MANAGING PENSION COSTS AND FUNDING ISSUES

I. The Problem

Most of a defined benefit pension plan's benefit liabilities will be paid over time in future years. Other things being equal, the measured value of those liabilities will "grow" with the passage of time.

To illustrate, assume that an 8% discount rate is used to determine the present value of the plan's benefit liabilities. Assume further that benefit liabilities, measured as of January 1, 1999, total $100.00. All other things being equal, the measured value of those same liabilities, as of January 1, 2000, would be roughly $108:

$100 x 1.08 = $108.

Likewise, the (simplified) measured value as of January 1, 2001 and January 1, 2002 would be roughly $116.64 and $125.97, respectively:

$108 x 1.08 = $116.64; and

$116.64 x 1.08 = $125.97

The market value of plan assets, in contrast, is unlikely to grow at a similarly steady rate of interest. In recent years, many plans have experienced negative or flat investment returns.

Assume, for example, that the hypothetical pension plan noted above had assets worth $90 as of January 1, 1999. Assume further that the plan had a flat investment return over the next three years (*i.e.*, the market value of assets remained at $90 as of January 1, 2000, 2001 and 2002). All other things being equal, the plan would see its funding gap grow from $10, measured as of January 1, 1999, to $35.97 as of January 1, 2002 – a more than 200% increase in just three years:

Date	Liabilities	Market Value of Assets	Net Liabilities (Assets)
1999	$100	$90	$10
2000	$108.00	$90	$18
2001	$116.64	$90	$26.64
2002	$125.97	$90	$35.97

The deficit reduction contribution ("DRC") requirements exacerbate this problem. Section 412(l) of the Internal Revenue Code requires additional charges to the plan's funding standard account to amortize liabilities at a faster rate than otherwise would be required. Code § 412(l)(1). This additional funding obligation applies to a plan for any plan year in which the funded current liability percentage is less than 90%. Code § 412(l)(9)(A). Under an exception to this rule, if a plan's funded current liability percentage is at least 80% for the plan year and has been at least 90% for the two preceding plan years, or for the second and third preceding plan years, the deficit reduction contribution is not required. Code § 412(l)(9)(B). In other words, as long as the plan's funded current liability percentage is 90% for two consecutive years, the plan's funded current liability percentage can go as low as 80% for the next two years without triggering additional funding obligations.

II. Refinancing Tools

The Code and ERISA offer a number of tools that a plan can use to spread funding costs over a broader or different number of years. These tools do not eliminate or extinguish plan liabilities. Nor do they increase the market value of plan assets. They are merely techniques for refinancing plan debt. Notably, these techniques do not reduce the deficit reduction contribution obligation because they do not alter the plan's assets or liabilities.

A. Waiver of Minimum Funding Standard

Code § 412(d) permits the IRS to issue up to three waivers for any 15 consecutive plan years.

- Standard. Must furnish evidence that (1) the employer and all of its controlled group members are unable to satisfy the minimum funding standard for a plan year without temporary substantial business hardship and (2) application of the minimum funding standard would be adverse to the interest of plan participants in the aggregate. Code § 412(d)(1).

- Temporary, substantial business hardship. Factors include whether the employer is operating at a loss, whether there is substantial unemployment or underemployment in the trade or business or the industry, whether industry sales and profits are depressed or declining and whether it is reasonable to expect the plan to be continued only if the waiver is granted. Code § 412(d)(2).

- Security may be required. A security interest enforceable by the Pension Benefit Guaranty Corporation on behalf of the plan may be required as a condition of waiver. Code § 412(f)(3). PBGC, which bears the risk of a termination while the plan is underfunded, has the opportunity to comment on pending requests for waiver. Code § 412(f)(3).

- Timing. Application must be filed by the 15th of the third month following the close of the plan year for which the waiver is requested. Code § 412(d)(4)

- Notice. Advance notice to participants, beneficiaries, alternate payees and employee organization is required. Code § 412(f)(4)(A).

- Procedure. Submit request to IRS pursuant to Rev. Proc. 94-41.

B. Extension of Amortization Periods

Code section 412(e) permits the IRS to extend by up to ten years the number of years over which certain liabilities may be amortized.

- Standard. Must furnish evidence that (1) extension is needed to continue the plan or to prevent substantial curtailment of benefit plan levels or employee compensation and (2) a denial would be adverse to the interests of plan participants in the aggregate. Code § 412(e).

- Security may be required. A security interest enforceable by the Pension Benefit Guaranty Corporation on behalf of the plan may be required as a condition of waiver. Code § 412(f)(3). PBGC, which bears the risk of a termination while the plan is underfunded, has the opportunity to comment on pending requests for waiver. Code § 412(f)(3).

- Notice. Advance notice to participants, beneficiaries, alternate payees and employee organizations is required. Code § 412(f)(4)(A).

- Procedure. Submit request to IRS. See Rev. Proc. 79-61 and Rev. Rul. 79-408.

III. Method and Assumption Changes

The plan's interest, mortality and other actuarial assumptions affect the present value of plan liabilities. The actuarial valuation method affects the way liabilities are funded. Changing these assumptions and methods therefore may change contribution obligations, including DRC obligations. Whether a change can be made depends, of course, on the facts and circumstances in each case. Generally, for purposes of the minimum funding obligation, actuarial assumptions and methods must each be reasonable, taking into account the experience of the plan and reasonable expectations, or must in the aggregate result in a total contribution equivalent to the contribution that would be determined if each assumption and method were reasonable. Code § 412(c)(3)(A). In addition, the actuarial assumptions and methods, in combination, must offer the actuary's best estimate of anticipated experience under the Plan. Code § 412(c)(3)(B).

- Certain changes may be made without IRS approval. For example, adopting a smoothing method for valuing plan assets alleviates the effect of poor asset returns by spreading the change in asset value over several years. A change to the smoothed market value method of valuing assets with a smoothing period of not more than five years is automatically approved. Rev. Proc. 2000-40, §§ 3.15 and 3.16.

IV. Structural Changes

A. In-Kind Contribution of Employer Stock

Generally, in-kind contributions to a defined benefit plan would constitute a prohibited sale or exchange of property between the plan and a party in interest (the contributing employer). ERISA § 406(a)(1)(A); 29 C.F.R. § 2509.94-3(c). *See Commissioner v. Keystone Consolidated Industries, Inc.*, 508 U.S. 152 (1993). A statutory exemption, however, permits a contributing employer to make in-kind contributions of employer stock to a defined benefit plan subject to certain restrictions. The same tax deduction rules apply to stock contributions as to cash contributions.

- The plan's acceptance and continued holding of employer stock must be prudent and consistent with the fiduciary duty to diversify assets under sections 404(a)(1)(B) and (C) of ERISA.

- The stock must be a "qualifying employer security." ERISA § 407(a). This means that, immediately after the plan's acquisition of the stock, no more than 25 percent of the aggregate amount of stock of the same class issued and outstanding is held by the plan and (2) at least 50 percent of the aggregate amount of stock of the

same class issued and outstanding is held by persons independent of the issuer. ERISA §§ 407(d)(5), (f)(1).

- The value of employer stock must not exceed 10% of the fair market value of plan assets. ERISA § 407(a).

- The stock must be acquired for "adequate consideration" (*e.g.*, prevailing price traded on a national exchange) and no commission may be charged. ERISA § 408(e); Code § 4975(c).

B. Benefit Reductions

ERISA and the Code generally prohibit plan amendments that reduce the accrued benefits of plan participants. ERISA § 204(g); Code § 411(d)(6). Under Code § 412(c)(8) (and its Title I analog in ERISA § 302), however, the IRS may approve certain kinds of retroactive amendments where there is "substantial business hardship."

- Two courts have concluded that the statutory anti-cutback rule does not prohibit reductions to benefits awarded to retirees as a result of a plan amendment adopted post-retirement. Trustees of the Sheet Metal Workers' National Pension Fund v. Commissioner, 117 T.C. 220 (Dec. 4, 2001) (appeal pending); Scardelletti v. Bobo, 1997 U.S. Dist. LEXIS 14498 (D. Md. Sept. 8, 1997). The IRS does not agree with this result.

Reduction or elimination of *future* accruals by plan amendment are not constrained by the anti-cutback rule. But they can trigger other issues, such as mandatory vesting in the case of a "partial" termination, and require advance notice to participants.

- ERISA § 204(h) and new Code section 4980F require notice to certain plan participants in advance of any plan amendment that is reasonably expected to significantly reduce or eliminate future benefit accruals, early retirement benefits or retirement-type subsidies.

  - Under the proposed 204(h) regulation, the 204(h) notice generally must be provided at least 45 days before the amendment's effective date. However, there are exceptions to this timing rule, for example, if an amendment subject to the 204(h) notice requirement is adopted in connection with a corporate transaction, the 45-day period is reduced to 15 days.

- If the notice is not provided, an excise tax will be imposed under Code section 4980F. Generally, this penalty is $100 per day for each omitted notice. Liability is capped at $500,000 per year if reasonable diligence was exercised to meet the notice requirement. In addition, the IRS may waive all or part of the penalty if it determines that the payment would be inequitable relative to the failure.

- The failure to provide the notice also has consequences under ERISA. If the failure is "egregious," participants will be entitled to the greater of (i) the benefits to which they would have been entitled without regard to the amendment or (ii) the benefit under the plan as amended. Generally, a failure is "egregious" if the failure is within the plan sponsor's control and either (a) is intentional or (b) there is a failure to provide most of the individuals entitled to the notice with most of the required information. It is less clear what the ERISA consequences are if the failure is not "egregious." In any event, the regulations expressly state that a participant can seek recourse under ERISA section 502 for any failure to provide a proper 204(h) notice.

C. PBGC Workout

- If the facts support a distress termination, a plan may be terminated and payment of termination liability negotiated with PBGC. PBGC has discretion to negotiate terms for payment of termination liability. Success of the negotiation will depend on the particular facts.

- PBGC generally is reluctant to use its authority to initiate termination of a plan under section 4042 of ERISA. PBGC similarly does not often approve terminations based on the "PBGC distress" test. The more common method for terminating a plan in a distress termination is under the "reorganization distress" test, which requires the plan sponsor and all of its controlled group members to have filed a petition for reorganization under Chapter 11 of the Bankruptcy Code.

D. Plan Merger

A merger with an over-funded or better-funded plan maintained by the same employer could reduce contribution liability. The merger decision is a settlor decision. *E.g.*, *Systems Council EM-3, Int'l Bhd. of Elec. Workers v. AT&T Corp.*, 159 F.3d 1376, 1380 (D.C. Cir. 1998). Implementing the

decision to merge single-employer plans may involve fiduciary actions, but courts generally have concluded that compliance with section 208 of ERISA, which tracks the requirements of Internal Revenue Code section 414(l), satisfies the fiduciary's duties. *E.g.*, *Blaw Knox Retirement Income Plan v. White Consol. Industries*, 998 F.2d 1185, 1190 (3d Cir. 1993), *cert. denied*, 510 U.S. 1042 (1994). Section 414(l) generally requires that the funded status of accrued benefits on a termination basis be maintained.

E. Multiemployer Plan

Forming a multiemployer plan also affects funding obligations. Multiemployer plans are not subject to the deficit reduction contribution requirements (and pay lower PBGC premiums). Funding the same or a similar benefit structure in a multiemployer plan therefore could be more manageable.

- To meet the definition of multiemployer plan under applicable Department of Labor regulations, the plan must, among other things, be established for "a substantial business purpose." 29 C.F.R. § 2510.3-37(c). To determine whether a plan meets this test, the Department considers:
    - the extent to which the plan is maintained by a substantial number of unaffiliated contributing employers and covers a substantial portion of the trade, craft or industry in a geographic area,
    - the extent to which the plan provides benefits more closely related to years of service within the trade rather than years of service with an employer,
    - the extent to which collective bargaining takes place between contributing employers and the union on matters other than employee benefit plans, and
    - the extent to which the administrative burden and expense of providing benefits through single-employer plans would be greater than through a multiemployer plan. 29 C.F.R. § 2510.3-37(c)(1)-(4)
- This option has risks, however. For example, the employer loses control of the plan because the multiemployer plan is administered by a joint board of management and labor trustees. The employer

also is subject to withdrawal liability if the multiemployer plan is not fully-funded. And the PBGC guarantee for multiemployer plans is substantially lower, about $12,000 for a participant with 20 years of service, than the single-employer guarantee.

V. Legislative Relief

On March 9, 2002, President Bush signed the "Job Creation and Worker Assistance Act of 2002" into law. Pub. L. No. 107-147, 116 Stat. 21 (2002). That Act includes a provision that gives modest DRC and PBGC premium relief for the 2002 and 2003 plan years. Under the legislation –

- Single employer plans may calculate their DRC obligations using interest rates within a higher range of the weighted average of 30-year Treasury rates for the last four years – up to 120% of the "applicable rate" instead of only 105% -- for the 2002 and 2003 plan years; and

- Single-employer plans may calculate variable-rate PBGC premiums for the 2002 and 2003 plan years based on 100% of the applicable rate instead of 85% of the applicable rate.

The legislation does not provide relief for the 2001 plan year. Proposals to extend relief back to 2001 are unlikely.