ISSUES RELATING TO THE USE OF PENSION PLAN ASSETS IN LEVERAGED BUYOUT TRANSACTIONS

Scheduled for a Hearing
Before the
SUBCOMMITTEE ON OVERSIGHT
of the
COMMITTEE ON WAYS AND MEANS
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CONTENTS

		Page
	INTRODUCTION	1
I.	SUMMARY	2
II.	PRESENT LAW	5
	A. Qualified Pension Plans	5
	B. Rules Relating to Pension Plan Investments	8
	C. Rules Relating to Overfunded Pension Plans	13
III.	ISSUES	15

INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides an overview of the issues relating to the involvement of qualified pension plans in leveraged buyout transactions.

The Subcommittee on Oversight of the House Ways and Means Committee has scheduled a hearing on April 27, 1989, to review the utilization of pension plan assets in leveraged buyouts and related transactions.

The first part of the document is a summary. The second part discusses applicable present law under the Internal Revenue Code and the Employee Retirement Income Security Act of 1974 (ERISA), including rules relating to qualified pension plans, rules relating to the investment of pension plan assets, and rules relating to overfunded pension plans. The third part discusses relevant issues.

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[1] This document may be cited as follows: Joint Committee on Taxation, Issues Relating to the Use of Pension Plan Assets in Leveraged Buyout Transactions (JCX-6-89), April 21, 1989.

I. SUMMARY

Background

If a pension, profit-sharing, or stock bonus plan qualifies under the Internal Revenue Code ("qualified plan"), then (1) a trust under the plan generally is exempt from income tax, and (2) employers generally are allowed deductions (within limits) for contributions to the trust for the year for which the contributions are made even though plan participants are not taxed on plan benefits until the benefits are actually distributed.

A defined benefit pension plan is a type of qualified plan. Under a defined benefit pension plan, benefits are based on a formula specified in the plan rather than on the amount held in an account for an employee. Issues have been raised about the involvement of defined benefit pension plans in leveraged buyouts and other leveraging transactions.

A defined benefit pension plan typically plays a role in the financing of leveraged buyout transactions in two basic ways: (1) through the existence or use of the excess assets (assets in excess of the plan's liabilities for benefits on a termination basis) of the plan; and (2) as a general investment by the plan, such as investing in a leveraged buyout fund. Qualified plan assets can be used by both the management of the target and the management of the purchaser; for example, they can be used to finance a takeover and also can be used as part of defensive tactics to prevent a hostile takeover. The use of qualified plan assets in leveraged buyouts raises tax as well as retirement policy questions. In addition, the security of the benefits of participants of a defined benefit pension plan maintained by a company that has been involved in a leveraged buyout may be affected by the buyout.

Certain present-law rules affect the investment of pension plan assets in leveraged buyouts and the role of pension plans in leveraged buyouts. These rules include (1) the special fiduciary requirements applicable to pension plans, and (2) the funding requirements applicable to qualified pension plans and their impact on overfunded pension plans.

Pension plan investments

The Employee Retirement Income Security Act of 1974 (ERISA) contains rules relating to the investment of assets of defined benefit pension plans. In general, these rules require that plan fiduciaries discharge their duties in a prudent manner and for the exclusive purpose of providing benefits to plan participants and beneficiaries. In addition, plan fiduciaries are generally required to diversify the investments of the plan so as to minimize the risk of large losses. As long as these general requirements are satisfied, there are no rules prohibiting a plan from investing in certain types of assets, e.g., junk bonds.

There is little evidence that leveraging investments have, to date, put plan assets at more risk than other investments available to pension plans. As long as ERISA's fiduciary requirements are satisfied, then leveraged buyout investments may present little risk of overall loss to a pension plan.

There has also been some concern as to whether the voting of shares held by defined benefit pension plans encourages take-over activity.

Use of excess defined benefit pension plan assets

Under present law, if a company terminates a defined benefit pension plan, any assets in excess of the assets necessary to provide for employees' accrued benefits may be returned to the employer if the plan has provided for such reversion for 5 years before the reversion. In general, any such reversion is includible in the income of the employer and is subject to a 15-percent nondeductible excise tax payable by the employer. There are no restrictions on the employer's use of the excess assets after the termination of the plan.

Because excess assets are a ready source of cash, the existence of excess assets in a defined benefit pension plan may make a company attractive as a target, and some transactions have involved the termination of a defined benefit pension plan in order to help finance the acquisition. In addition, existing management may terminate a plan and recover the excess assets as part of takeover activity, for example, in order to make the company a less attractive target or to use the funds in its own takeover initiatives.

When a pension plan terminates, benefits accrued up to the date of plan termination are protected. However, the right of employees to earn benefits following the termination, which will control whether the employees are benefited or hurt by a plan termination, depends on what type of plan, if any, the employer maintains following the termination.

Effect of leveraging on a company's pension plan

Within limits, the Pension Benefit Guaranty Corporation (PBGC) guarantees benefits under a defined benefit pension plan in the event the plan is terminated and there are insufficient assets in the plan to pay benefits. Leveraging transactions may affect the solvency of defined benefit pension plans or the solvency of the employer sponsoring the plan and thereby increase the risk of loss to the PBGC. For example, a company that has undergone a leveraged buyout may use its available cash to satisfy its debt commitments and therefore may have difficulty funding the plan, with the result that the plan becomes underfunded.

The extent to which leveraging increases the risk of loss to the PBGC has not been documented.

II. PRESENT LAW

A. Qualified Pension Plans

In general

If a pension, profit-sharing, or stock bonus plan meets the qualification standards of the Internal Revenue Code (a "qualified plan"), an employer may make deductible contributions (within limits) to a trust to provide benefits under the plan. Such a trust holding qualified plan assets is exempt from Federal income tax. Although the employer's contributions to the plan generally are deductible when made, participants in the plan generally are not taxed on plan benefits until the benefits are distributed.

Defined benefit pension plans

A defined benefit pension plan is a type of qualified plan. Issues have been raised about the involvement of defined benefit pension plans in leveraged buyouts and other leveraging transactions. Under a defined benefit pension plan, employees who participate in the plan and satisfy the conditions for receipt of benefits under the plan are entitled to the benefits specified under the plan's benefit formula. An employee's benefits under the plan are not determined based on an account established for the employee.

For example, a defined benefit pension plan might provide a monthly benefit of $10 for each year of service completed by an employee. Benefits under a defined benefit pension plan may also be specified as a flat- or step-rate percentage of the employee's average compensation or career compensation.

An employer is not required to maintain any qualified plan for its employees or to provide minimum benefits to employees under the plan.[2] However, if an employer elects to maintain a tax-qualified defined benefit pension plan, then present law provides that certain minimum standards are to be satisfied.

Under present law, a defined benefit pension plan is required to satisfy certain minimum standards relating to (1) the conditions under which employees may be excluded from the plan, (2) the method under which plan benefits are accrued

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[2] If the employer maintains a top-heavy plan (sec. 416), then the employer is required to provide certain minimum benefits to employees who are not key employees of the employer. In general, a top-heavy plan is one that primarily benefits key employees of the employer.

(i.e., the method under which benefits are earned), and (3) the rate at which benefits are required to be vested (i.e., the method under which benefits become nonforfeitable). In addition, an employer's contributions to the plan are required to meet minimum funding requirements.

Minimum funding requirements

Under the Internal Revenue Code (the Code) and ERISA, defined benefit pension plans are required to meet a minimum funding standard for each plan year. This requirement is designed to ensure that the employer contributes sufficient amounts to the plan to pay for benefits promised under the plan. Under this standard, benefits are funded over time on an actuarial basis under one of several permitted funding methods. These methods permit the liabilities under the plan to be amortized over time.

Special minimum funding requirements apply to underfunded plans that require increased employer contributions. For this purpose, an underfunded plan is defined as a plan that has assets less than "current liability." Current liability is generally defined as the amount that would have to be paid to plan participants if the plan were terminated, without regard to the liability for certain unpredictable contingent event benefits (e.g., plant shutdown benefits). These special rules are designed to ensure that at a minimum a plan has sufficient assets to pay the benefits that participants have earned to date, i.e., the benefits that are payable on plan termination. The generally applicable minimum funding standards do not guarantee that plan assets will always be sufficient to satisfy current liability because those standards permit the amortization of plan liabilities over a period of time and the plan may be terminated before the amortization period has ended. Although the special rules for underfunded plans require faster funding, they also permit funding over time, so that a plan may be terminated before the amortization period under these rules has expired.

A company that is experiencing a temporary financial distress may obtain a waiver of the minimum funding requirements. In general, a funding waiver may not be granted with respect to more than 3 out of any 15 years. Waived contributions must generally be amortized over 5 years.

Deduction limits

The Code places limits on the amount of contributions that may be deducted in a year for contributions to qualified plans. Deductible contributions to a defined benefit pension plan may not exceed the full funding limit for the plan. The full funding limit is generally the excess, if any, of (1) the lesser of (a) the accrued liability (including normal cost) under the plan, or (b) 150 percent of current liability, over (2) the lesser of the market or actuarial value of plan assets. An employer that makes contributions in excess of the maximum deductible contributions is subject to a nondeductible excise tax equal to 10 percent of the nondeductible contributions.

Pension Benefit Guaranty Corporation

ERISA established the Pension Benefit Guaranty Corporation (PBGC), a Federal corporation within the Department of Labor, to insure the pension benefits of employees when defined benefit pension plans terminate with assets insufficient to satisfy the plan's liability to provide benefits to employees.

Subject to limits, the PBGC guarantees basic benefits under a plan. Basic benefits consist of nonforfeitable retirement benefits under a plan other than those benefits that become nonforfeitable solely on account of the termination of the plan. Guaranteed benefits are limited to basic benefits of $750 per month adjusted for inflation since 1974 ($2,028.41 for 1989). Guarantees are generally limited with respect to benefits in effect for fewer than 60 months at the time of plan termination.

Plan termination procedures

Vesting

Upon termination of a defined benefit pension plan, all benefits accrued to the date of plan termination are required to be 100 percent vested and nonforfeitable. In addition, plan benefits are to be distributed to plan participants or annuity contracts providing for the payment of benefits to plan participants must be purchased and distributed to participants.

Termination of underfunded plans

Under present law, an employer voluntarily may terminate a defined benefit pension plan in a standard termination or a distress termination. A standard termination is permitted only if the plan holds assets sufficient to pay all fixed and contingent liabilities to plan participants and beneficiaries ("termination liability"). A plan with assets insufficient to provide termination liability may be terminated in a distress termination only if the PBGC determines that the plan sponsor and each member of the contributing sponsor's controlled group satisfies at least one of four standards of financial distress.

Following a distress termination, the contributing sponsor and each member of the contributing sponsor's controlled group remains liable to the PBGC for the amount of unfunded guaranteed benefits. In addition, the contributing sponsor and controlled group members are liable to plan participants for the amount of termination liability in excess of guaranteed benefits.

Termination of overfunded plans

The present-law rules relating to termination of overfunded defined benefit pension plans are discussed below.

B. Rules Relating to Pension Plan Investments

Fiduciary requirements

In general

ERISA contains rules governing the conduct of fiduciaries of employee benefit plans. ERISA has general rules relating to the standard of conduct of plan fiduciaries and also contains specific rules prohibiting certain transactions between a plan and parties in interest with respect to the plan, such as a plan fiduciary. Plan participants as well as the Department of Labor may bring suit to enforce the fiduciary rules. Plan fiduciaries are personally liable under ERISA for any losses to a plan resulting from a breach of fiduciary duty. A court may also impose whatever equitable or remedial relief it deems appropriate for a violation of the fiduciary standards.

The Code does not contain extensive fiduciary rules. However, in order for a plan to be qualified under the Code, a plan is required to provide that the assets of the plan be used for the exclusive benefit of employees and their beneficiaries. In addition, the Code contains rules prohibiting transactions between a plan and disqualified persons with respect to a plan that are similar to the prohibited transaction rules under ERISA.

Exclusive purpose rule; prudence standard

The general fiduciary standard under ERISA requires that a plan fiduciary discharge his or her duties with respect to a plan (1) solely in the interest of the plan participants and beneficiaries, (2) for the exclusive purpose of providing benefits to participants and their beneficiaries and defraying reasonable administrative expenses of the plan, (3) with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent person acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims, and (4) in accordance with the documents and instruments governing the plan to the extent such documents and instruments are consistent with ERISA.

The prudence requirement is the basic rule governing the standard of conduct of plan fiduciaries, and it is against this rule that actions of plan fiduciaries are generally tested. A plan fiduciary does not violate the prudence standard merely because one investment bears greater risk of loss than others; rather, the prudence standard requires an evaluation of the investments of all assets in the aggregate. The prudence standard charges fiduciaries with a high degree of knowledge. This standard measures the decisions of plan fiduciaries against the decisions that would be made by experienced investment advisors. For this reason, some plan fiduciaries hire professional asset managers to invest plan assets.

Other than the prohibited transaction and self-dealing rules described below, neither the Code nor ERISA contains specific limitations on the types of investments a pension plan may make. Thus, there is no specific prohibition on the use of pension plan assets in leveraged buyouts or other corporate transactions. However, the use of pension plan assets in a leveraged buyout could be a violation of ERISA's fiduciary rules if, for example, the investment does not satisfy the prudence standard.

Diversification

ERISA requires that plan fiduciaries diversify the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so. Generally, a pension plan is not permitted to invest more than 10 percent of its assets in qualifying employer real property and qualifying employer securities. Qualifying employer securities are stock or marketable obligations issued by the employer of employees covered by the plan or an affiliate of such employer. Qualifying employer real property is property leased to the employer or affiliates of the employer and that meets certain other requirements.

Fiduciary responsibility with respect to proxy voting

The Department of Labor has issued specific guidance with respect to the responsibilities of plan fiduciaries in voting proxies on stock held by a pension plan. Because the exercise of proxies is an act of plan asset management, ERISA generally requires that the plan trustee have the exclusive authority to vote proxies. There are two exceptions to this general rule. First, the plan may specify that the trustee act in accordance with the directions of a named fiduciary who is not a trustee. Second, if the investment authority for plan assets has been transferred to an investment manager, then the investment manager has the responsibility to vote the proxies.

In voting proxies, the responsible fiduciary is required to analyze the issues and determine which course of action is in the best interests of plan participants and beneficiaries. The fiduciary cannot be passive on the issue of exercising proxy votes. For example, the fiduciary cannot, as a general policy, decline to vote proxies or vote only on noncontroversial issues. Nor can the fiduciary vote proxies exclusively in favor of management-backed positions without an analysis of the underlying issues.

There has been an issue as to whether plan fiduciaries must always vote for a tender offer if the plan is offered a premium for the shares. The Department of Labor and the Treasury Department recently issued a joint statement clarifying the Administration's position on this issue.[3]

According to the Departments, a fiduciary is not required automatically to tender shares held by the plan. Rather, the fiduciaries must base their decision on what is in the economic interest of the pension plan, recognizing that the pension trust is designed to provide retirement income. A fiduciary must evaluate a tender offer on its merits. One of the factors that may be taken into account is the long-term value of the company against the value presented by the tender offer and the ability to invest the proceeds elsewhere. In making this determination, the long-term business plan of the target company's management would be relevant. However, any attempts by corporate management to utilize the assets of the corporation's on-going plans either as an offensive or defensive tool in battles for corporate control would clearly violate ERISA.[4]

The Department of Labor recently concluded a study on the extent to which proxy voting by investment managers follows ERISA's requirements.[5] The study was based on 111 responses from investment managers who held shares in 23 target companies on behalf of approximately 4,860 employee benefit plans.

The study found that 61 percent of the investment

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[3] Joint Department of Labor/Department of Treasury Statement of Pension Investments, January 31, 1989.

[4] Special issues are raised with respect to the voting of shares held by individual account plans, such as profit-sharing plans. These issues are beyond the scope of this pamphlet.

[5] Proxy Project Report, Pension and Welfare Benefits Administration, U.S. Department of Labor, March 2, 1989.

managers surveyed exercised voting responsibility. Of the 31 percent who said they did not have voting responsibility, the Department was unable to determine positively who voted the proxies.

Ninety-one companies responded to questions on internal decision-making. Only 6 firms reported that they had no procedures in place. Twenty-eight firms reported having formal written procedures.

Eighty-three percent of the managers surveyed stated that they followed their standard voting procedures. Most of the failures to follow stated procedure involved failures to vote the proxies or administrative error.

Thirteen managers reported a policy to vote for management, and eight reported no policies in place.

The Department noted that one common problem in reviewing the results of the survey was the lack of accurate recordkeeping by the investment managers. For example, one investment manager did not know if it had voted proxies because no records were kept.

There has been some concern that ERISA's fiduciary rules require investment managers to vote in favor of tender offers if they are offered a premium for the shares. Some have argued that the fiduciary rules fuel leveraged buyouts because they require the fiduciary to accept buyout offers.

Such concerns were behind the issuance of the joint Department of Labor and Department of Treasury statement regarding proxy voting. The statement clarified that managers are not required to accept takeover bids, but rather are to make the decision that is in the long-term best interests of the plan participants.

Prohibited transaction rules

In general

In order to prevent persons with a close relationship to a plan from using that relationship to the detriment of plan participants and beneficiaries, the Code prohibits certain transactions between a plan and a disqualified person.[6] A

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[6] ERISA contains prohibited transaction provisions that are very similar, although not identical, to the prohibited transaction rules of the Code. In addition, ERISA prohibits the acquisition of any employer security or employer real property that is not a qualifying employer security or

(Footnote continued)

disqualified person includes any fiduciary, a person providing services to the plan, an employer any of whose employees are covered by the plan, an employee organization any of whose members are covered by the plan, and certain persons related to such disqualified persons.

Transactions prohibited include (1) the sale or exchange, or leasing of property between the plan and a disqualified person, (2) the lending of money or other extension of credit between the plan and a disqualified person, (3) the furnishing of goods, services, or facilities between the plan and a disqualified person, or (4) the transfer to, or use by or for the benefit of, a disqualified person of any assets of the plan.

The Code imposes a two-tier excise tax on prohibited transactions. The initial level tax is equal to 5 percent of the amount involved with respect to the transaction. In any case in which the initial tax is imposed and the prohibited transaction is not corrected within a certain period, a tax equal to 100 percent of the amount involved may be imposed.

A violation of the prohibited transaction rules could occur in a leveraged buyout transaction if, for example, a defined benefit pension plan holds securities of the employer maintaining the plan, and the plan trustee (who is an executive of the employer) responds to a tender offer in the interests of management, rather than in the interests of plan participants and beneficiaries.

Exemptions from prohibited transaction rule

The Code and ERISA contain a number of statutory exemptions to the prohibited transaction rules. These rules permit the Secretary of the Treasury and the Secretary of Labor, respectively, to grant exemptions from the prohibited transaction rules on a case-by-case basis. The prohibited transaction exemption program under both the Code and ERISA generally is administered by the Secretary of Labor.[7]

Exclusive benefit rule

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[6] (continued)
qualifying real property or that violates the 10-percent limitation on acquisition of such securities and property.

[7] This authority was transferred to the Secretary of Labor pursuant to Reorganization Plan No. 4, which divided the administrative responsibility for enforcement of the overlapping provisions of the Code and ERISA between the Departments of Labor and Treasury.

The Code does not have extensive rules regarding the investment of pension plan assets. The Code does require, however, that, prior to the termination of a qualified plan, no part of the assets of the plan may be used for or diverted to purposes other than for the exclusive benefit of the employees and their beneficiaries. This provision prohibits all objects or aims not solely designed for the proper satisfaction of all liabilities to employees or beneficiaries.

Fiduciary standards for retirement plans maintained by State and local governments

The ERISA fiduciary standards do not apply to retirement plans maintained by State and local governments; accordingly, there are no generally applicable Federal standards for the investment of assets of such plans. No uniform fiduciary standards have been adopted by the States, although many States have adopted some variant of the ERISA prudence standard.

State retirement plans have been among the largest investors in leveraged buyout funds. For example, according to the January 25, 1988, issue of Pensions and Investment Age, the Washington State Investment Board is the largest pension investor in buyouts with a total of nearly $1 billion committed to such investments. Other large State and local plan investors, according to the same issue of Pensions and Investment Age, include Oregon Public Employees ($262 million), New York State and Local Retirement Systems ($218 million), Wisconsin Investment Board ($144 million), and Michigan State ($110 million). Since the publication of these statistics, it has been reported that New York Governor Cuomo has called for a freeze on leveraged buyout investments by that State's $39 billion public employee pension fund.[8]

C. Rules Relating to Overfunded Pension Plans

If a defined benefit pension plan is terminated, the rights of employees to benefits accrued up to the date of the plan termination must be nonforfeitable. Although a qualified pension plan must be established for the exclusive benefit of employees, present law provides that an employer is entitled to recoup excess plan assets on plan termination to the extent the plan has assets remaining after all obligations to employees have been satisfied (i.e., to the extent that the plan is overfunded), if the plan has provided for such a reversion for at least 5 years. The employer is required to include the recouped amounts in gross income for the year in which the amounts are received. Other deductions

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8 The Wall Street Journal, November 29, 1988, p. C-21.

or credits (including loss carryovers) that the employer is entitled to claim may be used to offset the tax on this income. In addition, a nondeductible 15-percent excise tax is imposed on the amount of excess assets that revert to the employer. There are no restrictions on the use of the excess assets following plan termination.

Certain factors may contribute to the overfunding of defined benefit pension plans. Under certain of the permissible funding methods, an employer's funding costs are leveled over an employee's working years even though the costs of benefits earned normally increase as the employee approaches retirement age. Thus, at any time, the plan may have assets that exceed the present value of the liabilities to employees for previously-accrued benefits.

In addition, in recent years, high rates of return on investments have contributed to substantial increases in the value of the assets held in many trusts under qualified pension plans because investments have performed better than expected when the minimum funding requirement was calculated. The excess of the return on investments over the rate of return assumed under the plan's funding method will be taken into account over time and will reduce the otherwise required funding contributions. For years before 1989, such investment gains were amortized over 15 years. Given this amortization period, a plan's assets may be substantially greater than its liabilities prior to the time the amortization period has expired. For years after 1988, the amortization period has been shortened to 5 years, with the result that overfunding attributable to investment gains could decrease.

III. ISSUES

Investment by pension plans

One aspect of qualified plan involvement in leveraged buyouts that has received attention recently is the participation by pension plans as an investor. Such investments generally raise two issues: (1) whether such investments put pension assets at more risk and therefore jeopardize the solvency of the pension plan, and (2) whether the availability of pension plan assets promotes overall increases in the level of leveraging in the United States.

With respect to the first issue, there is little evidence that leveraging investments have, to date, put pension plan assets at more risk than other investments available to pension plans. Indeed, such transactions are often very profitable. As long as the ERISA fiduciary and diversification standards are met with respect to the investment, then leveraged buyout investments may present little risk of overall loss to a pension plan.

With respect to the second issue, the concern is that if too much leveraging is not beneficial to the economy, then perhaps pension plans (which have significant amounts of assets) should not be permitted to invest in leveraging transactions. Such concerns led New York Governor Cuomo to call for a freeze on leveraged buyout investments by the state's $39 billion public employee pension fund.[9]

This issue is not a pension issue, but rather involves the broader question of whether corporations are assuming excessive levels of debt relative to their assets. Similarly, if it is concluded that excessive leveraging should be discouraged or prohibited, limiting the investment of pension plan assets in leveraged buyout transactions is only one indirect way of addressing the problem.

There has been some concern that ERISA's fiduciary rules require investment managers to vote in favor of tender offers if they are offered a premium for the shares. Some have argued that the fiduciary rules fuel leveraged buyouts because they require the fiduciary to accept buyout offers.

Such concerns were behind the issuance of the joint Department of Labor and Department of Treasury statement regarding proxy voting. The statement clarified that managers are not required to accept takeover bids, but rather are to make the decision that is in the long-term best

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9 The Wall Street Journal, November 29, 1988, p. C-21.

interests of the plan participants.

Use of overfunded pension plans

An overfunded pension plan represents a pool of assets that may make a company a target for a takeover. Conversely, this pool of assets may be used by the company to ward off a hostile takeover. In recent years, some companies with significantly overfunded pension plans have been acquired by other companies. After the acquisition, the acquiring company terminated the overfunded pension plan and used the excess assets partially to finance the takeover.

Data are not available on the extent, if any, to which the existence of excess pension plan assets has contributed to the proliferation of takeover activity.

As the financial markets have become more familiar with the existence of excess assets in companies' pension plans, the relevance of excess assets in takeovers may have diminished because the value of the excess assets is reflected in the purchase price of the company. On the other hand, an overfunded plan represents an attractive source of cash even if the value of the assets is included in the purchase price. Thus, companies with overfunded pension plans may continue to be attractive takeover targets. However, in recognition of the attractiveness of excess pension assets to potential acquirors, some companies have taken steps (such as a plan amendment providing an automatic increase in pension benefits) that are triggered in the event of a hostile takeover.

Another possibility is that a company itself will terminate an overfunded pension plan to assist its efforts to thwart a hostile takeover attempt. This can be accomplished in one of several ways. For example, the company can invest the excess assets in plant and equipment, thus making itself less attractive than if it held a large amount of liquid assets.

As discussed above, when a pension plan is terminated, benefits accrued up to the date of plan termination are protected. The right of employees to earn benefits following the termination of the plan, which will control whether the employees are benefited or hurt by the plan termination, depends on what type of plan, if any, the employer maintains following the termination. If the employer maintains a comparable plan, then the employees may be in just as good a position after the termination as before. If, however, the employer does not adopt another plan, or establishes a less generous plan, then the retirement security of the participants may have been impaired.

The question of what to do with excess pension assets may become less important over time. The number and amount of reversions generally have been decreasing. In addition, the full funding limitation will tend to reduce the incidence of overfunding. In addition, the excise tax imposed on nondeductible contributions to a defined benefit pension plan further discourages excessive funding of such plans.

Effect of leveraging on a company's pension plan

Leveraged buyout transactions may affect the solvency of defined benefit pension plans and increase the risk to the PBGC and plan participants. First, a company that has undergone a leveraged buyout may be short on cash and therefore may have difficulty satisfying its funding obligation to the plan, with the result that the plan becomes underfunded.

If a company with an underfunded pension plan is in financial distress, the company may terminate the plan, and the PBGC pays guaranteed benefits to plan participants to the extent such benefits cannot be paid from plan assets. The PBGC attempts to recoup at least a portion of its benefit payments from the company. If a company is highly leveraged and has used the leveraging to make distributions to shareholders, then the assets of the company may be depleted to the point that there are insufficient assets to pay all creditors. In that case, the PBGC will generally not be able to recoup its benefit payments and will suffer a loss which is borne by the Federal government.

At this time, there is yet little, if any, evidence linking leveraging with the existence or termination of underfunded defined benefit pension plans. As a result, the extent to which leveraging increases the risk to the PBGC is not yet clear.