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MANAGING DEFINED BENEFIT PENSION PLAN FUNDING

Despite massive infusions of contributions to defined benefit plans in the past few years, rising interest rates, and stock market recovery, many defined benefit pension plans remain underfunded and face significant contribution obligations. The deficit reduction contribution or "DRC" rules exacerbate this problem, and often require additional contributions at a time when an employer can least afford to make them.

This article describes methods for managing defined benefit plan funding, ranging from changing actuarial assumptions to more drastic measures, such as a reducing or freezing benefits.

Temporary Fixes

A number of steps can change the timing, but not the amount, of required contributions to a defined benefit plan.

Change in Actuarial Methods and Assumptions

One of the small steps that may affect contributions is changing actuarial methods and assumptions used for funding. An actuarial cost method is the technique the actuary uses to assign costs among the different periods of service worked by the plan's participants. Employee Retirement Income Security Act of 1974, as amended ("ERISA") § 3(31). The plan administrator may select from among different actuarial cost methods to measure the plan's funding obligation. Switching from one acceptable method to

another may have the effect of moving part of the pension funding cost from one year to another.

A plan also may use different techniques for measuring the actuarial value of assets. Rev. Proc. 200-40, §§ 3.15, 3.16. For example, a plan may use a method to smooth fair market value over periods of up to five years using different actuarial techniques. Rev. Proc 2000-40, §§ 3.15-3.16.

The plan's actuary also may consider whether assumptions for things like interest rate, mortality, retirement age and turnover assumptions may be changed. The actuary must determine that the assumptions used are reasonable and offer the actuary's best estimate of the anticipated experience under the plan. Internal Revenue Code ("IRC") § 412(c)(3)(A).

Minimum Funding Waiver and Extension of Amortization Period

A minimum funding waiver postpones all or part of a contribution requirement otherwise due and payable with respect to a plan year, but the delayed payment must be made in the future, with interest. IRC § 412(d).

To obtain a waiver, the plan sponsor must demonstrate to the Internal Revenue Service ("IRS") that the plan sponsor and the trades or businesses in its controlled group -- that is, the companies within the corporate family liable for funding the plan -- are undergoing a period of temporary and substantial business hardship. In plain English, the plan sponsor needs to show the IRS that the company is temporarily in financial hard times through some circumstance like a down cycle in the industry, or other specific

event regarding the company or companies. At the same time, the plan sponsor must show that the company or companies are very likely to rebound and be able to pay back the funding waiver in the future. The IRS also must conclude that requiring full contributions would be adverse to the interest of the plan participants and beneficiaries.

Procedurally, the timing requirements for a waiver or extension of amortization periods can be a problem. Minimum funding obligations are computed on a plan year basis. To obtain relief from the first quarterly payment, a plan must receive the waiver by April 15. The IRS, however, discourages waiver applications until after the plan sponsor has at least a half year of financial results to demonstrate temporary financial business hardship. Earlier applications have been accepted and acted upon by the IRS, however.

Extending the amortization periods for certain charges to the funding standard account achieves a result similar to a minimum funding waiver by pushing payments out into the future. IRC § 412(e). IRS may grant an extension upon a showing that failure to grant the extension would result in a substantial risk to continuation of the plan or substantial curtailment or benefit levels under the plan or employee compensation and denial of the extension request would be adverse to participants and beneficiaries in the aggregate. *Id.*

For both waivers and extensions, benefits may not be increased while the waiver or extension is in effect, advance notice to participants is required and a user fee is charged. IRC §§ 412(f)(1), (3); Rev. Proc. 2004-8. If a waiver involves $1 million or more, the IRS routinely conditions the waiver on providing collateral, which may be

exercised by the Pension Benefit Guaranty Corporation ("PBGC") for the benefit of the plan. IRC § 412(f)(3). In addition, the IRS, as a condition of the waiver, may extend the restriction against amendments increasing benefits to all other plans maintained by the plan sponsor. For the same reason, the IRS recently has updated its procedure for applying for waivers, and now specifically requires the plan sponsor to provide financial information about other plans, including executive compensation plans. Rev. Proc. 2004-15.

Significantly, waivers and extensions of the amortization period may exacerbate the effect of the DRC. If a plan receives a waiver for 2004, the DRC for 2005 could be substantially higher because, with no contributions for 2004, there may be fewer assets and the same or greater liabilities. Serial waivers may alleviate this problem and the IRS is permitted to grant up to three waivers in any consecutive 15-year period. IRC § 412(d)(1). The IRS staff has taken the position, however, that the revenue procedure governing waivers does not permit a single application for multiple year waivers. A plan sponsor therefore cannot be assured of receiving multiple-year waivers.

Non-Cash Contributions

Section 406(a)(1)(A) of ERISA prohibits the sale or exchange of property between a plan and a party and interest. The Department of Labor and the courts have interpreted this to mean that contributing anything other than cash to a plan is a prohibited transaction. *E.g.*, *Commissioner v. Keystone Consolidated Industries, Inc.*, 508 U.S. 152 (1993). There is a statutory exemption, however, for contributions of employer securities

and employer real property. ERISA § 407. In addition to meeting the requirements for the statutory exemption, plan fiduciaries must assure that the contribution is consistent with the fiduciary duty of prudence and the duty to diversify plan assets. ERISA §§ 404(a)(1)(B), (C).

Under the exemption, employer securities must be qualifying employer securities. ERISA § 407(a). This means that immediately after the plan acquires the securities, not more than 25% of the aggregate amount of the security in the same class is held by the plan, and at least 50% of the aggregate amount of the security in that class is held by persons independent of the issuer. ERISA § 407(d)(5), (f)(1). In addition, the value of the employer securities and employer real property held by the plan must not exceed 10% of the fair market value of plan assets, and must be acquired for adequate consideration. ERISA § 407(a). The trading price on a public exchange or the price determined by an independent appraiser would meet this requirement. ERISA § 408(e). Finally, no commission can be charged for the transfer the securities to the plan. *Id.*

Employer real property held by a plan under the exemption must be qualifying employer real property. ERISA § 407(a)(1). To meet this standard, the property must be leased to an employer or an affiliate of the employer that employs people in the plan. ERISA § 407(d)(2). There must be more than one parcel of property dispersed geographically and each parcel must be adaptable without excessive cost for more than one use. ERISA § 407(d)(4).

A plan administrator also may ask the Department of Labor for an individual prohibited transaction exemption for contributions that do not meet the statutory exemption requirements. ERISA § 408(a). To obtain an exemption, the Department of Labor must conclude that the proposed exemption is administratively feasible, in the interests of participants and beneficiaries, and protective of the rights of participants and beneficiaries. *Id.* Often, individual exemptions granted by the Department of Labor not only protect the plan from any loss in connection with the transaction, but also include an upside potential for the plan.

Structural Changes

Benefit Reduction

ERISA and the Internal Revenue Code prohibit the cutback or elimination of accrued benefits, but benefits may be reduced or eliminated going forward, in accordance with section 204(h) of ERISA. ERISA § 204(g); IRC § 411(d)(6). Section 204(h) generally requires 45-day advance notice to affected participants.

Section 412(c)(8) of the Internal Revenue Code permits a reduction of accrued benefits under limited circumstances. Under this provision, a plan sponsor may amend a plan within two and a half months after the end of a plan year to eliminate accruals going back to the first day of the prior plan year with the approval of the Secretary of Treasury. IRC § 412(c)(8). The Secretary's decision is based on the minimum funding waiver standard, that is, substantial business hardship, and only in a case where a minimum-funding waiver is unavailable or inadequate.

Merger

An obvious structural change is merging an over-funded plan with an under-funded plan. To do this, section 414(l) of the Internal Revenue Code requires the funded level of benefits for each participant in the plan on a termination basis after the merger to be the same as or better than it is before the merger. This means that the 100% funded level of benefits in over-funded plan must be preserved after the merger. If the merger otherwise would reduce the funded level of the plan below 100%, the plan may be required to maintain a special schedule of benefits to assure compliance with IRC section 414(l). Treas. Reg. § 1.414(l)-1(e)(2).

The decision to merge plans is a settlor, rather than a fiduciary 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). Courts generally have concluded that, in implementing the merger, compliance with section 208 of ERISA, which tracks the requirements of IRC section 414(l), satisfies fiduciary requirements under ERISA. *E.g.*, *Blaw Knox Retirement Investment Plan v. White Consolidated Industries, Inc.*, 998 F.2d 185, 1190 (3d Cir. 1993), *cert. denied*, 510 U.S. 1042 (1994).

Similar to a merger, single-employer plans also can combine to form a multiemployer plan. Multiemployer plans are not subject to the DRC and generally have longer amortization periods for determining minimum funding contributions. These differences permit multiemployer plans to be funded more slowly than single employer

plans. 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). The Department of Labor has denied multiemployer plan status to plans that appeared to be formed to obtain contribution relief.

Transfer of Plan to an Unrelated Entity

Pension plans can be transferred to another entity in a business transaction. This often occurs as a matter of course if stock and ongoing operations of a corporation are transferred to an unrelated buyer. In addition, there are commercial "matchmakers" that offer, for a price, to place plan liabilities with willing, unrelated parties.

Generally, the transfer of a pension plan to an unrelated entity eliminates the seller's ongoing liability for the plan going forward. This is not true, however, where a principal purpose of the transaction is to evade termination liability. ERISA § 4069. If a principal purpose of a transaction is to evade termination liability, the seller remains liable for any termination liability that may arise within five years after the transaction. *Id.*

Under its "Early Warning Program," PBGC also may seek additional protection for the plan, such as enhanced contributions or security, if PBGC believes that the transfer would put the plan at risk of termination and adversely affect PBGC's ability to recover termination liability.

Termination

Terminating a plan eliminates the ongoing obligation to make contributions to the plan. A plan termination also matures PBGC's claim for underfunding under section 4062(b) of ERISA, however. The amount of the liability is the difference between the fair market value of plan assets on the date of plan termination and the value of plan liabilities on the date of plan termination, measured in accordance with conservative assumptions in PBGC's regulations. ERISA § 4062(b)(1). The resulting liability amount generally is much higher than if the ongoing plan assumptions were used. This means that funding the plan in accordance with ongoing funding assumptions generally is more favorable for a plan sponsor than facing a termination liability bill. If the plan sponsor is in bankruptcy, however, liability to PBGC is treated as a general unsecured claim, which often is satisfied by payment of less than 100 cents on the dollar. Moreover, some courts have reduced the amount of PBGC's underfunding claim by applying a different interest assumption than PBGC uses to determine liability. *E.g., In re CSC Industries, Inc.*, 232 F.3d 505 (6th Cir. 2000); *In re CF&I Fabricators of Utah*, 150 F.3d 1293 (10th Cir. 1998), *cert. denied*, 526 U.S. 1145 (1999). Recently, however, a bankruptcy court upheld the use of PBGC's regulation assumptions for determining liability, rather than the market-based assumptions proposed by the plan sponsor. *In re US Airways Group, Inc.* , 296 B.R. 734 (Bankr. E.D. Va. 2003).

Termination of an underfunded plan is strictly controlled. The PBGC is authorized to seek termination of an underfunded pension plan when PBGC believes that

its guarantee fund or the interest of participants and beneficiaries are at risk. This is called an involuntary termination. If PBGC does not initiate an involuntary termination of an underfunded plan, the only way to terminate the plan is in a distress termination.

There are three tests for distress termination . ERISA §§ 4041(c)((2)(B)(i), (ii), (iii). The plan sponsor and each member of its controlled group must meet a distress test, but they need not all meet the same distress test. Two of the distress tests require the company be in bankruptcy. The third test, which has two separate standards, is administered by PBGC.

(1) The liquidation distress test requires the entity to be liquidating in bankruptcy. ERISA § 4041(c)(2)(B)(i).

(2) The reorganization distress test, which is the most common, requires the entity to be reorganizing in bankruptcy in a case that hasn't been dismissed, and requires a finding by the bankruptcy court that unless the plan is terminated, the plan sponsor will be unable to pay all of its debts pursuant to a plan of reorganization, and will be unable to continue in business outside the Chapter 11 reorganization process. ERISA § 4041(c)(2)(B)(ii). This standard is applied very strictly as essentially a "but for" test. The entities in reorganization must demonstrate that they have made all of the cuts that reasonably are possible, and still are unable to reorganize and emerge from bankruptcy unless the plan is terminated.

Companies have met this standard in a number of ways. They have shown that, based on the income of the controlled group members post-bankruptcy, there will not be

enough cash flow to make the required contributions to the plan. *In re Wire Rope Corp.*, 287 B.R. 771, 779 (Bankr. W.D. Mo. 2002). They have shown that lenders will not provide debtor in possession financing or financing required for the reorganized company to continue in business outside of bankruptcy unless the plan is terminated. *In re US Airways Group, Inc.*, 296 B.R. 734, 746 (Bankr. E.D. Va. 2003).

(3) Under the PBGC distress test, the company must demonstrate to PBGC that, unless the plan is terminated, the company will be unable to pay its debts when due and will be unable to continue in business (similar to the reorganization distress test) or (4) the cost of providing pension coverage has become unreasonably burdensome solely because of a decline in the company's workforce. ERISA § 4041(c)(2)(B)(iii).

The first PBGC distress test sets a standard similar to the reorganization distress test and similarly would require a showing that the contributing sponsor and controlled group members had obtained concessions from creditors across the board but still is unable to continue in business. As a practical matter, obtaining creditor concessions often is difficult outside of bankruptcy, limiting the situations in which this distress test may be used.

The second PBGC distress test similarly has limited applicability, requiring a showing that the pension plan's cost has become unreasonably burdensome *solely* because of a workforce decline.

Conclusion

The measures described above offer an array of approaches for addressing defined benefit plan funding issues. A combination of measures may be used to obtain the desired funding relief. And while many plans have achieved a higher level of funding over the past few years, some of these approaches can be used even when there is no funding crisis to manage contributions for planning and budgeting purposes.