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PBGC Expands Scope of Early Warning Program

BY HAROLD J. ASHNER AND DEBORAH WEST

On December 21, 2016, the Pension Benefit Guaranty Corporation announced that, in an effort to increase transparency about PBGC's Early Warning Program, it had ''enhanced and reorganized the information available on its website.'' While much of the newly-posted guidance regarding its Early Warning Program reflects longstanding PBGC guidance and practices, PBGC added a new basis for possible action—''*trends* that may pose an increased risk to plans and the pension insurance system'' (emphasis added)—that appears to signal a significant expansion of the scope of the Program. *See* www.pbgc.gov/prac/whatsnew.html and www.pbgc.gov/prac/risk-mitigation.html.

By way of background, since the inception of the Early Warning Program in 1993, PBGC has monitored certain employers and identified planned corporate transactions that it believes may result in a significant increase in PBGC's losses in the event of a future plan termination. If PBGC is concerned about a transaction, it may intervene to seek protection for a pension plan or for itself.

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Historically, Early Warning Program cases have been opened because of a specific transaction of concern to PBGC. (The term ''transaction'' is used broadly in this article to encompass all significant business events, whether or not they involve an unrelated person.) Under the new basis for possible action, an employer facing financial challenges may be surprised to find itself the target of an Early Warning Program investigation—and possibly an Early Warning Program demand—even in the absence of a specific transaction.

In announcing the new guidance, PBGC said that, with the goal of posting a new set of Early Warning Program FAQs on www.pbgc.gov in early 2017, it was inviting dialogue on the Early Warning Program, and encouraged practitioners to send questions to webmaster@pbgc.gov.

PBGC's Screening Criteria

Under ERISA, a contributing sponsor of a pension plan and each of the members of its ''controlled group'' (who together with the contributing sponsor constitute a single ''employer'' for purposes of Title IV of ERISA) are responsible, on a ''joint and several'' basis, for certain plan-related liabilities. PBGC's monitoring efforts focus on controlled groups maintaining plans that, in the aggregate, have: (1) underfunding of $50 million or more; or (2) 5,000 or more participants. Although the new guidance refers to ''plans'' crossing the two thresholds, informal guidance from PBGC staff makes clear that PBGC aggregates all plans in the controlled group when applying the thresholds. *See, e.g.*, www.pbgc.gov/Documents/2013bluebook.pdf, Q&A 22(a).

In a July 2000 Technical Update regarding the Early Warning Program, PBGC stated that it would contact a company about a transaction *only if* PBGC's then-existing screening criteria were met. PBGC Technical

Update 00-3: PBGC's Early Warning Program (available at web.archive.org/web/20150328012414/http://www.pbgc.gov/prac/other-guidance/tu/tu00-3.html) at Section II, Paragraph 2. The new guidance does not expressly address the issue, but in informal guidance given long after the 2000 Technical Update, PBGC staff has indicated that PBGC may open an Early Warning Program case with respect to a controlled group that does not meet either the $50 million screening criterion or the 5,000-participant screening criterion for other reasons as appropriate. *See*, *e.g.*, www.americanbar.org/content/dam/aba/events/employee_benefits/PBGCQA2016_final.authcheckdam.pdf, Q&A 20.

PBGC's Identification and Processing of Cases

PBGC stated in the new guidance that it ''learns of a transaction or other event from its own monitoring efforts, reports in the financial press, and notices provided by companies as reportable events under section 4043 of ERISA . . . .'' Once PBGC has identified a case of concern, it is likely to issue follow-up information requests to the employer. PBGC provided, as part of its new guidance, a sample information request letter (available at www.pbgc.gov/documents/Company-Contact-Initial-Inquiry-FINAL.pdf).

The guidance notes that PBGC will generally request the following information:

- *Event*—To help [PBGC] understand the potential impact on the sponsor (and its controlled group members and its pension plans), [PBGC] need[s] information to help [PBGC] assess how the event will affect the companies responsible for the plan and the cash flow available to support the plan.
- *Controlled Group*—To help [PBGC] understand the financial support the plan has available to it (both before *and* after a transaction), [PBGC] need[s] information about the ownership structure of the sponsor and each controlled group member.
- *Credit Quality*—To help [PBGC] understand whether the financial health of the sponsor and its controlled group may deteriorate as a result of an event or a downward business trend, [PBGC] need[s] current and projected financial information about the sponsor and any members of its controlled group.
- *Pension Plan(s)* —To help [PBGC] assess the health of the plans, [PBGC] review[s] recent actuarial information about the plans, including the most recent actuarial valuation report, latest market value of each plan's assets, contribution history, and information about any events that have had a material effect on the plans since the last actuarial valuation.

In its guidance, PBGC stated that it ''internally identifies about 300 transactions, events, or trends each year that are potentially of concern and engages the plan sponsors to obtain additional information.'' PBGC said it then assesses the impact of these situations ''based on each employer's financial and operational ability to support its pension promises.'' PBGC also said that it averages about 100 Early Warning Program cases each year, and that, in recent years, it has entered into an average of about 5 settlements each year. It remains to be seen whether this level of activity will increase and, if so, how significantly, under the expanded scope of the Early Warning Program.

PBGC's Leverage

PBGC's leverage to extract settlements in Early Warning Program cases is a consequence of its authority under ERISA Section 4042(a)(4) to initiate termination proceedings whenever PBGC determines that ''the possible long-run loss of the [PBGC] with respect to the plan may reasonably be expected to increase unreasonably if the plan is not terminated.''

Although PBGC has no authority to approve or disapprove a corporate transaction, and no authority to terminate a pension plan unilaterally, if PBGC concludes that an Early Warning Program case increases PBGC's risk of long-run loss, PBGC can threaten to initiate an involuntary termination of a plan unless it is provided with the protection it seeks. PBGC's initiation of an involuntary termination could, in many cases, result in a cascade of potentially catastrophic consequences, including the triggering of various defaults, the increase and acceleration of pension liability, the creation of a new liability for termination premiums, the need to file for bankruptcy protection, and job losses.

Because of the potential consequences of plan termination, even the threat that PBGC might initiate an involuntary termination could significantly destabilize the business. If a transaction is planned, such a threat could scare away lenders and/or other parties to the transaction and thus have the effect of blocking the transaction. However, in threatening—implicitly or explicitly—to initiate an involuntary termination action in an Early Warning Program case, generally PBGC's goal is not to terminate the pension plan, but rather to obtain a settlement that PBGC views as strengthening the plan's financial condition and reducing PBGC's risk.

Early Warning Program Settlements

The new PBGC guidance gives the following examples of negotiated protections provided in Early Warning Program cases:

- *Cash Contributions*. The employer agrees to make cash contributions to its plan in excess of minimum funding requirements.
- *Letters of Credit*. The employer provides PBGC a letter of credit to secure its agreement to make future pension contributions or to secure a plan's unfunded liabilities.
- *Security Interests*. The employer grants PBGC a security interest in specific company assets to secure a plan's unfunded liabilities.
- *Guarantees*. A related entity agrees to assume the pension plan or guarantee payment of termination liability if the financially weaker sponsor/controlled group cannot support the plan following a transaction.

In Early Warning Program settlements, as consideration for the negotiated protection provided by the employer, PBGC typically will agree to forbear from initiating an involuntary termination based on the transaction at issue. It is unclear what consideration PBGC will provide to an employer in a settlement that does not involve a specific transaction.

PBGC's Guidance Expanding Basis For Possible Action

From its inception, the Early Warning Program has focused on certain types of corporate *transactions* that PBGC believes may pose an increased risk to plans and the pension insurance system. *See* PBGC Technical Update 00-3, Sections I.1, I.2. I.3, II.1, and III. However, as noted above, PBGC's new guidance regarding the Early Warning Program states that PBGC reviews ''corporate transactions, events, *or trends* that may pose an increased risk to plans and the pension insurance system . . . .'' (Emphasis added.) Typically, there is no question as to whether a transaction has occurred (or is proposed to occur). By contrast, it may often be difficult to predict when PBGC may reach out to an employer to investigate—and potentially make a demand—based on a ''trend.''

The new PBGC guidance does not provide a complete list of all the types of ''transactions, events, or trends'' that may be of concern. However, the guidance does provide seven examples, the first five of which are consistent with earlier PBGC guidance, and the last two of which are new:

- A change in the controlled group that is legally responsible for supporting a pension plan;
- A major divestiture by an employer that retains significantly underfunded pension liabilities;
- A leveraged buyout involving the purchase of a company using a large amount of secured debt;
- A substitution of secured debt for a significant amount of unsecured debt;
- The payment of a very large dividend to shareholders;
- Significant credit deterioration involving the downgrading of a plan sponsor's credit ratings, which PBGC views as a possible signal that the sponsor is, or is becoming, unable to support its plan(s); and
- A downward trend in cash flow or other financial factors, which PBGC views as a possible signal that the sponsor is becoming unable to support its plan(s).

Clearly, PBGC has always taken into account an employer's financial soundness (including credit ratings and other financial factors) in evaluating Early Warning Program cases. *See, e.g.*, www.pbgc.gov/Documents/2012bluebook.pdf, Q&A 23; PBGC Technical Update 00-3, Section II, Paragraph 2(1). However, this is the first time that PBGC has issued guidance stating that credit ratings and other financial factors—standing alone—could trigger an Early Warning Program investigation or demand.

Prior to PBGC's issuance of the new guidance, there were anecdotal reports that PBGC appeared to be expanding the scope of the Early Warning Program by pursuing Early Warning Program investigations and demands in the absence of any transaction.

- For example, the PBGC Participant and Plan Sponsor Advocate (the ''Advocate'') noted in her 2015 Annual Report that she had ''become aware of PBGC using the Early Warning Program outside of the context of business transactions to intervene in how a company runs its business'' and that ''[t]his is not consistent with the guidance issued by the PBGC on the Early Warning Program.'' *See* www.pbgc.gov/Documents/pbgc_advocate_report_2015.pdf at p. 25.
- Another example appears in the Intersector Group's ''Notes from Intersector Meeting with PBGC, April 16, 2015,'' which state that ''a number of clients are getting letters from PBGC asking for all kinds of information . . . in the absence of any transaction.'' The Intersector Group is composed of delegates from a number of actuarial organizations. Twice a year, the Intersector Group meets with PBGC representatives to dialogue with them on regulatory and other issues affecting pension practice. *See* https://www.ccactuaries.org/Portals/0/pdf/Intersector/Intersector-PBGC-2015-04-16.pdf) at pp. 1 and 3.

PBGC's new guidance on the Early Warning Program thus may be viewed as an effort to ensure that its published guidance corresponds with its recent practice.

The Advocate discussed the new guidance in her just-released 2016 Annual Report, noting that the guidance ''significantly expands on the types of situations that might trigger an Early Warning Program case, as PBGC has now added 'significant credit deterioration' and 'a downward trend in cash flow or other financial factors' to the standard list of considerations.''

- With respect to the first factor, the Advocate recalled that PBGC's request, in the context of the 2006 Pension Protection Act, that statutory contribution requirements be increased for companies with bad credit ratings had been rejected by Congress, and stated that PBGC now appeared to be pursuing the same goal in the Early Warning Program context.
- With respect to the second factor, the Advocate expressed concern that the vague language could give rise to very burdensome PBGC demands on many companies.

See www.pbgc.gov/Documents/PBGC-Participant-and-Plan-Sponsor-Advocate-2016-Annual-Report-FINAL.pdf at p. 9.

Implications of Expanded Basis For Possible Action

PBGC's addition of the ''trends'' basis for possible action, and of the two new examples based solely on credit ratings and other financial factors, is troubling because it represents a potentially significant expansion of the scope of the Early Warning Program, and indeed may be a harbinger of an unwelcome increase in PBGC's attempts to involve itself in an employer's business challenges and decisions.

Clearly, PBGC's Early Warning Program has undergone significant changes over the years. In the past, PBGC would open an Early Warning Program case only if the screening criteria were met *and* if there was a transaction of potential concern. Today, PBGC may decide to open an Early Warning Program case regardless of whether the screening criteria are met, and regardless of whether any transaction is occurring or expected to occur. As a result, for many employers for whom there previously was certainty that the employer would not be the subject of an Early Warning Program investigation or demand, that certainty has now disappeared.

Conclusion

It remains to be seen how broadly PBGC will seek to apply the new guidance. It is clear, however, that an employer facing PBGC investigations under the Early Warning Program should have a thorough understanding of the nature of PBGC's concerns and effective alternatives for addressing those concerns, as well as of the scope and limits of PBGC's authority.