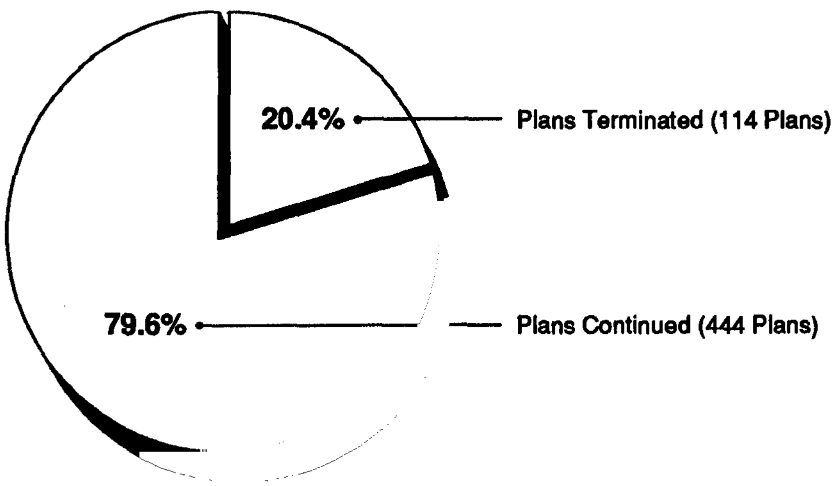
Table 1: Plans of Sample Companies Before LBO Announcements by Funding Status

Dollars in billions

Status	Plans	Participants	Assets	Liabilities
Overfunded	343	663,358	$7.4	$5.2
Underfunded	215	252,841	2.2	3.1
Total	**558**	**916,199**	**$9.6**	**$8.3**

As figure 1 shows, 114 ongoing plans were terminated after the LBO.

Figure 1: About 20 Percent of Pension Plans Were Terminated After LBOs



Of the 107 companies that had sponsored plans, 54 (50.5 percent) terminated at least one plan after the LBO. The terminated plans had $2.3 billion in assets, $1.7 billion in liabilities, and about 218,000 participants. Of the 114 plans that were terminated, 99 were overfunded, 9 had assets equal to benefits, and 6 were underfunded.

PBGC studied 278 LBO transactions that occurred from 1980 to 1987 and a control group of 220 firms from the same industries. PBGC's study indicates some relationship between LBO announcements and plan terminations. PBGC found that companies for which LBOs were announced terminated 4.5 percent of their plans in the year of and the year following the announcement and about 2 percent in other years. The control group terminated about 2 percent of their pension plans each year.

Reasons for Terminations

Companies usually reported that they terminated plans to adopt a new plan or because the companies sold a plant or division and terminated the pension plan that covered these employees. As shown in table 2, these reasons accounted for 71 plan terminations (about 62 percent). PBGC's records did not show why a company wanted to adopt a new plan; however, about three-fourths of the 35 companies that said they terminated their plan to adopt a new plan indicated they intended to provide a replacement defined contribution plan.

Table 2: Reasons for Termination by Years After LBO Announcements

	Years after LBO announcement						
Reasons for termination	**1**	**2**	**3**	**4**	**5**	**After 5**	**Total**
Adopt a new plan	28	3	1	3	0	0	**35**
Plant sold	15	8	4	5	2	2	**36**
Plant closed	3	3	1	1	0	0	**8**
Bankruptcy	0	0	0	1	4	2	**7**
Plan consolidation	3	0	0	0	0	0	**3**
Other reasons[a]	9	8	3	4	1	0	**25**
Total	**58**	**22**	**9**	**14**	**7**	**4**	**114**

[a]Includes adverse business conditions, union decertification, eliminating an uncontrolled liability, and recovering an actuarial surplus.

The reasons for termination changed depending on how long after the LBO announcements the plans were terminated. In the first 2 years, plans were terminated primarily because companies adopted new plans or because a plant was sold. During the next 2 years, plant sales were the primary reason for most terminations. In succeeding years, more than half the plans were terminated because the company declared bankruptcy.

Most Plan Terminations Resulted in Asset Reversions

Of the 114 plan terminations, 99 (about 87 percent) resulted in a reversion of excess plan assets to the company. The reversions totaled $862.4 million (about 37 percent of the assets) in overfunded plans that were terminated. Of the 54 companies that terminated plans, 51 received reversions. As shown in table 3, 22 companies received reversions of $10 million to $50 million, and 4 companies received over $50 million.

Table 3: Reversion Amounts

Range of reversions	Companies	Dollars (in millions)
Less than $1 million	8	$2.3
$1 million but under $5 million	12	34.6
$5 million but under $10 million	5	31.0
$10 million but under $25 million	12	196.4
$25 million to $50 million	10	339.3
Greater than $50 million	4	258.8
Total	**51**	**$862.4**

Most Terminated Plans to Be Replaced

The 114 defined benefit plans that were terminated after the LBOs had about 218,000 participants. Two-thirds of these terminated plans were to be replaced,[7] and most active participants were to be provided replacement defined benefit plans.[8]

Companies reported that replacement plans were to be provided for 75 of the 114 terminated plans (about 66 percent). Of the replacements, 38 were to be defined benefit plans, and 37, defined contribution plans. Replacement plans were not provided for 15 terminated plans—8 in which the companies permanently closed a plant and terminated the employees' plan, and 7 where the companies were in bankruptcy proceedings.[9]

Table 4 shows the number of active participants in 86 terminated plans by the type of replacement plan that they were to be provided. Information on these participants in the other 28 terminated plans, which had 26,020 participants, was not available.[10]

[7]Companies generally indicate to PBGC whether they intend to replace a terminated plan. We did not contact the company to verify that the terminated plan was actually replaced.

[8]Active participants are those working for the plan sponsor when the plan is terminated. Other participants include retirees and former employees with benefit rights.

[9]We could not determine if replacement plans were to be provided for the 24 other terminated plans primarily because the company sold a plant and terminated the plan for employees at that plant; PBGC records did not identify the purchaser or indicate if a replacement plan was to be provided.

[10]In April 1986, PBGC eliminated the requirement that companies report the number of active participants in overfunded plans that were being terminated.

Table 4: Active Participants in Terminated Plans by Type of Replacement Plan

Type of replacement plan	Plans	Active participants Number	Active participants Percent
Defined benefit	29	88,104	70.3
Defined contribution	28	30,904	24.7
Could not determine if replaced	18	3,839	3.1
No replacement plan	11	2,323	1.9
Total	**86**	**125,170**	**100.0**

About 95.0 percent of the active participants, covered by the 86 terminated plans for which we had information, were to be provided replacement plans. Although there were about the same number of replacement defined benefit and defined contribution plans, most active participants (70.3 percent) were to be provided a replacement defined benefit plan. Generally, information on the provisions of replacement plans was not available at PBGC.[11]

Limited Data Indicate Plans' Financial Condition Did Not Deteriorate After LBOs

For 208 of the 444 plans (46.8 percent) that continued, we compared the funding ratio in the year before the LBOs were announced with the ratio in 1986. As shown in table 5, the funding ratio of 156 plans (75.0 percent) improved after the LBOs; the financial condition of 52 plans (25.0 percent) declined.[12]

[11] We noted that 15 plans were terminated in spinoff terminations. In a spinoff termination, an existing plan is split into two plans. The first covers retirees and former employees with a right to a pension; the second covers active participants. The excess assets are allocated to the plan covering retirees and former employees with vested benefits, annuity contracts are purchased, and the plan is terminated allowing the employer to recover the excess assets. The original plan continues with the active participants.

[12] We were unable to determine the change in the financial condition of the remaining 236 plans. Of these plans, 217 were sponsored by companies for which there was no post-LBO financial data available because the LBOs were announced in 1986 or 1987. Data for 1986 for the remaining plans were not in the IRS files.

Table 5: Changes in Plan Funding Ratios After LBO Announcements

	Plans
Funding ratio improved	
Changed from underfunded to overfunded	33
Underfunding reduced	39
Became more overfunded	84
Subtotal	**156**
Funding ratio declined	
Changed from overfunded to underfunded	5
Underfunding increased	17
Became less overfunded	30
Subtotal	**52**
Total	**208**

Generally, changes in the financial condition of continuing plans of LBO companies were consistent with changes in the financial condition of other pension plans during the same period.

We did not obtain written comments on this report. However, we discussed its contents with representatives of PBGC and incorporated their comments where appropriate.

Copies of this report are being sent to other interested congressional committees, the Executive Director of PBGC, the Commissioner of Internal Revenue, and the Secretary of Labor, and will be available to others on request. If you have any questions about information in the report, please call me at (202) 275-5365. Other major contributors are listed in appendix I.

Sincerely yours,

Gregory J. McDonald
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