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Shutdown and Pay Up

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The Pension Benefit Guaranty Corporation ("PBGC"), the U.S. agency which insures defined benefit pension plans, recently issued a proposed regulation on how it intends to calculate and assess pension liability when a facility shuts down.[1] If adopted in final regulations, PBGC may have another enforcement tool to collect extra pension funds.

While a provision to require security in these situations has been on the books since 1974, PBGC rarely utilized it because the law was drafted in a way that did not allow for a meaningful calculation.[2]

PBGC's proposal is a signal that the agency intends to become more active and vigilant in corporate restructurings. Many companies are unaware of how PBGC can insert itself in corporate facility shutdowns and can end up posting millions of dollars of security to the PBGC even though the pension plan remains ongoing. Careful advance planning may avoid or minimize this liability.

Employee Retirement Income Security Act ("ERISA") § 4062(e) provides that if a facility ceases operations and as a result at least 20% of the active pension plan participants lose their jobs, PBGC can require the company to provide an escrow for a portion of the pension plan underfunding or post a surety bond equal to 150% of this amount for five years.[3] If, during this time, the plan is terminated, PBGC can access these funds to satisfy any underfunding. Otherwise, after five years, the liability is extinguished and the escrow is returned (without interest) or the bond is cancelled.

Since the existing law was non-functional, PBGC has, on a case-by-case basis, approximated this liability by taking a percentage of the total pension underfunding.

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[1] The proposed regulation was published at 70 Federal Register 9258-9260 (Feb. 25, 2005). Comments to the proposed regulation may be submitted to the PBGC through April 26, 2005.

[2] Current law provides that the security be calculated as if the pension plan was a multiple-employer plan, which results in a non-meaningful formula when applied to single employer plans. ERISA gave PBGC authority to alter the methodology by regulation, which is the reason PBGC is issuing this regulation.

[3] The exact wording in ERISA as to whether a § 4062(e) event has occurred is: "If an employer ceases operations at a facility in any location and, as a result of such cessation of operations, more than 20 percent of the total number of his employees who are participants under a plan established and maintained by him are separated from employment,…"

Absence clear authority, this approach became a negotiation between PBGC and the company sponsoring the plan (the "plan sponsor"). Many plan sponsors objected to PBGC applying a formula not found in law and frequently PBGC's enforcement efforts stalled.

PBGC is now proposing to codify its case-by-case approach. This methodology may cause a company to incur tens of millions of dollars of additional obligations and should be taken into account when planning a facility shutdown. While the proposed regulations do not indicate an effective date, regulations are not generally applied retroactively.

<u>The Proposed Formula</u>

PBGC is proposing that the § 4062(e) liability equal the total plan underfunding times the percentage decline in pension plan participants as a result of the cessation of operations.

Assume a company sponsors a pension plan with 50,000 participants of which 20,000 are active and 30,000 are non-active (i.e., deferred vested and retirees), all of whom were employees of the company or its controlled group. Further assume that the pension plan is underfunded on a <u>PBGC termination basis</u> by $80 million.

The company decides to cease operations at a U.S. facility and move the operations offshore. This results in the loss of jobs for 5,000 people, all of whom are participants in the pension plan. Since the decline in active plan participants is 25%, an ERISA § 4062(e) event has occurred.

Consequently, PBGC could require the company to post an escrow equal to $8 million:

$$\$80 \text{ million underfunding} \times \frac{5{,}000 \text{ plan participants separated from employment}}{50{,}000 \text{ total plan participants before cessation of operations}}$$

or a surety bond in the amount of $12 million.

In another scenario, assume that the company moves the operations to a different geographic location in the U.S and immediately hires 5,000 different employees who are offered retirement income via a 401(k) plan instead of in the existing defined benefit pension plan. This too qualifies as an ERISA § 4062(e) event and an $8 million liability is created.

Presumably, if the new employees are added to the original pension plan, PBGC would not take the position that a § 4062(e) event had occurred. However, this is one of the many unanswered questions about how § 4062(e) will operate.

Two important aspects about the § 4062(e) calculation:

1. The plan's liability is computed on a PBGC termination basis assuming the plan terminates immediately after the cessation of operations. A termination basis

calculation uses different assumptions than those used to book pension liabilities on a company's balance sheet. For example, the interest rate PBGC uses to discount the liabilities is significantly lower than the interest rates most companies use to discount their pension liabilities. PBGC's March 2005 rates are 3.80% for the first 20 years and 4.75% thereafter. PBGC also specifies mortality tables, retirement age assumptions, and adds on a "load factor" (which it believes approximates the cost of purchasing annuities in the private market).[4]

2. If the plan provides for shutdown benefits, these are assumed to be incurred pursuant to PBGC's proposed regulations. Since shutdown benefits are not advance funded, this will create a larger pension liability.

Observations

This provision of ERISA does not take into consideration the financial health of a company. Rather, it applies the same rules to a company with an AAA credit rating and one with a CCC rating.

Also, PBGC does not consider the financial implications of the shutdown on the health of the company. That is, the facility could be immensely inefficient, decrepit and in need of millions of dollars of improvements, while a new facility in a different location could be more efficient, thereby improving the company's financial profile. This does not factor into the liability assessment.

Most troubling is that the assessment is based on the plan's total liabilities. A portion of the liabilities associated with deferred vested and retiree participants are captured in the calculation, regardless of whether they ever worked at the facility.

Significant Uncertainty Remains

ERISA § 4062(e) is a bright line test. If the percentage decline in active plan participants is 20.1%, a § 4062(e) event occurred. If it is 19.9%, no event occurred and no liability is assessed.

While the calculation and results appears straightforward, in fact, a significant number of uncertainties exist which PBGC's proposed regulation does not address. Understanding these unresolved issues is paramount for plan sponsors set to embark on facility closings.

1. The § 4062(e) requirement is that "an employer ceases operations at a facility…" What is a cessation of operations?

[4] PBGC has just proposed an updated mortality table which, when adopted, may increase termination liability as well.

If one portion of a facility ceases to operate, which causes at least 20% of the pension plan's actives to become non-active, but other non-related operations at the facility continue, is that a cessation of operations?

What if all of the facility's operations were involved in producing a single product, but there were different parts of the manufacturing process. Would ceasing one part of the manufacturing process but continuing the remaining processes at the facility result in a cessation of operations?

What if operations cease with respect to new manufacturing, but remains open for a significant amount of time to complete work in progress, when would a cessation of operations occur?

2. What is the time frame for measuring the decline in actives?

A company may announce that if market conditions do not improve, it will close a facility at some date in the future. This announcement may cause workers to seek employment elsewhere, in advance of this future date. Should these employees be included in the change in active plan participants when they left the company on their own accord? When does the measurement period begin?

3. How does normal attrition get factored into the equation?

If a company can demonstrate that a percentage of plan participants at a facility become non-active (i.e., resign/retire/die) on an annual basis as a matter of course, should these employees be included in the change in active plan participants in the calculation?

4. What is "a facility?"

Many manufacturing sites have multiple buildings. If operations cease in one building, but continue in other buildings on the same campus, does this qualify as a cessation of operations at a facility?

Often there are multiple and related manufacturing sites in different parts of the same town. Does ceasing operations at one site but retaining ongoing operations at the other site factor into the § 4062(e) formula?

5. Some companies offer "recall rights" to employees who are laid off if a similar position becomes available in the future. Should these employees be included in the equation?

Because the issues discussed above are unsettled, PBGC's assertion that an ERISA § 4062(e) event has occurred may be subject to debate. Since PBGC has only achieved rare success historically with § 4062(e) activities, clear patterns of interpretation have not been developed within the agency.

Again, because of PBGC's limited achievements with § 4062(e) events, it is unclear what might happen if a company were unable to provide the demanded escrow or secure a bond. Would PBGC seek to force a company into bankruptcy? Would it attempt to place liens on corporate assets?

How does PBGC assert this liability? Unlike missed minimum funding obligations, this liability does not arise automatically by statute. While the plan administrator must notify the PBGC that the event has occurred, the burden is on PBGC to determine the amount of liability and notify the plan sponsor.[5] This provides a plan sponsor with time to consider its response as well as to allow the company to consider how its existing creditors may react.

Company officials should recognize that PBGC's proposed regulation is an indication that the agency intends to become more active in corporate restructurings and the impact they may have on underfunded pension plans. A company should carefully analyze potential cessation of operations well in advance of its occurrence in order to determine whether potential pension liability may be pursued. And companies should be cognizant that PBGC's historical § 4062(e) activities have not vetted key issues so that differing interpretations can be legitimately presented.

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[5] Initially, PBGC will contact the plan sponsor to request information about the number of active plan participants expected to become non-active by pension plan as a result of the cessation of operations. PBGC may also inquire about the expected timing of the cessation and request updated information about the pension plan(s)'s assets and liabilities in order to compute the funded status of the plan(s) on a termination basis.