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Understanding the PBGC's Role in Corporate Transactions

ABA Tax Section Meeting
Employee Benefits Committee
Subcommittee on Mergers & Acquisitions
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Overview

- Introduction to PBGC
- Standard, distress, and involuntary terminations
- PBGC reporting: "traps for the unwary"
- "Early Warning Program" negotiations
- Bankruptcy claims/disputes

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Introduction to PBGC

Introduction to PBGC

- PBGC established in 1974 to provide pension insurance
  - Single-employer program (focus of presentation)
  - Multiemployer program
- PBGC Board: Labor, Treasury, Commerce
- PBGC protects pensions
  - Covers more than 44 million workers and retirees
  - FY 2005:
    - Trustee of 3,600 plans
    - 1.3 million participants/beneficiaries
    - $3.7 billion in benefit payouts

Introduction to PBGC (Cont.)

- Government corporation
  - No “full faith and credit” backing
  - No tax dollars
- PBGC funding
  - Premiums
  - Assets from PBGC-trusteed plans
  - Recoveries from bankruptcies
  - Investment returns

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Introduction to PBGC (Cont.)

- PBGC premiums
  - Flat-rate ($30 per participant)
  - Variable rate (0.9% of underfunding for vested benefits)
  - New “exit fee” for underfunded terminations with ongoing employers ($1,250 per participant, per year, for 3 years)
- Single-employer plan terminations
  - Standard termination (fully funded)
  - Distress termination (underfunded)
  - Involuntary termination (underfunded)

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Introduction to PBGC (Cont.)

- Participants' guaranteed benefits
  - Limitations apply (*e.g.*, $47,659 annual max at age 65 w/o survivor benefits for plans terminating in 2006)
    - Most participants have fully guaranteed benefits
    - But some participants face major cutbacks
  - Nonguaranteed benefits may be partially or fully paid by PBGC to extent those benefits are funded by
    - Plan assets, or
    - PBGC recoveries from employers

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Introduction to PBGC (Cont.)

- PBGC reporting and disclosure requirements
  - Annual premium filings
  - "Reportable event" filings
  - Annual employer reports (large employers with significant plan underfunding)
  - Annual "Participant Notice" (for certain underfunded plans)
- PBGC "Early Warning" program
  - PBGC monitors corporate transactions
  - Threat of involuntary termination may lead to settlement

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Introduction to PBGC (Cont.)

- When underfunded plan terminates
  - PBGC becomes trustee
  - PBGC makes up shortfall to provide guaranteed benefits
  - Employer and each “controlled group” member liable to PBGC for *full* underfunding (guaranteed and nonguaranteed benefits)
  - PBGC makes claims in bankruptcies
  - PBGC shares recoveries with participants

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Standard, Distress, and Involuntary Terminations

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Standard, Distress, and Involuntary Terminations

- Standard termination requires full funding for all "benefit liabilities"
  - Lump sums (plan assumptions subject to statutory floor)
  - Irrevocable commitments (annuity pricing)
- If plan is underfunded, sponsor or controlled group member can make "commitment" to make sufficient
  - Funds must be provided by distribution date
  - If in bankruptcy, commitment must be approved by bankruptcy court or guaranteed by non-bankrupt entity
- Collective bargaining agreement can block standard termination

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Standard, Distress, and Involuntary Terminations (Cont.)

- Standard termination process
  - Various notices to participants/union
  - Notice to PBGC w/actuarial certification of sufficiency
  - Distribution after 60-day PBGC "review period" and (typically) receipt of favorable IRS determination letter
  - Certification to PBGC of proper distribution
  - Standard termination audit by PBGC
    - *All* plans w/500+ participants, some smaller plans
    - Audit based on sampling of participants

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Standard, Distress, and Involuntary Terminations (Cont.)

- If plan is underfunded, only way to terminate voluntarily is through "distress termination"
- *Each* controlled group member must meet a distress test:
  - Distress Test One: Liquidation in bankruptcy/insolvency
  - Distress Test Two: Reorganization in bankruptcy
  - Distress Test Three: Inability to continue in business
  - Distress Test Four: Unreasonably burdensome pension costs
- Each controlled group member may meet different test
- Almost always in bankruptcy (liquidation/reorganization)
- But watch out for *non-debtor* controlled group members!
- Collective bargaining agreement can block distress termination

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Standard, Distress, and Involuntary Terminations (Cont.)

- Liquidation distress test: automatic (for liquidating member(s) of controlled group)
- For reorganization distress test, should demonstrate
  - "Meaningful sacrifices" in various areas (not just pensions);
  - Plan is unaffordable even with freeze and waiver; and
  - If lender/investor insists on plan termination,
    - Sound financial basis for lender's/investor's position
    - Inability to find lenders/investors not insisting on plan termination

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Standard, Distress, and Involuntary Terminations (Cont.)

- Involuntary termination (initiated by PBGC)
  - May be used/threatened to block corporate transaction (*e.g.*, sale of subsidiary)
  - May be used to cut off shutdown benefits
  - Less controversial uses
    - "Abandoned" plans
    - "Shortcut" in lieu of distress process
  - May be (and often is) accomplished by agreement with plan administrator ("consensual involuntary" termination)

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Standard, Distress, and Involuntary Terminations (Cont.)

- Criteria for involuntary termination
  - Minimum funding standard not met (annual "catch-up," not just quarterlies)
  - Plan "will be unable" to pay benefits when due (*mandatory* termination if *currently* unable)
  - Substantial owner distribution (rare)
  - 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."
- Collective bargaining agreement *cannot* block involuntary termination

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Standard, Distress, and Involuntary Terminations (Cont.)

- "Long-run" loss analysis
  - Likelihood of future termination if PBGC does not act now
  - Expected PBGC loss in current v. future termination
- PBGC trusteeship (distress or involuntary termination)
  - Trusteeship agreement
  - Estimated benefit payments and cutbacks
  - Much PBGC "hand-holding" throughout process

PBGC Reporting Requirements: "Traps for the Unwary"

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- Penalty exposure up to $1,100 *per day* for *each* person required to report or disclose
  - "Guideline" penalties generally much lower
  - But maximum penalty applies to certain important and time-sensitive notices
- Reportable events: need system to track events involving other members of controlled group

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PBGC Reporting Requirements: "Traps for the Unwary" (Cont.)

- "Change in controlled group" reportable event
  - Covers plan transfer without *any* change in CG makeup
  - Timing keyed to binding agreement, not to closing
- "Active participant reduction" reportable event
  - Could occur *any day* of plan year (not an annual snapshot)
  - Need not occur based on discrete "event"
  - May need to report *twice* in same plan year

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PBGC Reporting Requirements: "Traps for the Unwary" (Cont.)

- Transfers of benefit liabilities
  - Generous waiver (use PBGC "safe-harbor" assumptions)
  - But may still be reportable as active participant reduction!
- "Extraordinary dividend" reportable event
  - Does *not* match IRC definition
  - Captures significant value transfer to *any* CG member

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PBGC Reporting Requirements: "Traps for the Unwary" (Cont.)

- Loan defaults
  - 30-day deadline runs from date of actual/constructive knowledge of underlying default (when not yet reportable)
  - "Cure period extensions" to only *one day* after
    - Expiration of cure period
    - Loan acceleration
    - Notice of default
- "Annual employer reporting (ERISA Section 4010)
  - New requirement: report that you no longer need to report!
  - Mandatory e-filing now in effect

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“Early Warning Program” Negotiations

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“Early Warning Program” Negotiations

- “Early Warning” program focuses on increased risk resulting from corporate transactions
- Controlled group joint/several liability is key
- PBGC staffing:
  - Financial analysts
  - Actuaries
  - Accountants
  - Attorneys

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“Early Warning Program” Negotiations (Cont.)

- PBGC Technical Update 00-3 limits program based on plan funding and employer credit rating
  - PBGC contact allowed only if current liability >$25M *and*:
    - Junk bond rating, *or*
    - *Unfunded* current liability >$5M
  - NOTE: 4010 reporting independent basis for PBGC contact
- Consider contacting PBGC first (where contact is inevitable, the earlier the better)

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“Early Warning Program” Negotiations (Cont.)

- PBGC concerns
  - Breakup of controlled group
  - Transfer of plan to weaker controlled group
  - Movement of value between/among CG members
  - Highly leveraged transactions

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“Early Warning Program” Negotiations (Cont.)

- PBGC leverage
  - Involuntary termination (the “nuclear” option)
    - Full underfunding becomes immediately due
    - Accruals cease
    - Benefits may be reduced
  - “Evade or avoid” lawsuit, but
    - Years of litigation
    - Uncertain outcome
- Your leverage
  - Save jobs (political/public relations leverage)
  - Plan *will* continue (financial leverage)

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“Early Warning Program” Negotiations (Cont.)

- ERISA Section 4069 “comfort letters”
- What PBGC may be looking for
  - Additional contribution to plan (with credit balance restriction)
  - Retention of plan by strong seller
  - Guarantee by seller if future plan termination
  - Transfer to plan of security interest

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Bankruptcy Claims/Disputes

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Bankruptcy Claims/Disputes

- Key PBGC concerns
  - Adequate information in disclosure statement
  - Funding of plan during bankruptcy
  - Future of plan
    - Ongoing
    - Standard termination
    - Distress or involuntary termination
  - PBGC claims
    - Guarantor claims
    - Successor trustee claims

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Bankruptcy Claims/Disputes (Cont.)

- PBGC bankruptcy claims
  - Many priority arguments raised by PBGC
  - Most arguments rejected by courts
  - Usually resolved with "global" PBGC settlement

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Bankruptcy Claims/Disputes (Cont.)

- Guarantor claims
  - Unpaid premiums
    - General unsecured if plan year starts pre-petition
    - Check PBGC calculation methodology!
  - "Unfunded Benefit Liabilities"
    - Contingent on plan termination
    - Often filed as unliquidated
    - Disputes re amount: based on PBGC valuation regulation assumptions (controversial)
    - Disputes re priority: PBGC claims tax status up to 30% of aggregate positive net worth in CG, but courts have rejected

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Bankruptcy Claims/Disputes (Cont.)

- Successor trustee claims
  - Unpaid contributions
    - Contingent on plan termination and PBGC trusteeship
    - Tax status arguments ($1M+) rejected by courts
    - Post-petition "administrative" priority
      - Limited (at most) to normal cost
      - Reduce for decline in employment levels
    - Limited priority for 180-day pre-petition period
    - Rest is general unsecured

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Bankruptcy Claims/Disputes (Cont.)

- Successor trustee claims (Cont.)
  - Fiduciary breach (not common)
- Resolving claims with PBGC
  - Settlement common
  - Actuary to actuary (plan/PBGC): agree on numbers
  - Attorney to attorney (debtor/PBGC): resolve priority and (for UBL claim) amount disputes
  - End result:
    - May be single sum
    - If PBGC sees good "test case," settlement may not happen

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For Further Information . . . .

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