Defined Benefit Plans: Distress and Involuntary Terminations

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This Note describes the requirements for distress and involuntary terminations of defined benefit plans under the Employee Retirement Income Security Act of 1974 (ERISA).

A defined benefit plan subject to the Employee Retirement Income Security Act of 1974 (ERISA) can be terminated only by following certain specific procedures set out in Title IV of ERISA. If the plan has enough money to pay all of the benefits that have been earned, it can be terminated in a standard termination. However, a plan that does not have enough assets to pay its liabilities can only be terminated in a distress or involuntary termination.

This Note describes:

- Distress and involuntary terminations.
- The requirements for each type of termination.
- The effects on a plan sponsor of a distress termination.

TYPES OF DEFINED BENEFIT PLAN TERMINATIONS

If a defined benefit plan does not have enough assets to meet its benefit liabilities, the plan can be terminated through one of two types of plan terminations:

- A "distress" termination initiated by the plan sponsor (see *Distress Termination*).
- An "involuntary" termination initiated by Pension Benefit Guaranty Corporation (PBGC) at its discretion (see *Involuntary Termination*).

Regardless of the type of termination, terminating a defined benefit plan:

- Stops future benefit accruals.
- Stops future minimum funding obligations.
- Causes the PBGC's claim for unfunded benefit liabilities to mature.
- May trigger termination premiums.

DISTRESS TERMINATION

The plan sponsor can initiate a distress termination if it can show that it (and each of its controlled group members) meets one (but not necessarily the same one) of four distress tests specified by ERISA:

- **Reorganization distress test.** Under the reorganization distress test the:
  - company must be in reorganization in bankruptcy or insolvency proceedings; and
  - bankruptcy court must find that unless the plan is terminated, the company cannot pay all its debts under a plan of reorganization and cannot continue in business outside a Chapter 11 reorganization.
- **Business continuation distress test.** Under the business continuation distress test, the company must demonstrate to the PBGC that, unless a distress termination occurs, the company cannot:
  - pay its debts when due; and
  - continue in business.
- **Liquidation distress test.** Under this test, the company must have filed, or had filed against it, a petition seeking liquidation under federal or state law which has not been dismissed.
- **Pension cost test.** Under this test, the company must demonstrate to the PBGC's satisfaction that the company's

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costs of providing pension benefits have become unreasonably burdensome solely as a result of declining covered employment.

Of the four tests, the most commonly used are the reorganization distress test and the business continuation distress test. The two tests are substantively similar but each has a different focus. The focus of the business continuation distress test is the company's ability to remain in business outside of bankruptcy, as determined by the PBGC rather than a court. The focus of the reorganization distress test is on the company's ability to emerge successfully from bankruptcy, as determined by the bankruptcy court.

Process for Distress Termination

A plan administrator initiates a distress termination by issuing a notice of intent to terminate to:

- All plan participants and beneficiaries.
- Unions (if any) in which plan participants are members.
- The PBGC.

The notice must propose a date of plan termination (see *Date of Plan Termination*) that is at least 60 days but not more than 90 days after the date the notice is issued.

After issuing the notice of intent to terminate, the plan administrator must stop:

- Making loans to participants.
- Distributing plan assets or taking any other action to terminate the plan.
- Paying benefits attributable to employer contributions (other than death benefits) in any form other than an annuity.
- Buying irrevocable commitments from an insurer.

To complete a distress termination, the plan administrator submits documents to the PBGC demonstrating that the plan sponsor and each of its controlled group members satisfy one of the distress tests. The PBGC reviews the documents and other information concerning the assets and liabilities of the plan and determines whether all of the conditions for a distress termination have been met. If so, the PBGC and the plan administrator enter into an agreement to terminate the plan on the proposed date of plan termination and to appoint the PBGC as trustee of the plan. If the distress tests are not satisfied, the plan remains ongoing.

Significantly, the PBGC cannot continue processing a distress termination if it is notified of a challenge to the termination under an existing collective bargaining agreement. In that event, the PBGC stops processing the termination until it is notified that the challenge has been resolved.

INVOLUNTARY TERMINATION

The PBGC **must** initiate an involuntary termination if it determines that a plan does not have assets available to pay benefits currently due under the plan. The PBGC **may** initiate an involuntary termination, at its discretion, after making one of three other statutory findings:

- The plan has not met the minimum funding requirements. In the PBGC's view, this occurs only when a funding deficiency arises. For example, missing a quarterly payment would not permit the PBGC to make this finding.
- The PBGC's possible long run loss for the plan may increase unreasonably if the plan is not terminated. The PBGC applies the "long run loss" standard by comparing its liability risk for the plan assuming a termination **before** a specific transaction to its liability risk for the plan assuming a termination **after** the transaction. If the transaction, for example, would substantially increase plan liabilities or reduce the PBGC's ability to collect termination liability (see *Termination Liability*), the PBGC could conclude that it faces a long run loss if the plan is not terminated.
- There has been a distribution to a substantial owner that caused the plan to become underfunded.

After making one of the findings, the PBGC can enter into an agreement with the plan administrator to terminate the plan on a proposed termination date (see *Date of Plan Termination*), appoint the PBGC as trustee of the plan and therefore avoid litigation over termination. Alternatively, if the plan administrator does not agree to the termination, the PBGC can ask a court to order termination of the plan based on a finding that termination is necessary to:

- Protect the interest of plan participants.
- Avoid any unreasonable deterioration of the financial condition of the plan.
- Avoid any unreasonable increase in the PBGC's liability.

Unlike a distress termination initiated by the plan administrator, an involuntary termination can proceed even if the plan sponsor has an obligation to continue the plan under a collective bargaining agreement.

Preventing an Involuntary Termination

The PBGC has implemented an early warning program designed to improve a defined benefit plan's funded status and avoid a plan termination. The program monitors certain companies with underfunded defined benefit plans. The PBGC works with them to arrange suitable protections for the plans before a corporate business transaction significantly increases the PBGC's risk of loss or otherwise makes the pension plan no longer affordable to the plan sponsor and its controlled group. This way the PBGC can prevent losses before they occur, potentially preventing the need for a distress or involuntary termination. The PBGC focuses on two types of companies:

- Financially troubled companies.
- Companies with pension plans that are unfunded on a current liability basis.

The plan itself must meet one of the early warning program's screening requirements:

- A bond rating below investment grade and current liability exceeding $25 million.
- Current liability exceeding $25 million and unfunded current liability exceeding $5 million.

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Once one of the requirements has been met, the PBGC asks about corporate business transactions that may substantially weaken the financial support for the plan, such as:

- The break up of a controlled group (such as a spin-off of a subsidiary).
- A leveraged buyout.
- The transfer of significantly underfunded pension liabilities in a sale of a business.

If the PBGC decides that a transaction could significantly increase its risk of loss, the PBGC negotiates with the company to secure protections (such as letters of credit or financial guarantees) instead of terminating the plan.

DATE OF PLAN TERMINATION

The date of plan termination is significant because it is the date on which:

- Benefit accruals stop.
- Contribution obligations stop.
- Liability to the PBGC is measured (see *Liability to the PBGC*).

In addition, beginning on the date of plan termination, the plan administrator must limit benefit payments to participants in pay status to the estimated benefits guaranteed by the PBGC (see *Effect of Distress Termination*).

DISTRESS TERMINATION

In a distress termination, the termination date is the date chosen by the plan administrator. The termination date must be at least 60 days but not more than 90 days after the plan administrator issues the notice of intent to terminate.

INVOLUNTARY TERMINATION

In an involuntary termination, the date may be set by agreement between the PBGC and the plan administrator or, if they do not agree, by the court. Generally, courts have required a termination date on or after the date that plan participants receive actual or constructive notice that the plan will be terminated.

The PBGC is not required to provide individual, written notice to participants that it is seeking termination. Instead, notices may be published in newspapers where participants live and work.

If the plan already is frozen (see *Practice Note, Freezing a Defined Benefit Plan (http://us.practicallaw.com/6-502-3611)*) or the plan sponsor is liquidating or out of business, participants may have constructive notice that they are no longer accruing benefits under the plan.

In rare cases, a court will establish a retroactive date of plan termination to protect the PBGC's financial interests.

EFFECT OF DISTRESS TERMINATION

When an underfunded plan is terminated, the PBGC:

- Is appointed trustee of the plan.
- Takes over the assets of the plan.
- Pays benefits under the plan up to the amounts permitted by law.

For plans terminating in 2010, the PBGC guarantees $54,000 per year for each participant retiring at age 65. This amount is actuarially adjusted for joint and survivor annuities and for retirement ages below and above 65. Participants who have retired or could have retired three years before the date of plan termination may receive more, depending on the plan's funded level.

If the plan has sufficient assets to pay benefits above the guaranteed amount, participants can receive more than the maximum guaranteed benefit. Participants and beneficiaries do not have claims against the plan sponsor for the difference between the benefit paid by the PBGC and the benefit they may have received if the plan had been fully funded on termination.

LIABILITY TO THE PBGC

When an underfunded defined benefit plan terminates in a distress or involuntary termination, the PBGC has three types of claims:

- Claims for PBGC premiums (see *Premium Liability*).
- A claim for the difference between the value of all accrued liabilities under the plan on the date of plan termination and the value of plan assets on the date of plan termination, calculated using assumptions established in PBGC regulations (see *Termination Liability*).
- A claim for unpaid contributions to the plan, if any, pro-rated to the date of plan termination (unpaid contributions liability).

These liabilities are joint and several obligations of the plan sponsor and each member of its controlled group (see *Joint and Several Liability*).

Premium Liability

PBGC premiums consist of:

- Annual flat-rate and variable-rate premiums, which are due until a plan is terminated (see *Practice Note, Freezing a Defined Benefit Plan: PBGC Premiums and Reporting Requirements (http://us.practicallaw.com/6-502-3611)*).
- A termination premium, which is due after the plan terminates.

The termination premium generally is $1,250 times the number of participants in the plan immediately before the plan termination. The termination premium arises unless the plan is terminated in a liquidation distress termination (see *Distress Termination*).

Under the general rule, the premium is payable for each of the three consecutive 12-month periods beginning with the first month following the month in which the date of termination occurs. Under a special rule, if the plan is terminated in a

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reorganization distress or involuntary termination during the pendency of any bankruptcy reorganization proceeding under Chapter 11 or under similar state law, the premium is payable for each of the three consecutive 12-month periods beginning with the first month following the month in which the date of discharge or dismissal occurs.

At least one court has concluded that a termination premium does not arise if the debtor liquidates in Chapter 11 bankruptcy because there is no discharge in such a case.

Termination Liability

Termination liability is the difference between the fair market value of plan assets on the date of plan termination and the value of the plan's liabilities on the date of plan termination. The value of the plan's liabilities is determined using conservative assumptions in PBGC regulations. Generally, the assumptions are intended to produce a benefit liability value that tracks the cost of purchasing an annuity contract from an insurer to provide the benefits to participants. Several courts of appeals have found that the value of plan liabilities can be recalculated in bankruptcy using a "prudent investor rate", rather than the rate in the PBGC's regulations. The prudent investor rate is the long-term rate of return a plan could expect to receive from a portfolio prudently invested in stocks, bonds and similar investment products. The prudent investor rate can be substantially higher than the discount rate in the PBGC's regulations, which can result in a substantially lower termination liability claim.

More recently, some courts have rejected the prudent investor rate theory and applied the PBGC's regulations to determine the amount of the PBGC's termination liability claim.

If the PBGC's termination liability claim is not paid on demand, a lien arises on the assets of the plan sponsor and the members of its controlled group (see *Lien and Priority*).

Joint and Several Liability

The PBGC may, at its option, seek payment of 100% of the joint and several liability from any one or more controlled group members, but may not collect more than 100% of the amount owed. In bankruptcy, the PBGC files its entire claim separately against each debtor in the controlled group and can pursue its claim against non-debtor controlled group members as well.

There is no provision in ERISA for allocating unpaid contributions liability or controlled group liability among controlled group members.

LIEN AND PRIORITY STATUS

Lien

If the PBGC's termination liability claim is not paid on demand, a lien arises in the amount of the lesser of:

- The termination liability.
- 30% of the net worth of the plan sponsor and its controlled group.

The PBGC may perfect this lien to obtain a security interest in the assets of the plan sponsor and controlled group members if the entities are not protected by the automatic stay in bankruptcy.

Priority Status in Bankruptcy

In bankruptcy, the PBGC's claim for termination liability is treated as a general unsecured claim (see *Practice Note, Order of Distribution in Bankruptcy: General Unsecured Claims (http://us.practicallaw.com/7-383-1336)*).

Unpaid contribution claims attributable to prepetition services generally are treated as general unsecured claims, except that contributions attributable to service during the 180 days before the bankruptcy filing receive priority treatment under Section 507(a)(5) of the Bankruptcy Code (see *Practice Note, Order of Distribution in Bankruptcy: Priority Claims (http://us.practicallaw.com/7-383-1336)*). Contributions attributed to postpetition services may receive administrative priority treatment (see *Practice Note, Order of Distribution in Bankruptcy: Administrative Expenses (http://us.practicallaw.com/7-383-1336)*).

The US Court of Appeals for the Sixth Circuit has found that obligations under a collective bargaining agreement are entitled to priority status until the obligation has been modified in accordance with Section 1113 of the Bankruptcy Code, regardless of whether the claims otherwise would meet the requirements for administrative priority status under the Bankruptcy Code (see *Practice Note, Order of Distribution in Bankruptcy: De Facto Priorities (http://us.practicallaw.com/7-383-1336)*). Accordingly, in the Sixth Circuit, an obligation under a collective bargaining agreement to contribute to a plan could give unpaid contribution claims administrative priority until the bargained obligation is modified under Section 1113.

Other courts that have addressed the issue, however, continue to apply the Bankruptcy Code test for administrative priority to obligations required under a collective bargaining agreement. For example, in the:

- US Court of Appeals for the Second Circuit, claims for prepetition vacation pay under a collective bargaining agreement are not entitled to administrative priority.
- US Court of Appeals for the Third Circuit, claims for prepetition vacation pay and severance pay under a collective bargaining agreement are not entitled to administrative priority.
- US Court of Appeals for the Fourth Circuit, contributions to multi-employer plans attributable to prepetition services are not entitled to administrative priority.

NONQUALIFIED DEFERRED COMPENSATION PLANS

The Internal Revenue Code also limits the ability of a plan sponsor of an underfunded defined benefit plan (and members of its controlled group) to set aside assets to pay nonqualified deferred compensation to certain covered employees during a restricted period. A restricted period is:

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- Any period during which any defined benefit plan maintained by the company (or any member of its controlled group) is in at-risk status (generally less than 80% funded).
- Any period during which the plan sponsor is a debtor in a Chapter 11 bankruptcy proceeding or any similar proceeding under federal or state law.
- The 12-month period beginning on the date which is six months before the termination date of any defined benefit plan maintained by the company (or any member of its controlled group) if the plan does not have enough assets to cover benefit liabilities on the termination date.

If a company (or any member of its controlled group) funds a nonqualified deferred compensation plan during the restricted period, the assets set aside during the restricted period and any earnings on those assets become immediately taxable (to the extent vested) to the covered employees who are then also subject to a 20% penalty tax.

Not only are the covered employees of the plan sponsor affected, but also:

- Covered employees of a member of the plan sponsor's controlled group.
- Any former covered employee who was a covered employee of the plan sponsor or a member of the plan sponsor's controlled group on the date of his termination of employment.

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