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Pension Plans and Leveraged Buy-Outs

Statement of
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Before the
Subcommittee on Oversight
Committee on Ways and Means
House of Representatives

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SUMMARY

GAO is reviewing the role of pension plans in leveraged buy-outs (LBOs) for the Subcommittee on Oversight, House Committee on Ways and Means.

The initial phase of GAO's work focused on identifying (1) a universe of companies taken over in LBOs, (2) the number of pension plans sponsored by these companies before the LBO, and (3) the number and characteristics of pension plans terminated after the LBO. GAO also reviewed the investments of eight public and private pension plan sponsors in limited partnerships (called LBO funds) used to help finance LBOs.

GAO identified 190 companies for which LBOs were announced from 1982 through 1987. These companies sponsored 899 pension plans before the date on which an LBO was announced. These included 656 defined benefit plans and 243 defined contribution plans covering about 1.65 million participants. The 899 plans had about $15.7 billion in assets.

Almost 40 percent of the 190 companies terminated pension plans after the takeover. These terminations involved 107 defined benefit plans and 23 defined contribution plans covering about 290,000 participants. The terminated plans had about $1.8 billion in assets at the time of termination.

Of the 107 defined benefit plans, 88 (about 82 percent) were terminated with assets in excess of the amount needed to pay benefits. Plan sponsors obtained a reversion of excess assets of about $581.6 million, or about 34 percent of total plan assets, for 79 of the 88 terminations. For six other plans, the excess assets were either distributed to the plan participants or split between the participants and the sponsor. Pension Benefit Guaranty Corporation records did not indicate how excess assets were distributed for the other three plans. The reversions averaged $7.4 million, and ranged from $490 to $64.4 million. Two plans were terminated without sufficient assets to pay plan benefits.

Eight large pension plan sponsors had invested about $3.4 billion (about 3.7 percent of their combined plan assets) in 53 LBO funds. The rate of return the sponsors obtained on their LBO fund investments, with one exception, greatly exceeded the return obtained on total plan investments.

Four of the LBO funds in which the plan sponsors invested had financed LBOs of 8 companies that terminated pension plans.

Mr. Chairman and Members of the Subcommittee:

I am pleased to be here today to discuss the preliminary results of our work on the role of pension plans in leveraged buy-outs (LBOs).

LBOs have increased dramatically in the past few years. In February 1989, the Congressional Research Service reported that the number of LBOs more than tripled from 99 in 1981 to 318 in 1988. The value of these transactions also rose sharply-- from $3.1 billion in 1981 to $42.9 billion in 1988. Typically, LBOs involve the acquisition of a public company by a group of investors who purchase the company's stock using mostly borrowed funds with the acquired company's assets as collateral.

Congressional concerns about LBOs were heightened following the recent takeover of RJR Nabisco for about $25 billion. These concerns have included the tax consequences of LBOs that replace equity with debt, the ability of debt-laden companies to withstand economic downturns, and the impact of LBOs on company productivity and performance.

Among the concerns that you and others have expressed about LBOs are the implications for pension benefit security and the role of pension funds in financing LBOs. These concerns raise several questions regarding (1) the incidence of pension plan terminations by companies taken over in LBOs, (2) the extent of pension plan investments in limited partnerships used to help finance LBOs, and (3) the risk of investing plan assets in LBOs.

As requested in your February 10, 1989 letter, and as discussed with your office, our work to date has focused on identifying the incidence of pension plan terminations by companies that have been taken over in an LBO. We have also reviewed the investments of eight large public and private pension plan sponsors in limited partnerships (called LBO funds) used to help finance LBOs.

PLANS TERMINATED BY COMPANIES TAKEN OVER IN LBOs

We focused our analysis on 190 companies for which LBOs were announced from 1982 through 1987. The 190 companies sponsored 899 pension plans before the date on which an LBO was announced.[1] These included 656 defined benefit plans and 243 defined contribution plans covering about 1.65 million participants. The 899 plans had about $15.7 billion in assets.

Almost 40 percent of the 190 companies taken over in LBOs terminated pension plans after the takeover. These terminations involved 107 defined benefit plans and 23 defined contribution

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[1]Our methodology is discussed in more detail in appendix I.

plans covering about 290,000 participants. The terminated plans had about $1.8 billion in assets at the time of plan termination.

Defined Benefit Plans

Our analysis of the Pension Benefit Guaranty Corporation's (PBGC's) records showed that 61 companies taken over in LBOs terminated 107 defined benefit plans. The 107 plans covered about 159,000 participants, and had about $1.7 billion in assets at the time of termination.

Although we did not contact these plans during this phase of our work, PBGC's records show that a primary reason plan sponsors cited for defined benefit plan terminations was the sale or transfer of the company.

Timing of Terminations

The timing of a plan termination may suggest what role, if any, an LBO played in the sponsor's decision to terminate the plan. For example, a sponsor could terminate an overfunded plan before an LBO in an attempt to make the company a less attractive takeover target. A sponsor could also terminate a plan after an LBO to obtain any assets that exceeded what was needed to pay participants' benefits.

Of the 107 terminations, 23 occurred between the LBO announcement date and the date on which the LBO occurred. The other 84 terminations (about 78.5 percent) occurred within various time periods after the LBO. For example, 39 of the 84 terminations (about 46 percent) occurred within a year after the LBO.

Distribution of Plan Assets After Termination

Two of the 107 plans were terminated with insufficient assets to pay plan benefits. Seventeen plans were terminated with assets equal to benefits, and three were terminated with excess assets, but without documentation in PBGC's records explaining how they were distributed. The remaining 85 plans (about 79 percent) were terminated with assets in excess of the amount needed to pay benefits. PBGC's records show that in four terminations, all the excess assets, about $2.7 million, were distributed to the plan participants. In two other terminations, the distribution of excess assets was split, with the sponsors receiving $8.4 million and the participants $593,498. For the remaining 79 terminations with excess assets, the plan sponsors obtained a reversion of excess assets of about $581.6 million, or about 34 percent of total plan assets. The reversions to the plan sponsors averaged $7.4 million per plan, and ranged from $490 to $64.4 million.

PBGC reports reversion data for plans with reversions of $1 million or more. These data show that from 1982 through 1988, 1,853 plans were terminated with reversions of $19.7 billion. The average reversion was $10.6 million. Fifty-two of the terminated defined benefit plans we reviewed had reversions of over $1 million. The average reversion for these plans was $11.1 million.

Characteristics of Plans After Terminations

Sponsors for about 40 percent of the terminated plans stated that they intended to cover the participants with an existing plan, a new plan, or a spin-off plan. For example, nine sponsors said they intended to establish a new defined benefit plan, and three said they would cover the participants under another existing defined benefit plan. Twenty-two sponsors said they intended to establish a new defined contribution plan, and one said that participants would be covered by another existing defined contribution plan. Eight other sponsors said they intended to cover participants with a spin off plan.

We were unable to determine from the PBGC records we reviewed during our preliminary work whether the remaining sponsors intended to cover participants in the terminated plan with a new or existing plan.

Defined Contribution Plans

Our data base of pension plan annual returns (form 5500) filed with the Internal Revenue Service (IRS) showed that 21 companies terminated 23 defined contribution plans with about $149 million in assets, covering about 131,000 participants. Nine of these companies also terminated at least one defined benefit plan. Unlike defined benefit plans, assets in defined contribution plans belong solely to plan participants. As a result, there is no reversion of excess assets to the plan sponsor.

Defined contribution plan termination data, however, is not as reliable or as timely as the information on defined benefit plan terminations. Unlike defined benefit termination data, defined contribution data are not reported to PBGC; thus, there is no cross-check on the quality of the data. There are longstanding problems in the quality of the form 5500 data base, and there is also a time lag between the end of a plan year and when the annual return must be filed with IRS.

Because of problems with the data on defined contribution plans, and the lack of any claim to plan assets by the sponsor, we focused our attention on defined benefit plan terminations.

PENSION PLAN INVESTMENTS IN FUNDS USED TO FACILITATE LBOs

One way that pension plans can participate in LBOs is to invest in LBO funds that pool capital provided by large investors.[2] The funds are formed as limited partnerships by firms that specialize in LBOs. The firms serve as the general partner for the fund, and the pension plans and other investors are limited partners. Typically, LBO funds provide about 15 percent of the financing for the LBO transaction.

The eight public and private pension plan sponsors we contacted had 138 defined benefit plans with over $93 billion in assets. These sponsors had invested about $3.4 billion (about 3.7 percent of their combined plan assets) in 53 LBO funds. The proportion of plan assets each sponsor invested in these funds ranged from 0.4 to 8.4 percent.

The plan sponsors must decide to commit to the fund without knowing the specifics of any acquisition. Essentially, the plan is investing in a "blind pool," in which it has no input concerning the company to be acquired or the price of the acquisition. As a result, the plan's evaluation focuses on such factors as the reputation, experience, and track record of the

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[2]We testified on private pension plan investments in LBO funds on February 9, 1989, before the Subcommittee on Labor-Management Relations, House Committee on Education and Labor (GAO/T-HRD-89-5).

general partner as an LBO manager. Other factors that are examined include the investment criteria used to select acquisition targets, the minimum required capital commitment of the limited partners, profit or loss distribution between the general partner and the limited partners, and management fees.

LBO fund investments involve several types of risk. For example, there is a liquidity risk because plan assets are committed to a limited partnership for as long as 10 or 12 years, and the partnership interest cannot be traded on the open market like stocks or bonds. In addition, an economic downturn could result in the acquired company not having sufficient assets to pay off the large amount of debt issued for the acquisition.

The rate of return the sponsors have obtained on their LBO fund investments, with one exception, has greatly exceeded the return obtained on total plan investments. The returns on LBO fund investments ranged from 10.5 to 40 percent, while the return on total plan investments ranged from 9.0 to 16.1 percent.

It is interesting to note, Mr. Chairman, that some of the plan sponsors we visited had invested in LBO funds that financed takeovers of companies that terminated pension plans. In reviewing the takeovers financed by four of the LBO funds in which the plan sponsors invested, we found that 8 of the companies that were taken over terminated pension plans.

CLOSING OBSERVATIONS

In summary, almost 40 percent of the companies that were taken over in LBOs terminated 107 defined benefit pension plans with reversions of excess assets of over half a billion dollars, most of which went to the plan sponsors. For 43 of the 107 terminations, the sponsor intended to cover the participants with a new pension plan or an existing or spin off plan. Many of the new plans to be established were defined contribution plans.

The eight pension plan sponsors we contacted have invested a relatively small portion of their assets in LBO funds and have received higher returns than achieved on other plan investments. Further, the plans appear to have been selective in choosing LBO funds in which to invest and have diversified their investments among different funds. Four of the LBO funds in which the plan sponsors invested had financed LBOs of 8 companies that terminated pension plans.

We are continuing our work in this area to determine (1) what the role of the LBO is in the decision to terminate these plans and (2) how the terms of any follow-on plans established for company employees compare to those of the terminated plans.

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Mr. Chairman, this completes my statement. I would be happy to answer any questions at this time.

METHODOLOGY FOR IDENTIFYING PENSION PLANS AND PLAN TERMINATIONS FOR COMPANIES TAKEN OVER IN LEVERAGED BUY-OUTS

To identify the number of LBOs, we used information from a study coauthored by the Chief Economist of the Securities and Exchange Commission that identified 284 public companies for which LBOs were announced[3] from 1980 through 1987. We reduced the number of companies by 94 for several reasons.

We excluded 24 companies because we could not identify either a reliable date on which the LBO occurred[4] or a valid employer identification number used for tax purposes. We excluded another 40 companies where the LBO was announced during 1980 and 1981, because our data base of pension plan annual returns (forms 5500) did not go back far enough to enable us to identify the number of plans each company sponsored in the year preceding the LBO. Twenty-five companies were excluded because we were not able to identify any pension plans for the company's employer identification number. Finally, we excluded five

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[3]The date on which the LBO was announced represents either the date on which (1) the Wall Street Journal reported that an investor had expressed an interest in acquiring a company in an LBO, (2) an investor notified the Securities and Exchange Commission of its intent to pursue an LBO, or (3) the company's board of directors announced that they had agreed to an LBO.

[4]The date on which the LBO occurred represents the last date on which the company's stock was publicly traded.

companies because we could not obtain asset or participant data for the plans they sponsored.

As a result, we focused our analysis on 190 companies for which LBOs were announced from 1982 through 1987. These companies sponsored 656 defined benefit plans with $10.8 billion in assets, covering 920,691 participants.

We used pension plan annual returns (form 5500) to identify terminated defined contribution plans and determine their characteristics. PBGC does not insure defined contribution plans, and, therefore, does not maintain information on them. We found that the 190 companies sponsored 243 defined contribution plans with $4.9 billion in assets covering 731,710 participants.

It is possible that there were pension plans that we did not identify because the form 5500 data base is incomplete or the plans' tax returns were filed under a different name or employer identification number. Also, this data base excludes plans with less than 100 participants that file different returns.

We used PBGC's pension plan termination data base to identify (1) defined benefit plans sponsored by companies in the LBO data base that had been terminated, (2) the reason for the termination, (3) whether there was a reversion of excess assets to the plan sponsor, and (4) whether the sponsor intended to establish a replacement plan. To determine when the plan termination occurred in relation to the LBO, we compared the date of plan termination to the date on which the LBO was announced and the date on which it occurred.

We identified several plans with over 100 participants that were not included on our form 5500 data base. We used PBGC asset and participant data for these plans.