

Understanding the PBGC's Role in Corporate Transactions

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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

Introduction to PBGC

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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

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Introduction to PBGC (Cont.)

- Government corporation
 - No “full faith and credit” backing
 - No tax dollars
- PBGC funding
 - Premiums
 - Assets from PBGC-trusted 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

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PBGC Reporting Requirements: “Traps for the Unwary”

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PBGC Reporting Requirements: “Traps for the Unwary”

- 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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