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A non-bankruptcy solution for resolving unaffordable pension liabilities

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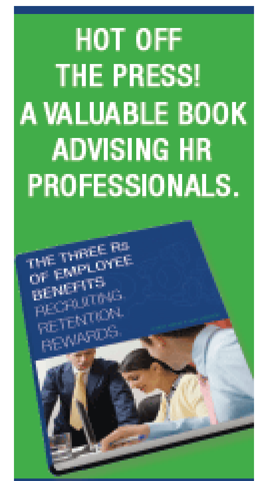

by Harold J. Ashner, Esq. and Deborah West, Esq.

During these financially difficult times, many employers are finding that the skyrocketing costs of funding their pension plans are threatening their viability and ultimate survival.

A little-known provision in ERISA, often referred to as the “Business Continuation Test,” could provide an employer with a non-bankruptcy solution to enable it to continue its business unsaddled by those pension obligations.

While ending a pension plan may be painful for both the company’s management and its current and former employees, if it comes down to a choice between death of the plan or death of the company, the company’s survival comes first—even under federal pension law.

Plan termination options

A single-employer plan covered by PBGC’s insurance program may be terminated only in accordance with Title IV of ERISA. There are only two ways to terminate a plan voluntarily: a “standard termination” and a “distress termination.” (In very limited circumstances, PBGC can initiate what is called an “involuntary” termination to protect its own interests or those of a plan’s participants.)

Because a standard termination requires, among other things, that the pension plan be fully funded (that is, it must have sufficient assets to cover all benefit liabilities), it is out of reach for many employers in today’s economic environment. That leaves a distress termination as the only remaining option.

Distress termination tests

To qualify for a distress termination, the plan sponsor and each member of its “controlled group” must meet one of four financial distress tests set forth in Title IV of ERISA. Generally, a controlled group includes companies related to each other through 80% or more ownership by a parent company or companies, or by the same five or fewer individuals, estates, and/or trusts. The controlled group members need not meet the same distress test.

The first two distress tests apply only to controlled group members who are in bankruptcy or similar proceedings under federal, state, or local law. Test one applies to liquidations, and test two applies to reorganizations. Both the third and fourth distress tests apply to ongoing employers that need not be in bankruptcy or similar proceedings.

Our focus here is on the third test—the Business Continuation Test—which is discussed in detail below. The fourth test—which applies when the costs of providing pension coverage have become unreasonably burdensome solely as a result of a decline in the workforce covered by the employer’s pension plans—is rarely used, but should always be considered where there has been a significant drop in the covered workforce.

Business continuation test

Typically, an ongoing employer seeking to terminate its underfunded pension plan does so in the context of a Chapter 11 reorganization case, relying on the second distress test. However, bankruptcy can be expensive, time-consuming and inefficient; in addition, it can disrupt the employer’s customer base and result in a loss of control.

For an employer whose non-pension debt is manageable or can be successfully renegotiated outside of bankruptcy, the third distress test (and, in limited circumstances, the fourth distress test) provides the possibility of relief from unaffordable pension costs without the burdens and costs of filing for bankruptcy.

Under the Business Continuation Test, a controlled group member qualifies for distress if it demonstrates “to the satisfaction of the [PBGC] that, unless a distress termination occurs, such person will be unable to pay such person’s debts when due and will be unable to continue in business.”

The Business Continuation Test is stringent, and the employer bears the burden of demonstrating to PBGC’s satisfaction that the test is met. PBGC can be expected to make a searching inquiry into the employer’s financial status and prospects. Thus, PBGC requires the submission of substantial information, including:

- financial statements for the five most recent fiscal years;
- projections of future revenues, expenses, and cash flow for at least five fiscal years; and

- pension cost information.

In addition, the employer will need to show PBGC that all other reasonable cost-cutting measures have been implemented and that **plan termination is the last resort** to prevent the company's demise. Relevant evidence would include showing that:

- loans have been renegotiated to the extent possible;
- contracts with employees and suppliers have been renegotiated where appropriate and feasible;
- capital expenditures have been cut or postponed to the maximum extent prudent;
- executive compensation has been reduced and perquisites curtailed or eliminated to the extent feasible, taking into account the need to offer competitive compensation packages;
- inefficiencies have been identified and corrected where possible;
- non-performing business units have been sold or closed;
- the employer will be unable to obtain financing or capital investment absent plan termination; and
- the possibility of a plan freeze, a minimum funding waiver from the IRS, or changes in actuarial assumptions have been considered but either are not feasible or would not render the plan affordable.

Plan termination liabilities

If distress is found under the Business Continuation Test and the plan terminates, the plan sponsor and the members of its controlled group are each liable, on a joint and several basis, for:

- the plan's unfunded plan benefit liabilities;
- any unpaid minimum funding contributions;
- any unpaid annual PBGC premiums and related penalty and interest charges; and
- a "termination premium" of $1,250 per participant, per year, for three years following plan termination.

Typically, once the plan terminates, **the employer and PBGC** negotiate a claims settlement that the employer can afford to pay and that enables it to continue in business, thus fulfilling the purpose of the Business Continuation Test.

Need for prompt action

It is important to assess the situation promptly and carefully. As long as the plan continues, **its costs will mount**. For example:

- statutorily-required minimum funding contributions will continue to accrue;

- if required but unaffordable minimum funding contributions are missed, liens enforceable by PBGC under Section 430 (k) of the Internal Revenue Code will arise once the total amount (including interest) exceeds $1 million; and
- any failure to satisfy the minimum required contribution for a plan year will result in excise taxes under Section 4971 of the Internal Revenue Code.

Thus, delaying action could prove disastrous. Consequently, if it appears that plan termination is appropriate, the process should be initiated as soon as prudently possible and liability issues should be addressed proactively.

If timely invoked, the Business Continuation Test could be the key that enables a company to turn around its **troubled business** into one that thrives. Successfully navigating the thicket of ERISA's distress termination rules is challenging, but it is doable; indeed, it may be essential for an employer's survival.

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