

# Non-Bankruptcy Distress Terminations: The “Business Continuation” Test

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## Voluntary Terminations of Underfunded Plans

- If a PBGC-covered pension plan is underfunded with no ability to fund up, the only way to terminate the plan voluntarily is through a “distress termination”
- CBA can block a distress termination – 11 U.S.C. § 1113 motion possible
- *Each* controlled group member must meet at least one distress test:
  - *Distress Test One*: liquidation in bankruptcy (essentially automatically met)
  - *Distress Test Two*: reorganization in bankruptcy (if *bankruptcy judge* determines that there is no feasible plan of reorganization unless pension plan is terminated)
  - *Distress Test Three*: inability to continue in business (if *PBGC* determines that, unless pension plan terminated, entity could not pay debts when due and continue in business)
  - *Distress Test Four*: unreasonably burdensome pension costs (if *PBGC* determines that costs have become unreasonably burdensome solely as result of decline of workforce covered by plan(s) – but *PBGC* routinely resists this test due to “solely” requirement)
- Each CG member may meet different test
- Distress terminations usually arise in bankruptcy setting (liquidation/reorganization)

# Bankruptcy Distress Tests

- Liquidation distress test (Test 1): essentially automatically met
- Reorganization distress test (Test 2): often contested
  - Show “meaningful sacrifices” in all areas
  - Show plan unaffordable even with freeze & waiver
  - If lender/investor insists on plan termination, show:
    - Lender/investor has sound financial basis
    - Inability to find lender/investor not insisting on termination
  - Multiple plans: PBGC argues for plan-by-plan analysis
  - Watch out for any *non-debtor* controlled group members (each one must also meet distress)
  - Watch out for “follow-on” replacement plans (major PBGC concerns)

## Non-Bankruptcy Distress Tests

- Distress termination permitted outside bankruptcy under Tests 3/4
  - Can be useful for small to mid-size employer where bankruptcy not otherwise needed, too costly, etc.
  - Business continuation test (Test 3) analogous to reorganization test (Test 2)
  - Test 3 determination made by PBGC, not by bankruptcy judge
  - Test 4 very rarely used to date (some overlap with Test 3)

## Making Your Test 3 Case

- Explain why bankruptcy is not a solution
- Establish “enough” distress but not “too much” distress (*but for* pension plan, entity *could* continue in business)
- Demonstrate that plan termination is “last resort”
  - Contribution and financial projections drive affordability analysis
  - Demonstrate inability to meet contribution requirements despite implementing austerity measures, divesting assets, seeking financing, renegotiating loans/contracts, etc.
- Process can take many months or even years (particularly if application is not complete or financial statements are not adequately supported)
  - No deadline exists for PBGC to decide whether distress test is met
  - Alert PBGC if fast action needed to save jobs and/or to enhance PBGC recovery
  - File distress termination application well before failure is imminent
  - But if failure is too far down the road, PBGC “wait and see” approach likely

# Making Your Test 3 Case: Projections

- Contribution/financial projections needed for Test 3 (and Test 4)
- Contribution projections
  - Absent legislative funding relief, contributions for many plans will spike over next few years (due primarily to phase-out of interest rate stabilization)
  - Reflect any legislative funding relief (taking full advantage of any choices offered in legislation so as to show unaffordability even with contribution obligations minimized)
  - Incorporate cost of making up any missed contributions
  - Reflect results with and without funding waivers (or explain why waivers won't work)
  - Project range of results (e.g., baseline, optimistic, and pessimistic) based on:
    - Future interest rate scenarios
    - Future investment experience scenarios
  - PBGC may have questions (often leading to productive discussions between PBGC actuaries and plan actuaries)

## Making Your Test 3 Case: Projections (Cont.)

- Financial projections
  - Focus is on 5-year cash flow projections showing unaffordable contributions
  - Provide also 5-year projections for Income Statement & Balance Sheet
  - Provide key assumptions underlying projections
  - Include projections with pension plan terminated and payment of assumed PBGC settlement amounts (effectively, your “first offer” to PBGC)
  - Expect PBGC to critically analyze the assumptions
  - PBGC will likely have questions (often leading to productive discussions between PBGC financial analysts and employer financial experts)
  - PBGC may hire industry consultant to assist it
  - PBGC may develop its own assumptions and forecast

# Fiduciary Concerns

- Following distress termination process, PBGC as trustee could assert a breach of fiduciary duty
  - Duty of loyalty
  - Duty of prudence
- Payment of expenses using plan assets
  - Settlor vs. plan expenses
  - Expenses incurred after termination date will ultimately be borne by PBGC if distress termination application is approved and PBGC becomes trustee
- Watch out for prohibited transactions (e.g., plan pays settlor expense)
- Investment of plan assets during pendency of process
- Communications to participants
- Participants may have standing to bring a fiduciary breach action

## Distress Procedures

- All funding, filing, and plan administration requirements continue at least until PBGC approves termination
  - Consider asking PBGC for waivers of reporting requirements
  - Once plan is terminated, funding obligations retroactively change
    - Past termination date is then taken into account, resulting in final short plan year (unless termination date is last day of plan year)
    - Final short plan year funding obligations are prorated and subject to special rules governing number, timing, and amount(s) of quarterlies
  - PBGC premium obligations continue until PBGC trusteeship plan year
    - Thus, termination date does *not* cut off premium accrual
    - Short plan year proration applies to premium for PBGC trusteeship plan year if trusteeship occurs prior to last month of plan year

## Distress Procedures

- All funding, filing, and plan administration requirements continue at least until PBGC approves termination (cont.)
  - 5500 filings required for all plan years through PBGC trusteeship plan year (and thus typically are required for post-termination plan year(s))
  - Payments from plan assets
    - May not pay PBGC premiums (or related penalties or interest) from plan assets once first NOIT is issued
    - PBGC must approve payment of expenses after date of trusteeship

## Distress Procedures (Cont.)

- Helpful first step before formal process: “Pre-Filing Consultation”
  - Consider submitting high-level projections/narrative
  - Useful feedback is likely
    - May result in decision not to pursue distress termination
    - May result in improved submission to PBGC and faster action
- Various notices and filings (tracks standard termination process, but with significant differences)
- Note possible disclosure to participants of confidential information provided to PBGC (per PPA changes)

## Distress Procedures (Cont.)

- Notice of intent to terminate (“NOIT”): at least 60 days and (except with PBGC approval) no more than 90 days before proposed termination date
- NOIT to “affected parties” other than PBGC
  - Must go to participants, beneficiaries, alternate payees, any current union, and (if no current union) any prior union (5-year look-back)
  - Best to use model NOIT in PBGC instruction booklet
  - Allowed to give additional information if not misleading (helpful to provide memo, FAQs, to reassure participants where appropriate)
- NOIT to PBGC is filed on Form 600 (after all other NOITs issued)
  - Includes much “off-the-shelf” information (e.g., plan documents, latest actuarial valuation report, 5500s)
  - Requires identification of all controlled group members
  - Requires identification of applicable distress test(s) and supporting evidence/argument

## Distress Procedures (Cont.)

- PBGC regulatory benefit restrictions (which apply in addition to any IRC Section 436 restrictions) are effective as of date first NOIT is issued
  - Can't make loans to participants
  - Can't pay benefits attributable to employer contributions, other than death benefits, in any form other than annuity (no lump sums, not even de minimis)
  - Can't purchase irrevocable commitments
- Implement estimated benefit cutbacks as of proposed termination date
  - Estimated cutback rules can lead to reductions larger than necessary
  - Consider asking PBGC for modification (29 CFR § 4022.61(e))
- PBGC issues “tentative finding of compliance” after Form 600 review
- Distress Termination Notice (Form 601) due by 120<sup>th</sup> day after proposed termination date
  - Consider filing Form 601 (very easy form) shortly after filing Form 600
  - Complete filing process ASAP so that ball is entirely in PBGC's court

## Distress Procedures (Cont.)

- Don't forget "net worth" notice and submission (29 CFR § 4062.6)
  - Can affect amount of ERISA Section 4068 lien
  - Notification due by 90<sup>th</sup> day after Form 600 filing
  - Supporting information due by 120<sup>th</sup> day after proposed termination date
- PBGC internal process
  - PBGC "team" consists of lawyers, actuaries, financial analysts
  - Team recommendation goes to "Trusteeship Working Group" (ultimate approval authority varies)
- If distress termination is approved:
  - PBGC and plan administrator sign termination/trusteeship agreement (may await settlement); or
  - In rare case where plan is sufficient for guaranteed benefits, PBGC issues notice authorizing private-sector closeout

# Role of Plan Actuary

- Determining benefit cutbacks
- Developing contribution projections
- Schedule EA-D attestation
  - Sufficiency level relative to guaranteed benefits and benefit liabilities at proposed termination date using 4044 assumptions
  - Take into account total value of plan's assets (including value, if any, of contributions receivable)
  - Take into account *nonguaranteed* PC 3 benefits
  - Almost always, plan will be insufficient for guaranteed benefits

## Role of Plan Actuary (Cont.)

- Evaluating PBGC's calculation of unfunded benefit liabilities ("UBL")
  - Determine whether UBL amount matters, as in many cases it won't because controlled group has no ability to satisfy even much lower UBL
  - PBGC generally provides PDF of "Pension Information Profile"
  - Request underlying Excel spreadsheet – PBGC will provide it in locked form with no hidden cells
  - Identify and test underlying assumptions (e.g., duration of liabilities, male/female split, adjustment for benefit payouts, other roll-forward issues)
  - Consider running seriatim valuation as of termination date rather than relying on PBGC's roll-forwards and adjustments

## Settlement Considerations and Options

- Liabilities in “Business Continuation” distress cases are routinely settled
  - PBGC resists “selling” a termination
  - But settlement negotiations possible pre-termination (will be contingent on PBGC approval of termination)
- Timing of termination/trusteeship agreement vs. settlement agreement
  - Once termination/trusteeship agreement is executed, new liabilities arise
    - Immediate obligation to pay UBL plus interest
    - Future obligation to pay termination premium
  - Ideally, new liabilities are settled at same instant they arise
- Primary liabilities to be settled with PBGC are UBL, termination premium, and unpaid contributions
- Consider addressing excise tax relief as part of settlement

## Settlement Considerations and Options (Cont.)

- PBGC and employer goal: settlement that allows for business continuation
- PBGC and employer often have differing views as to what's affordable
- Settlement options include:
  - One-time cash payment
  - Note for period of years
  - Profits participation
  - Equity interest
- Settlement may or may not include security interest

# Questions?



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