

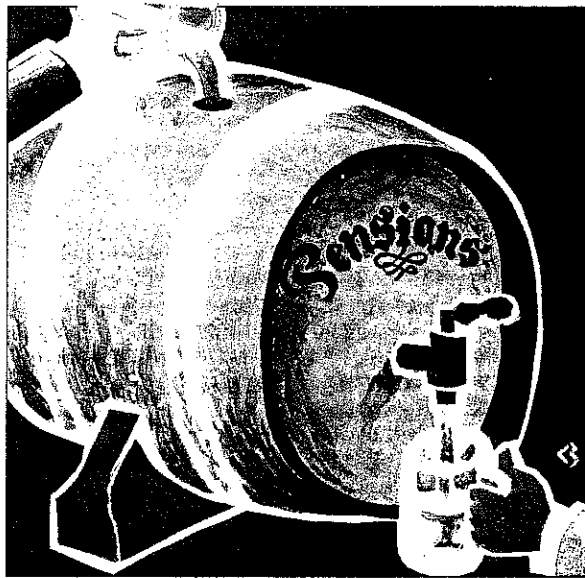
CORPORATE
FINANCEHOW THE PENSION FUND
CAN WORK
FOR THE COMPANY

Pension transactions can benefit the company—if they are properly structured.

While pension assets must be invested for the exclusive benefit of plan participants, the law does not preclude using them for corporate purposes as well. If properly structured, borrowing from a plan or paying an in-kind contribution instead of cash can provide the plan a good investment, help guard against raiders, strengthen the balance sheet, and reduce pension expenses.

The Omnibus Budget Reconciliation Act of 1987 changed many of the rules concerning corporate/plan transactions. Some of the changes make transactions with pension plans less attractive and harder to structure, but others make them more appealing. In light of the 1987 act, companies that have already entered into financial arrangements with their pension plans should review their legality. Companies that have not entered into such arrangements may profit from considering whether to do so.

In recent years, many companies have borrowed from their defined benefit and defined contribution plans. In 1986, Sherwin-Williams arranged to borrow up to \$65 million from its defined benefit plan, then overfunded on a termination basis by \$314 million. Smaller companies have borrowed amounts ranging from \$1 million to \$5 million from plans with total assets of less than \$20 million. Borrowing from the pension plan is appealing because it is easier than going to outside lenders, can save investment



banking or application fees, and provides the plan the "spread" that a third party otherwise gets.

If a plan is overfunded, borrowing from it enables the company to use the excess without the complications of a termination and reversion, a procedure that the 1987 budget act made more difficult. Borrowing from the plan also reduces the allure for raiders by converting the surplus from liquid form to a promissory note. If the loan is structured as a line of credit, the company retains the flexibility to clear it out and acquire its stock as a further defense. Whether borrowing assets for these reasons is legally permissible, however, is a separate matter.

The fiduciary responsibility provisions of the Employee Retirement Income Security Act prevent insiders from abusing plan assets and impose standards of loyalty and care on fiduciaries. Erisa deems the plan

a distinct entity with assets and interests separate from the sponsor. Persons closely related to the plan are "parties-in-interest," prohibited from specific financial transactions with plan assets. Other rules prohibit self-dealing by fiduciaries, acting on behalf of a party with interests adverse to the plan, and taking kickbacks on a plan transaction.

The Labor Department waives prohibitions if it deems a transaction to be *administratively feasible*, in the plan's interest, and protective of participants and beneficiaries. Applications for

exemptions must meet the department's detailed Procedure 75-1. The department has typically taken two to four months to reach a decision. Even when a proposed transaction is exempted from the prohibited transaction rules, more general "exclusive purpose," "prudent man," and related rules still apply.

The Labor Department's basic requirement is that the loan be a good investment from the plan's perspective. The department places great emphasis on whether the plan will be represented by an independent fiduciary—an unrelated party responsible for its investment decisions. As the department has stated, "While not impossible, the likelihood of favorable action without this protection is significantly reduced."

The Labor Department also stresses that the yield on the loan

Borrowing from the pension plan or making an in-kind contribution can help guard against raiders and improve the balance sheet.

must be at least equal to the rate on a similar arm's length transaction with an unrelated party, and also that collateral is sufficient. The department typically requires an independent appraisal of the collateral's worth.

Also be sure that cash flows from a promissory note meet plan liquidity needs and that the loan is prudent in terms of overall portfolio diversification. The department has never approved a loan of more than 25 percent of a plan's portfolio.

Elsewhere, corporate sponsors can make a plan contribution putting up property or securities instead of cash. In late 1987, Pan Am proposed a contribution and leaseback of its facilities at JFK Airport for a reported \$200 million. Earlier, USX repurchased the last of 2.5 million preferred shares it had contributed to its plan. Other in-kind contributions have ranged from third-party promissory notes to oil and gas interests.

An in-kind contribution can conserve cash while satisfying the company's funding obligation and getting a tax deduction. Avoiding cash contributions may be more important under the 1987 budget act because new rules can increase volatility in plan liabilities and required contributions. The new law ties interest assumptions used to calculate a plan's funded status to 30-year Treasury bond rates. Fluctuation in rates can result in large and unforeseen changes in contributions. Compounding these difficulties, FASB 87 also introduces new volatility into pension expense.

In-kind contributions can also improve the corporate balance sheet. If the company carries the asset off the balance sheet (as with certain leaseholds) or at cost (as with real estate), it can contribute the asset and recognize a gain. A contribution of newly issued stock infuses new equity into the company. A contribution and leaseback of mortgaged real estate will remove debt from the balance sheet.

Some companies apparently have used their plans to warehouse property or securities, as USX and American Airlines have. In other cases, contributions of corporate securities

appear to have consolidated a company's position against a predator, as with Martin Marietta's defense against Bendix several years ago.

In-kind contributions must be financially sound from the plan's perspective. An in-kind contribution represents a prohibited transaction and requires an exemption. Certain types get automatic, or statutory, exemptions. Those are contributions of so-called "qualifying employer securities."

In essence, Erisa's statutory exemption permits a company to contribute employer securities or employer real property if such assets are sufficiently marketable, the value can be measured objectively, and the plan has been designed to acquire such assets.

Prior to the 1987 act, a "qualifying employer security" meant either stock or marketable obligations. While debt instruments were further circumscribed by conditions of liquidity, price, and distribution of ownership, the definition of stock was not. Numerous *Fortune* 500 corporations took the opportunity to contribute large amounts of special classes of convertible or nonconvertible preferred stock. Under the 1987 act, such contributions must now be exempted.

The 1987 act says that stock acquired by a defined benefit plan is "qualifying" only if 25 percent or less of the class is held by the plan, and if at least 50 percent is owned by persons independent of the issuer. Defined benefit plans which obtained nonqualifying stock before last December 17 must sell it by January 1, 1993. Real estate a plan

leases to an employer is deemed "qualifying" if it consists of a substantial number of geographically dispersed parcels that are suitable (or adaptable without excessive cost) to more than one use.

To satisfy the statutory exemption, the pension plan must acquire securities or property for no more than "adequate consideration." Although this standard has yet to be defined in final regulations, it is clear that plan fiduciaries must demonstrate they applied a reasonable process in determining value.

Even where a contribution of employer securities or real property satisfies the statutory exemption rules, the plan's fiduciaries must still act solely in the plan's interest. Plan fiduciaries who are corporate officers are well-advised to appoint an independent fiduciary or at least to hire an independent adviser.

Where an in-kind contribution fails to satisfy the statutory exemption, a company can still apply for an administrative exemption. The Labor Department applies the same kind of criteria here that it does with plan loans, including whether the plan is represented by an independent fiduciary, how the in-kind contribution compares with other investments, the contribution's expected rate of return, the impact on diversification, suitability to the plan's investment objectives, the contribution's appraised value, marketability and liquidity, and any fees or costs the plan would incur if it accepted the in-kind contribution rather than cash.

In sum, the 1987 act has generated new opportunities and problems for companies entering into financial transactions with their pension plans. To comply with the law, corporate officers who are plan fiduciaries must demonstrate that such transactions meet the new rules, are sound investments for the plan, and that plan interests are adequately protected. ■

SAMUEL W. HALPERN is executive vice president and general counsel of Bear Stearns Fiduciary Services in Washington D.C. and a former attorney with the U.S. Department of Labor.