CDBV Part 3: Advanced Valuation Topics

Understanding Underfunded Pension Liabilities

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Understanding Underfunded Pension Liabilities: Introduction

- 2 types of pension plans
  - Defined benefit plans
  - Defined contribution plans (401(k))

- Defined Benefit Pension Plans
  - Benefits determined under a formula
  - Formula includes factors like age, years of service, salary
  - Funded on a group basis using assumptions about long term interest rates, mortality, employee turnover, retirement age

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Understanding Underfunded Pension Liabilities: PBGC

- Regulate Title IV of ERISA, pension plan insurance program
  - By law, every plan must have insurance and PBGC is the only permitted insurer
- If a plan terminates and is underfunded, PBGC steps in, assumes plan and plan assets, and pays benefits to participants when they retire
- Funded from insurance premiums, recoveries from employers w/terminated plans, and assets of terminated plans

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Understanding Underfunded Pension Liabilities: Financial Implications – Income Statement

- Pension expense (income) is booked on the income statement, usually in COGS.
- Components of pension expense:
  - cost of benefits earned during year (called "normal cost")
  - Plus interest expense on pension liability
  - Minus expected return on plan assets
  - Plus/minus amortization of deferred gains/losses, improvements in pension benefits

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Understanding Underfunded Pension Liabilities: Financial Implications - Cash

- Cash is king!
- No correlation between expense booked on I/S and required cash contributions
- Funding requirements determined by actuary

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Understanding Underfunded Pension Liabilities: Cash – Pension Funding

- Timing is important
  - assume a plan year beginning January 1, 2008
  - Quarterly payments due April 15, 2008, July 15, 2008, October 15, 2008, January 15, 2009
  - "catch-up" payment, usually the largest payment, due September 15, 2009

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Understanding Underfunded Pension Liabilities: Restrictions

- If plans not well funded, have restrictions:
  - If less than 80% funded, calculate liabilities differently (increases liability amount) and creates bigger pymts
  - And can't improve plan benefits
  - If less than 60% funded, accruals cease

- Some industries have special rules, such as auto manufacturers, auto parts manufacturers, commerical passenger airlines

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Understanding Underfunded Pension Liabilities: Balance Sheet

- Pension plans can be
  - Overfunded (assets > liabilities)
  - Fully funded (assets = liabilities)
  - Underfunded (assets < liabilities)

- Pension plans booked on B/S
  - Overfunded plan – intangible asset
  - Underfunded plan – intangible liability

Understanding Underfunded Pension Liabilities: Funded Status

- Plan can be underfunded even if all payments made. Why?
  - Plan assets primarily invested in marketable securities such as equities and bonds
  - Interest rate used to discount the liabilities

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Understanding Underfunded Pension Liabilities: Funded Status – Yours, Mine, or His

- Funded status of a plan depends on the methodology used
- Different organizations have different methodologies
  - Financial statement purpose (FASB/SEC)
  - Termination basis (PBGC)
  - Funding (IRS)
  - Prudent Investor Rate (bankruptcy court)

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Understanding Underfunded Pension Liabilities: Funded Status

- FASB/SEC
  - Interest rate used should reflect current rates at which liabilities could be "settled"
  - SEC says this rate should not be higher than yield on portfolio of AA or higher bonds
- PBGC
  - Computes funded status on a termination basis; that is, how much money is needed today to pay for all benefits earned to date
  - Uses mandated retirement age, mortality, interest rate
  - Approximates public annuity markets

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Understanding Underfunded Pension Liabilities: Funded Status

- IRS
  - Determine minimum & maximum contribution amounts

- Prudent Investor Rate
  - A bankruptcy judge can decide on the interest rate to be used in present valuing pension liabilities

Understanding Underfunded Pension Liabilities: Pension Assets

- Pension assets are held in separate trust, apart from other corporate assets
- Pension assets cannot be used for other corporate purposes
- Assets of one pension plan cannot be applied to another pension plan

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Understanding Underfunded Pension Liabilities: Pension Terminations

- 3 ways to terminate a pension plan
  - Standard
  - Distress
  - Involuntary

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Understanding Underfunded Pension Liabilities: Standard Termination

- Plan has sufficient assets to cover all benefits earned to date ("accrued benefits")
- Form of payment
  - Pay out benefits in an immediate lump sum and/or
  - Purchase annuities from financially strong insurance carrier
- Depending on interest rates, lump sums can be more or less expensive, so need to calculate both methods before deciding on course of action

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Understanding Underfunded Pension Liabilities: Distress Termination

- Plan is underfunded & company is facing financial distress (in or out of bankruptcy)
- Company petitions PBGC to terminate plan & assume responsibility for assets and benefit payments
- Participants do not earn additional benefits
- Participants may receive smaller benefit from PBGC than if plan had not been terminated as PBGC pro-rates the amount participants receive based on value of assets in plan

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Understanding Underfunded Pension Liabilities: Distress Termination

- Burden of proof on company to demonstrate:
  - Debtor is liquidating in bankruptcy (7 or 11)
  - "the bankruptcy court (or such other appropriate court) determines that, unless the plan is terminated, [the debtor] will be unable to pay all its debts pursuant to a plan of reorganization and will be unable to continue in business outside the chapter 11 reorganization process and approves the termination"
  - Unless the plan is terminated, company will be unable to pay its debt when due and will be unable to continue in business, or
  - Cost of providing a pension plan has become unreasonably burdensome solely as a result of a decline in the company's workforce

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Understanding Underfunded Pension Liabilities: Distress Termination

- Each controlled group member (each 80% or more owned subsidiary) must meet 1 of the criteria
  - Positive cash flows from one entity cannot be offset against losses from others to arrive at a net loss for the controlled group
  - Regardless of whether healthy entity had contact with pension plan or its employees participated in plan
- Each plan must meet 1 of the criteria (unless in bankruptcy)
  - A large underfunded plan may be terminated while a smaller plan may remain ongoing
  - Kaiser Aluminum (bankruptcy) decision requires all plans to be aggregated to determine distress test.

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Understanding Underfunded Pension Liabilities: Distress Termination – Reorg Criteria

- PBGC's actions
  - Will file brief & participate in hearing
  - Will adhere to (final) court's ruling
  - Believes bankruptcy court can only opine on distress termination motion with respect to debtors in that court's jurisdiction
  - Believes it has sole jurisdiction over non-bankrupt controlled group members

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Understanding Underfunded Pension Liabilities: Distress Termination Outside of Bankruptcy

- Company must demonstrate that if plan not terminated, it will it not continue in business
- Since company probably in distress for non-pension reasons, need to demonstrate that pension is now an issue
- PBGC will review other creditors' concessions; wants everyone to "share pain"

Understanding Underfunded Pension Liabilities: Distress Termination

- PBGC evaluates distress application like any creditor
  - Review 5 year projections
  - Focus on Free Cash Flow
  - Probe key assumptions – revenue growth, cap ex, margin improvements
  - May engage industry expert

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Understanding Underfunded Pension Liabilities: Involuntary Termination

- PBGC initiates termination action, regardless of company's wishes
- Why? – if it can demonstrate that a corporate action today will
  - Increase likelihood plan may terminate in future and
  - PBGC's recoveries in future will be lower than recoveries today

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Understanding Underfunded Pension Liabilities: Involuntary Termination

- When?
  - Changes to capital structure which impact PBGC's status vis-à-vis other creditors
    - Replacing unsecured debt with secured debt
    - Issuing debt to redeem equity
  - Paying extraordinary dividend to equity
  - Leveraged buyout
  - Transferring underfunded plan in spin-off/sale where new co is smaller & less credit-worthy
  - Imminent shutdown of a facility

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Understanding Underfunded Pension Liabilities: Exit Premium

- If a plan terminates in either a distress or involuntary termination, the plan sponsor must pay an "exit premium" to PBGC in the amount of $1,250 per year per plan participant for three years.

Understanding Underfunded Pension Liabilities: 430(k) Liens

- If company misses at least $1M (cumulative) in pension funding to a plan, PBGC can (and does) file tax liens against all assets in controlled group
- PBGC retains secured position until missed payments are made
- PBGC stayed from filing 430(k) liens while company in bankruptcy against debtor entities; can file against non-debtors

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Understanding Underfunded Pension Liabilities: Pensions in Bankruptcies

- Companies are not required to fund their plans while in bankruptcy (except normal cost)
- If plan is to remain ongoing, company must make up all deficiencies in order to emerge from bankruptcy
- PBGC claims
  - Secured claim if previously perfected 430(k) liens
  - Priority claim for unpaid minimum funding pre-petition not subject to lien
  - Priority claim for unpaid minimum funding post-petition
  - Unsecured claim for underfunding (even if plan ongoing)

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Understanding Underfunded Pension Liabilities: PBGC's Claims in Bankruptcy

- If pension claims are expected to have significant impact on outcome of bankruptcy, pick appropriate venue
  - Some courts have rejected PBGC's priority claims
  - Other courts have rejected PBGC's termination basis methodology; recommend prudent investor rate
  - Not all courts have ruled on "Kaiser" methodology for terminating plans

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Understanding Underfunded Pension Liabilities: Joint & Several Liability

- All controlled group members responsible:
  - Funding the pension plan
  - Termination liability
- Rules are complex
- PBGC will examine how a transaction or proposed POR treatment will affect its claim
  - Assume subsidiary with little debt. Parent sells it at fair value and wants to put proceeds at holding company level which has significant amount of debt. Value of c.g. may remain same, but PBGC believes its claims have been compromised.

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