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Corporate Pensions in Turbulent Economic Times: An Overview of Key Issues and Options for Plan Sponsors

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Employers are facing a number of serious challenges that make managing a defined benefit pension plan even more difficult than usual. Plan sponsors are likely to see significantly higher future minimum funding requirements because of historically low interest rates, expiration of certain legislative funding relief, and negative asset performance. At the same time, the economic slowdown – caused by, or at least exacerbated by, the COVID-19 pandemic– will dramatically impact cash flows and the ability of plan sponsors to meet their pension obligations.

This article is intended to make plan sponsors aware of the most common reporting and regulatory issues that arise in an economic downturn and summarize the options for addressing serious pension funding challenges. We also discuss the recently passed pension funding relief and possible future changes to the funding rules under Employee Retirement Income Security Act of 1974, as amended ("ERISA"), and the Internal Revenue code of 1986, as amended (the "Code").

Common Pension Issues in an Economic Downturn

In an economic downturn, it is common for employers to engage in restructuring or to make difficult choices related to pension funding. This section discusses some of the key issues raised by those corporate actions, including potential pension reporting requirements, the consequences of missed contributions, actions by the Pension Benefit Guaranty Corporation ("PBGC"), pension liabilities triggered by material downsizing or facility closures, and partial plan terminations. It also discusses a pair of issues – benefit restrictions and executive compensation limitations – relevant to underfunded plans.

A. Reportable Events

ERISA section 4043 and PBGC's reportable event regulations (29 C.F.R. Part 4043) require plan administrators and sponsors of defined benefit pension plans to notify

PBGC of certain events that may signal problems with a pension plan or contributing employer. PBGC uses the reporting of these events to determine whether an event that occurs with respect to a particular plan or plan sponsor presents a risk to PBGC's pension insurance system, or to plan participants. Events that must be reported to PBGC include the following, though reporting waivers may apply in specific situations:

- A greater than 20 percent reduction in active participants (as a result of a single event or general attrition);
- a failure to make required funding payments,
- an inability to pay benefits when due,
- certain distributions to a substantial owner,
- changes in the controlled group of the contributing sponsor,
- a liquidation,
- an extraordinary dividend or stock redemption;
- certain transfers of benefit liabilities;
- an application for a minimum funding waiver (discussed below);
- certain loan defaults (even if waived by the lender);
- insolvency; and
- large cumulated funding underpayments and total underpayments (including interest) in excess of $1 million, including interest (discussed below).

The requirement to report an event to PBGC may be waived, depending on the event, for a number of reasons, generally including where the company is a public company, or a foreign or *de minimis* entity, where the plan is small or well-funded, or where the company represents a low-default risk.

Generally, reportable event filings must be made within 30 days after the event (unless waived altogether), but some plans are subject to an advance reporting requirement, which generally requires notice 30 days before the occurrence of certain events. Failure to timely report may result in a penalty of up to $2,233 per day, although the PBGC generally reduces or waives the penalty for most reportable events.

B. Missed Contributions Liens and Excise Taxes

It is common for plan sponsors facing financial challenges to miss one or more minimum required contributions. Missed contributions should be monitored carefully as they can result in reporting requirements, excise tax liability, and liens. When an employer misses a contribution that, together with any other missed contributions (including interest), exceeds $1 million, a statutory lien automatically arises on all of the assets of the plan sponsor and each member of its "controlled group" (generally, other businesses that are connected to the plan sponsor through at least 80% common ownership). While the lien automatically arises when the missed contributions to a plan exceed $1 million, the lien is not self-perfecting, meaning that PBGC has to perfect the lien to make it effective against other parties.

Missed contribution liens are generally treated as federal tax liens and can cause complications with current or prospective lenders. This is especially true for lenders that provide revolving lines of credit, as the lenders' interests can be primed by PBGC's perfected lien. PBGC has the right to (and does) enforce the lien in certain circumstances, but it will often agree to subordinate its interest to lenders in circumstances where subordination is in the best interest of the agency (*e.g.*, preventing the bankruptcy of a plan sponsor). Note that the plan administrator is required to notify PBGC ten days after the due date for the missed contribution exceeding (in the aggregate) $1 million.

Additionally, employers are responsible for excise taxes on all missed contributions that are outstanding 8 ½ months at the end of a plan year. The excise taxes are generally 10% of the aggregate missed contributions but can increase to 100% if the Internal Revenue Service ("IRS") "assesses" the 10% tax and the missed contributions are not corrected.

C. PBGC Early Warning Program

When facing business challenges, companies may seek to enter into strategic or refinancing transactions. However, PBGC may make those transactions more expensive, if not impossible. This is because, under the Early Warning Program ("EWP") PBGC monitors large pension plans and the plans' sponsors to identify corporate transactions or other events that could potentially negatively impact the plan and/or PBGC as the guarantor of the plan's benefits. Under the EWP, PBGC focuses its monitoring efforts on plans with $50 million or more of underfunding or 5,000 or more participants (aggregating the plan with any other plan sponsored by a related controlled group entity). EWP investigations are typically triggered by (1) a change in controlled group, such as a subsidiary spinoff, (2) a major divestiture by an employer, (3) a leveraged buyout, (4) substitution of secured debt for unsecured debt, and (5) payment of shareholder dividends. When PBGC has concerns or questions about a corporate event, it typically contacts the plan sponsor to request additional information.

When PBGC perceives a transaction will put the plan or PBGC at risk of future loss, PBGC may threaten to use its authority to involuntarily terminate the plan. Under ERISA 4042, PBGC may only do this if it determines that the "possible long-run loss [to the PBGC] with respect to the plan may reasonably be expected to increase unreasonably if the plan is not terminated." If the plan sponsor does not agree to termination, PBGC must go to federal court to obtain an order terminating the plan.

If a plan is terminated, the plan sponsor and each of its controlled group members would be liable for the entire amount of the plan's unfunded benefits, calculated by PBGC using conservative assumptions that inflates the liability. The threat of plan termination, then, may compel a plan sponsor to make supplemental pension contributions or take other actions, such as providing security, that PBGC believes protect it and the plan.

Although PBGC often threatens to terminate a plan in advance of a corporate transaction if the sponsor does not provide additional protections to the plan, PBGC rarely takes action to terminate a plan against the wishes of the plan sponsor. Indeed, in the history of the agency, PBGC has only taken such action a handful of times. More often, disputes under the EWP are settled without litigation, and since 2010, PBGC has entered into dozens settlement agreements with plan sponsors under the EWP.

D. Shutdown Liability

Plan sponsors may be required to make supplemental contributions to their plans in the context of corporate downsizing through facility closures. Specifically, ERISA section 4062(e) provides that a liability arises when a "substantial cessation of operations at a facility" occurs, meaning that operations at a facility permanently cease, resulting in a workforce reduction of more than 15 percent of eligible employees. An employee is considered an eligible employee if he or she is eligible to participate in any pension benefit plan of the employer, including defined contribution plans such as 401(k) plans. The amount of the liability is based on the unfunded benefit liability of the defined benefit pension plan determined as if the plan had terminated on the date of the facility shutdown using PBGC's conservative termination assumptions.

For purposes of determining whether there has been a substantial cessation of operations, an eligible employee generally is counted as part of a "workforce reduction" if he or she is terminated because of the employer's closure of the facility, though there are exceptions (e.g., employees relocated to another facility of the employer). There is a 3-year look-back period that will include earlier separations that are related to the permanent cessation (i.e., sometimes referred to as a "rolling shutdown".)

An employer may elect to satisfy its shutdown liability by making additional contributions to the plan over the 7-year period following the cessation of operations. The amount of the additional contributions is determined by multiplying the plan's unfunded vested benefits by a fraction equal to the number of the separated employees who are plan participants over the number of eligible employees of the employer who are plan participants. These contributions are in addition to the minimum required contributions. The requirement to make the contributions ceases when, among other things, the plan becomes at least 90 percent funded. If an employer fails to pay any additional contribution, the entire amount of the remaining additional contributions becomes due to the plan.

PBGC requires the sponsor to notify the agency when a facility shutdown occurs, as well as if the sponsor elects to satisfy its shutdown liability by making the additional contributions discussed above. Additionally, the sponsor must notify PBGC each time it makes an additional contribution to the plan.

E. Partial Termination

A pension plan can experience a partial termination when a group of plan participants loses coverage under the plan due to employer-initiated terminations. Whether a partial termination has occurred is generally determined based on the relevant facts and circumstances, but a general rule developed by the courts and the IRS is that a reduction in active participants of 20% or more creates a rebuttable presumption that a partial termination has occurred. Generally, for purposes of calculating the 20% threshold, participants terminated as a result of a corporate event (*e.g.*, downsizing) are counted, but employees who leave voluntarily (*e.g.,* routine turnover) are not. That said, determining which participants are affected can be a complicated, time-consuming process.

If there is a partial termination, all affected employees (*e.g.*, employees who left employment for any reason during the plan year in which the partial termination occurred) must be fully vested as of the date of the partial plan termination. There is no requirement that a plan notify participants that partial termination has occurred, but employers sometime elect to send notices to participants whose benefits are impacted. A partial termination that is the result of an active participant reduction of more than 20% triggers a PBGC reportable event filing (discussed above), unless the reporting requirement waived.

F. Benefit Restrictions

Pension plans that fall below certain funding thresholds may be subject to benefit accrual and payment restrictions. The benefit restriction rules are nuanced, and a violation can put the plan's qualification at risk. For example, plans that are under 60% funded (i.e., have an Adjusted Funding Target Attainment Percentage ("AFTAP") of less than 60%) generally cannot pay unpredictable contingent event benefits (e.g., shutdown benefits) or pay lump sum benefits or other benefits that exceed the value of a single-life annuity. Plans less than 60% funded are also required to freeze benefit accruals. Plans between 80% and 60% funded typically may not make changes that would increase the liabilities of the plan and may only pay partial lump sums (e.g., 50% of the value of the benefit).

The bankruptcy of a plan sponsor also gives rise to automatic benefit restrictions, even if the plan is generally well-funded. Specifically, when a plan sponsor is a debtor in bankruptcy, the plan may not pay lump sums or other benefits that exceed the value of a single-life annuity (such as Social Security level income annuity or term certain options). This restriction remains unless and until the plan actuary certifies that the plan is at least 100% funded.

Sponsors of plans subject to benefit restrictions are required to notify participants and beneficiaries in writing. Such notices can be concerning to participants and beneficiaries, and may increase the attention needed from the company and its human resources team. Therefore, plan sponsors should carefully monitor their plans' funded level and take appropriate actions in anticipation of any potential restrictions. For example, plan sponsors may want to consider options avoiding benefit restrictions by, for example, making additional contributions to increase plan funding.

G. Executive Compensation

Plans sponsors with pensions that are in "at-risk" status (generally a plan with a funding target attainment percentage less than 80% for a plan year and was less than 70% for the prior plan year) are prohibited from funding executive deferred compensation plans. The practical effect of this restriction is that employers must immediately stop making contributions to nonqualified deferred compensation plans established for executives and other key employees. Failing to do so could cause executives' nonqualified benefits to be included in their income and subject them to a 20% penalty. Notably, this rule applies for all pensions in the controlled group, so plan sponsors should monitor all its plans carefully. Also, note that are "at-risk" plans are subject to different funding rules that may increase required contributions.

Options for Underfunded Pensions

Plan sponsors under financial stress may find it impossible to fund their pension plan. Although there are no easy answers, plan sponsors do have options for addressing serious pension funding challenges. This section discusses five of those options.

A. Freezing Benefits

Plan sponsors can limit the growth of pension liabilities by "freezing" some or all of the plan's benefit accruals. There are a number of different approaches and each will have a different impact on future pension liabilities. For example, a plan sponsor could (1) close the plan to new entrants while allowing current participants to continue to accrue benefits, (2) eliminate accruals for all participants but allow benefits to increase based on wage growth, (3) stop benefit accruals for some participants based on age, tenure, job classification, or plant location, or (4) entirely cease accruals for all active participants.

To freeze a plan, the plan sponsor must adopt an amendment stopping some or all future accruals. Both ERISA and the Code prohibit reductions to participants' accrued benefits, so plan sponsors must ensure that all participants retain their accrued benefits after the plan is frozen. For this reason, although certain plan amendments can be retroactive, an amendment to freeze benefits may only apply prospectively. For plans with more than 100 participants, participants generally must be provided a written notice of the amendment at least 45 days before the effective date of the freeze. Similarly, the plan's annual funding notice may have to reflect the freeze because it may have a material effect on plan liabilities or assets for the year.

Before freezing benefits, plan sponsors should consider whether freezing pension benefits could increase the employer's liabilities under its executive compensation plans (i.e., 409A plans). In some cases, the benefits payable under an executive pension plan are offset by the benefits paid by the pension plan. If a plan sponsor freezes pension benefits, it could trigger increased obligations under the executive pension plan because the pension offset stops increasing.

A plan sponsor should also consider whether a benefit freeze would contravene any collective bargaining agreements with unionized workers. If a collective bargaining agreement requires the accrual of benefits, the sponsor will likely need to bargain with the union for an amendment to the agreement.

B. In-Kind Contributions

Another option for employers is to make an in-kind contribution of property to the pension instead of, or in addition to, a cash contribution. That allows the employer to conserve cash, which may alleviate pressures caused by economic or other conditions. However, employers should be aware that the process is subject to a variety of complex rules and restrictions.

In particular, the Department of Labor ("DOL") takes the position that in-kind contributions are prohibited transactions, so they are only permissible if an exemption is available. There is a statutory exemption that permits a plan to acquire "qualifying employer securities" (e.g., stock and some employer debt instruments) or "qualifying employer real property" (e.g., real property and related personal property leased by a plan to the plan sponsor or its affiliates). The exemption imposes additional requirements that demand careful scrutiny. The DOL has granted individual prohibited transaction exemptions for in-kind contributions that do not meet the conditions for the statutory exemption.

There are also fiduciary implications to making an in-kind contribution. For example, plan fiduciaries will have to consider the terms under which the plan will accept the contribution. Additionally, plan sponsors will have to carefully consider the tax consequences of the contribution, as in-kind contributions may not always be tax deductible.

C. Funding Waivers

Employers facing a temporary business hardship that prevents them from funding their defined benefit plan should consider applying to the IRS for a funding waiver. A funding waiver reduces the employer's minimum required contributions for a single year. It essentially acts to defer the funding obligation, and the waived contributions then must be repaid over the following five years. The IRS can grant a waiver for up to three of any 15 consecutive plan years, but generally does not grant a waiver for more than one year at a time.

An employer can obtain a funding waiver only if it is able to demonstrate that it and each of its controlled group members are (1) unable to make the minimum required contributions due without "temporary substantial business hardship" and (2) application of the minimum funding requirements "would be adverse to the interests of plan participants in the aggregate." The IRS generally considers factors such as whether (a) the employer is operating at an economic loss; (b) there is substantial unemployment or underemployment in the trade or business and in the industry concerned; (c) the sales and profits of the industry concerned are depressed or declining; and (d) it is reasonable to expect that the plan will be continued only if the waiver is granted. However, the IRS may consider other factors. In practice, the IRS is primarily concerned with the "temporary" nature of the business hardship and the sponsor's ability to demonstrate that a waiver of the current minimum funding requirement will ultimately help the plan's long-term viability.

Funding waivers can be helpful in certain circumstances, but the application process can be costly and challenging. The employer must supply a considerable amount of information about its financial condition, executive compensation arrangements, and the pension plan itself. The employer also must notify plan participants of the waiver request and consider any written comments from them. For public companies, the waiver may require an 8-K disclosure to the Securities and Exchange Commission.

Once a funding waiver application is submitted, the IRS notifies the PBGC of the application, and gives PBGC a chance to comment on it. In our experience, PBGC plays an active role in analyzing waiver requests, and the IRS gives substantial weight to PBGC's analysis and recommendations. If PBGC agrees that a waiver should be granted, it will often suggest security be provided to the plan. Even if the PBGC does not suggest security or other conditions, the IRS often imposes various conditions on waivers that can make taking advantage of the relief more complicated and potentially less helpful.

Additionally, the IRS has no deadline to respond to a funding waiver submission, and also has taken the position that it cannot waive contributions that were actually made. This means plan sponsors may have to make the difficult choice to either make contributions that are due while the waiver request is pending—even though doing so reduces the amount of the waiver—or fail to make contributions and risk the consequences.

D. Distress Terminations

The PBGC has the authority to permit a plan sponsor to terminate its underfunded pension plan through a distress termination when the sponsor and each member of its controlled group (excepting certain *de minimis* entities) meet certain tests indicating the company cannot afford the plan. The most common test is the "business continuation test"—generally that the company will be unable to pay its debts when due and continue in business unless the plan is terminated. When a company is reorganizing in bankruptcy, the test is similar, although the court (and not PBGC) must make the determination that without plan termination, the company will be unable to reorganize in bankruptcy. These are generally "but for" tests, meaning the company needs to prove to PBGC (or the court) that, but for the pension, the company could stay in business. PBGC generally reviews applications to ensure that the company has a viable business plan going forward and has taken all reasonable steps to either reduce costs or find alternative methods of funding the pension.

Because most sponsors prefer to avoid bankruptcy, which can be a costly, inefficient and risky process, the distress termination process provides an avenue for a plan sponsor to work with PBGC to resolve pension liabilities without resorting to bankruptcy. If the distress termination is granted, PBGC and the plan sponsor typically negotiate an agreement to settle the liabilities related to the termination, which includes the plan's unfunded benefit liabilities and, in most cases, termination premiums in the amount of $1,250 per participant per year for 3 years following the plan's termination. PBGC has a considerable amount of latitude when negotiating a settlement, as the ultimate goal is to reach an agreement that allows the company to continue as a going concern while providing PBGC with resources to pay guaranteed pension benefits. Settlements often include a mix of short-term payments with longer-term, secured obligations (*e.g.*, secured notes). PBGC also is typically willing to work with lenders to ensure that the company still has access to credit and does not breach its covenants.

An out-of-bankruptcy distress termination may be appropriate for some, but plan sponsors should be aware that the process can take a considerable amount of time. The success of an out-of-court distress termination is also largely dependent on PBGC's willingness to enter into a settlement that is affordable for the company. If PBGC and the sponsor are unsuccessful in negotiating a settlement, the plan sponsor may be responsible for accelerated funding obligations, and liens may arise. An in-bankruptcy termination may provide a quicker resolution, and PBGC's claims will be paid pursuant to the priority scheme in the Bankruptcy Code. It is important to note that settlement of termination liability with PBGC does not necessarily settle all plan-related obligations, such as funding-related excise taxes.

Funding Relief Legislation & Future Action

On March 27, 2020, Congress passed the *Coronavirus Aid, Relief, and Economic Security Act* (H.R. 748, the "the Act"). The Act allows plan sponsors to delay making contributions that would otherwise be due during calendar year 2020 (*i.e.,* quarterlies and final) until January 1, 2021. Although the contributions will not be due until January 1, 2021, they will still accrue interest starting on the prior deadlines. The interest charged would be at the plan's effective rate of interest, which is generally calculated each year by the actuary based on the interest rates used to determine the plan's liabilities.

For plan years that include any portion of 2020, the Act also permits a plan sponsor to elect to treat the plan's AFTAP as being equal to the percentage from the last plan year ending before January 1, 2020. Absent this relief, plans with plan years that start after January might have reported unusually low 2020 AFTAPs because of the recent decline in the financial markets. These low AFTAPs could have triggered funding-related benefit restrictions, such as lump sum prohibitions and benefit accrual restrictions. With the relief, plan sponsors may be able to avoid these restrictions by utilizing this provision.

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