Labor and Employment Law

The Pension Protection Act of 2006: Deathknell for Defined Benefit Pension Plans?

*By Michael J. Collins**

The private pension system in the United States has been in deep decline for many years. The Pension Benefit Guaranty Corporation ("the PBGC"), the federal agency that insures benefits under private-sector defined benefit pension plans, had an $18.9 billion deficit at close of the fiscal year ending September 30, 2006. In response to this crisis, Congress enacted the Pension Protection Act of 2006 ("the Act"). The primary goal of the Act is to preserve the private pension system by requiring employers to make larger contributions to their plans. However, the unintended effect may be to accelerate the longstanding trend away from defined benefit plans in favor of "401(k)" and other defined contribution plans.

Benefits to Employees

Americans support themselves in retirement with assets derived from three primary sources: Social Security, personal savings, and employer-sponsored retirement plans. Defined benefit pension plans are a particularly effective way to provide replacement income to workers after they retire. When benefits are taken in the form of an annuity, defined benefit plans pay predictable, secure benefits for life. Unlike most defined contribution plans, many defined benefit plans do not provide a "lump sum" distribution option. Rather, they provide annuity payments for life, and pay continuing annuity benefits to a participant's surviving spouse for the remainder of the spouse's life.

Defined benefit plans (including so-called "cash balance" plans that have been the subject of much controversy in recent years, due to their purported discrimination against older workers) have several important advantages compared to 401(k) plans and other defined contribution plans. First, participants bear the investment risk under defined contribution plans; their benefits are automatically reduced if their investments suffer a loss. Under a defined benefit plan, the employee receives a guaranteed benefit, and the employer is required to make up any shortfall resulting from investment losses. Second, because employers bear the investment risk, employees need not worry about investing in excessively conservative assets, a risk when a defined contribution plan is the participant's primary source of retirement income. Third, unlike defined contribution plans, defined benefit plans are insured by the PBGC. If plan assets are insufficient to satisfy liabilities upon plan termination and the employer is unable to make up the shortfall as a result of bankruptcy or otherwise, the PBGC guarantees a certain level of benefits. Fourth, the funding of defined benefit plans is more flexible. All benefits that accrue under a defined contribution plan during the year must be funded currently, even if the employer is experiencing severe financial difficulties. Thus, employer contributions to a defined contribution plan may be discontinued in down years, and there often is no way to make up for the lost contributions in later years. Under defined benefit plans, on the other hand, benefit accruals continue even if the employer is currently unable to afford to fund the plan.

ERISA: Background

Private defined benefit plans are regulated pursuant to the Employee Retirement Income Security Act of 1974 ("ERISA"). After more than ten years of hearings and debate, Congress enacted ERISA in 1974, in response to perceived failures in the private pension system. Prior to ERISA, pension plans often were designed with such stringent vesting standards that few employees ever qualified for pensions, and many plans were inadequately funded. In addition, some plans were administered dishonestly or incompetently.

The most prominent example given for the need for greater regulation of private pension plans was the situation involving Studebaker Corporation's employees. In December 1963, following years of losses, Studebaker decided to close its manufacturing plant in South Bend, Indiana. The plant closing resulted in the dismissal of more than 5,000 workers and termination of a pension plan that covered 11,000 members of the United Automobile Workers. The plan's assets were far less than what was needed to provide the benefits vested under the plan. Approximately 3,600 retirees and active workers who had reached age sixty received the full pension promised under the plan, and roughly 4,000 other vested employees received lump-sum distributions of roughly 15% of the value of their accrued benefits. The remaining employees, who had not yet vested in any benefits under the plan, received nothing.

Among other mandates imposed by ERISA on pension plans are specified funding rules. These rules are designed to avoid Studebaker-type situations by requiring employers to fund the plan over time to ensure that there are sufficient assets to pay promised benefits. However, the rules do not require immediate funding of any shortfall. When bankrupt employers cannot afford to continue funding their plans, ERISA permits a "termination" of the plan, with the PBGC taking over administration. PBGC pays all promised benefits, generally subject to an annual maximum benefit (currently $49,500 per year for benefits that commence at age sixty-five, and actuarially reduced for pre-sixty-five benefit commencement). A number of prominent employers have terminated massively under-funded plans in recent years, including United Airlines, U.S. Airways, and Bethlehem Steel. Large plan terminations account for the bulk of PBGC's deficit.

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The Crisis

The funded status of a pension plan is determined by two key variables, the interest rate and the return on plan assets. If interest rates decline, the present value of the promised benefits increases. If asset returns are poor, there are fewer funds available to pay benefits. This situation referred to as the "perfect storm" for pension plans, occurred in the early part of this decade. Interest rates have been historically low, driving up plan liabilities. In addition, the stock market decline that commenced in spring 2000 severely depleted plan assets. Although many sectors of the stock market have recovered, others have not. For example, the Nasdaq average is still more than 50% below its 2000 peak.

Because plan liabilities increased while assets decreased, ERISA's funding rules mandated higher contributions. These increases made it impossible for some employers to afford their plans. Other employers that did not meet ERISA's standard for terminating their plans instead "froze" the plans. A plan freeze preserves benefits accrued to date, but cuts off future benefit accruals. It is different than a plan termination because a termination requires full funding, which can be very expensive. A freeze has the same basic economic impact as a plan termination, without triggering the need to immediately fully fund the plan.

Decline in the Private Pension System

The statistics regarding the private pension system are sobering. In 1977, there were approximately 120,000 defined benefit plans maintained by private sector employers. This number increased to almost 173,000 by 1983, but declined to only 64,000 by 1995, and is below 50,000 now. In addition, many of the surviving plans are "frozen" and no longer provide for future benefit accruals. For example, IBM announced early in 2006 that it would freeze benefit accruals under its pension plan in 2008. Similarly, Verizon announced a freeze of its pension plan in December 2005. Other employers, such as Hewlett-Packard, have continued benefit accruals for existing participants, but do not permit new hires to participate in their plans.

The reasons for the decline are complex. It is at least in part market-driven, as 401(k) and other defined contribution plans are better-suited in many respects for a mobile workforce, the benefits being more "portable." Tighter governmental regulations on the amount of benefits that can be provided, and on disparities in the treatment of higher and lower-paid workers, have also made defined benefit plans less attractive to management. However, the expense of maintaining defined benefit plans probably has been the most important factor in the decline of the system.

The Pension Protection Act

The Pension Protection Act ("the Act") focuses on one problem with the pension system: limiting the PBGC's future exposure. In this area, it significantly tightens the plan funding rules. Some of the other key pension funding changes made by the Act include:

- Modification of the interest rates used to determine plan liabilities.
- Employers generally must now annually contribute the "normal cost" of the plan (i.e., the cost of benefit accruals for that year) and amortize over seven years any shortfall relating to prior years. This is significantly shorter than under prior law, which allowed some liabilities to be amortized over as many as thirty years.
- Special, additional funding rules for "at risk" plans, generally including most plans that are less than 70% funded, as determined using very conservative actuarial assumptions.

Likely Effect of the Act

Most of the provisions of the Act become effective January 1, 2008. The Act will likely be beneficial for employees of many *healthy* employers. Those employers will need to fund their plans more quickly, thereby providing more of a cushion in the event the employer later experiences financial difficulties that impact its ability to continue funding the plan.

However, the Act is likely to result in more pension plan terminations by less healthy employers. Because plans in poor shape are likely to be maintained by employers in precarious financial health, the "at risk" funding provision will mostly impact employers who can least afford to make additional contributions. In other words, employers who may struggle to make contributions required under prior law will now face larger obligations. This provision will probably drive some employers in precarious shape into bankruptcy. Once there, the additional funding obligations will make it easier for them to demonstrate to the bankruptcy court that they need to shed the plan to the PBGC in order to emerge from bankruptcy. Thus, more plans are likely to be terminated as a result of an act whose purported purpose is to shore up the pension system.

The Act is also likely to result in more plan freezes, even for employers that do not meet the standard for plan termination. By cutting off future benefit accruals, a plan freeze substantially reduces possible unexpected spikes in pension contribution obligations, and also reduces the risk that the plan will ever go into "at risk" status. Thus, any prudent employer has to consider whether continuing the plan is too risky for the employer's future financial health.

In sum, the Act seeks to preserve the private defined benefit pension plan system by putting plans on a surer financial footing. It will be interesting, however, to see if, consistent with the law of unintended consequences, it ends up further undermining that system.