# Coming in 2009: The Perfect Storm of Pension Plan Funding

## Market Crisis Combined with New Funding Rules Will Create Substantial New Liabilities and Benefit Restrictions

The global bear market, combined with the stringent new pension plan funding rules enacted by the Pension Protection Act of 2006 (PPA), has raised the specter of significantly increased funding obligations in 2009 for single-employer plans, as well as restrictions on the operation of underfunded plans and the funding of nonqualified plans. These restrictions may include:

- Restrictions on the payment of lump sum distributions, which will particularly affect cash balance and pension equity plans;
- Restrictions on any benefit increases, even pre-negotiated increases in collectively bargained plans;
- A prohibition on the funding of nonqualified deferred compensation plans while qualified plans are underfunded; and
- In extreme cases, a mandatory freeze on future benefit accruals and payment of plant closing and similar benefits.

Industry groups are lobbying Congress to grant relief from the new funding rules in light of the financial crisis, but there is no assurance that relief will be granted. All pension plan sponsors need to review the funded status of their plans before the beginning of the 2009 plan year in order to prepare for the effect of the new funding requirements. This memo (i) provides an overview of the PPA's benefit restrictions and proposed regulations, (ii) discusses timing requirements and assumptions applicable to the benefit restrictions, and (iii) examines alternative funding options to avoid the imposition of benefit restrictions. This summary is not intended to be definitive guidance on this subject but rather a guidepost for conversations between plan sponsors and fiduciaries with outside consultants. This summary discusses only the rules applicable to single-employer plans. Different, but no less serious, issues apply to multiemployer plans.

### PPA Benefit Restrictions

The PPA completely revised the minimum funding requirements for qualified plans, changing from a system that focused on long-term funding to a "pay as you go" system that requires current funding of all pension liabilities. The heart of the new PPA system is a plan's "funding target attainment percentage" (the "funding percentage") and its "adjusted funding target attainment percentage" (the "adjusted funding percentage"). A plan's funding percentage for a plan year is essentially the ratio of the fair market value of the plan's assets to the present value of its benefit liabilities, and the adjusted funding percentage is the funding percentage adjusted to reflect annuity purchases in the prior two years. The funding percentage is generally calculated as of the first day of the plan year, and for calendar year plans will be calculated using asset values on January 1, 2009.

Plans were first required to calculate their funding percentages under the PPA for the 2008 plan year. However, almost all plans can expect to experience a significant decrease in their funding percentage for 2009, which will be exacerbated by two factors:

- The effect of the recent drop in asset values will be magnified by the fact that the PPA requires that assets be valued at current market value. The old funding system used “smoothing” valuation methodologies that reduced the effect of short-term market volatility, but smoothing is generally not permitted under PPA.
- In calculating their funding percentages for 2008, plans were permitted to include 2007 minimum funding contributions that were anticipated to be made by September 15, 2008. For purposes of calculating the 2009 funding percentage, 2008 minimum funding contributions can only be counted if actually paid by the date the actuary certifies the percentage (although, as discussed below, a plan sponsor may count contribution obligations that are secured by a surety bond or escrow).

As a result of these factors, *virtually all pension plan sponsors must anticipate that the plan’s 2009 funding percentage will be significantly lower than the 2008 percentage*. The immediate effect of this drop in the funding percentage will be an increase in minimum funding contributions for 2009. However, PPA also imposes a number of other restrictions on the operation of plans, depending on the funding level.

The chart below provides an overview of the PPA’s funding-based benefit restrictions:

| **Funding Status** | **Plan Consequence** |
|---|---|
| Adjusted funding percentage between 80% and 100% | If the 2009 funding percentage is also below 94%, funding shortfall must be amortized over not more than seven years, and quarterly contributions may be required. |
| | No lump sum payments may be paid while the sponsor is in bankruptcy. |
| Adjusted funding percentage between 60% and 80% | Lump sums and other accelerated payment forms are limited to the lower of:<br>• 50% of the present value of the participant’s benefit; or<br>• the present value of the PBGC guaranteed benefit (currently $51,750 per year). |
| | No amendments to a plan that increases benefit liabilities. Prohibited increases include establishing new benefits, changing the rate of benefit accruals, or changing the vesting rate. This last requirement does not apply to a plan that adopts a mandatory faster vesting schedule such as vesting rules for hybrid pension plans. This restriction would also apply if the benefits attributable to the amendment would drop the plan’s adjusted funding percentage below 80%. |
| | Special funding notice to participants and PBGC. |
| | Plan may be “at risk” in *next* plan year (see below). |

| Funding Status | Plan Consequence |
|---|---|
| Adjusted funding percentage less than 60% | Lump sums and other accelerated payment forms are prohibited. |
| | Benefit accruals are frozen. |
| | Shutdown and unpredictable contingent event benefits (e.g., a special early retirement benefit that is triggered by a plant shutdown, or similar occurrence) cannot be paid. This restriction is imposed on participants who commence a distribution within the restricted period. For example, if a plant shutdown occurs in 2009 and the plan is subject to this (and other) benefit restrictions, the shutdown benefit related to the 2009 shutdown cannot be paid in later years (absent a plan amendment), even if the plan improves its funding. |
| | Special funding notice to participants and PBGC. |
| "At risk" plan—funding percentage for prior year is less than 80% using normal actuarial assumptions and less than 70% using special at risk assumptions | Significantly increased minimum funding contributions. |
| | Any amount funded by the plan sponsor or any affiliate under a nonqualified deferred compensation plan for the five most highly compensated executives will be taxable and subject to the 20% penalty tax provided by §409A. |

**Lump Sum Restrictions.** The restrictions on payments of lump sums will significantly impact cash balance and pension equity plans, and will override any provision of the plan that permits such distributions. However, all plans may be affected, as there is no exception for cashouts of amounts less than $5,000 (although legislation has been proposed to permit such distributions). The rules prevent circumventing the 50% limitation on lump sums through multiple distributions. The restriction also applies to any "accelerated payment form"—defined as any form of payment that pays benefits more rapidly than a single life annuity—which will cover installment payments as well as lump sums. In addition, the increased benefit payments payable prior to social security eligibility under a level payment formula may be prohibited; there is an exception for social security supplements, but in other contexts the IRS has taken the position that a level payment option is not a social security supplement. Plans in which all benefit accruals have been frozen since September 1, 2005 are not subject to the limits on lump sum payments.

**Application to Union Plans.** The restrictions on benefit increases for plans that are less than 80% funded, and on payment of plant closing and similar benefits for plans that are less than 60% funded, will particularly impact collectively bargained plans in which employers routinely negotiate benefit increases. The rules permit an employer to avoid the limitations by making a special contribution to fund the benefit increase (or the additional cost of the plant closing benefit), and companies may find themselves in the position of being required to make significant additional contributions to avoid a violation of the collective bargaining agreement and an unfair labor practice charge. Plan sponsors that have a union plan that may become subject to these restrictions should caution negotiators not to agree to benefit increases without determining the effect on the plan's funding status.

**Restriction on Funding of Nonqualified Plans.** The restriction on funding nonqualified plans, which applies to contributions to a rabbi trust or any other method by which funds are set aside for payment of benefits, applies not only to the sponsor of the at risk plan, but to any member of the sponsor's controlled group. Although it appears that this restriction was intended to apply only to the five proxy officers of a public company, it is not clear that the actual language of the statute is limited to public companies.

## Timing of Funding Percentage Determinations

In theory, the restrictions discussed above apply to the entire plan year in which the plan's adjusted funding percentage drops below the 80% or 60% threshold. However, in practice, a plan's funding percentage will not be known on the first day of the year, and, accordingly, the PPA includes a series of presumptions that are used to apply the benefit restrictions. A plan's funding level is based on a certification by the plan's actuary. Until the actuary certifies the funding status of a plan, the following rules apply:

- For the first three months of a plan year, the plan's funding status is assumed to be the same as its funding status for the prior year. In other words, until April 1, 2009, a calendar year plan may assume that its 2009 adjusted funding percentage is the same as the 2008 adjusted funding percentage, provided that the actuary has not certified a different percentage.
- For months four through nine, the plan's funding status is assumed equal to its funding status for the prior year minus ten percentage points. In other words, if a calendar year plan's 2008 adjusted funding percentage was 85%, effective April 1, 2009, its 2009 adjusted funding percentage is assumed to be 75%, and the lump sum payment restrictions would apply to any amount payable on or after April 1, again provided that the actuary has not certified a different percentage.
- If the actuary does not issue the certification by the end of the ninth month, the plan's funding status is conclusively presumed to be less than 60% for the rest of the year—even if the actuary later certifies a higher percentage.

These presumptions do not apply to the restrictions on at risk plans—specifically the prohibition on funding nonqualified deferred compensation—since at risk status is based on the prior year's funding level.

Plan sponsors should carefully consider the timing of a plan's certification. In some cases, the plan sponsor will want to delay certification until the ninth month of the plan year. For example, in the current bear market, the value of the plan's assets as of January 1, 2009, may have depreciated more than the 10% assumption applied on the first day of the fourth month. If the plan's 2008 adjusted funding percentage is 93%, the sponsor should consider delaying certification as long as possible. Even if the 10% assumption applied to the plan's assets as of the first day of the fourth month, the revised adjusted funding percentage will not trigger benefit restrictions and may be greater than the plan's actual adjusted funding percentage. In contrast, a plan that is subject to benefit restrictions in 2008 may wish to obtain its certification as soon as possible in 2009 to lift the plan's benefit restrictions.

Generally, a benefit restriction will apply until the plan's actuary certifies that the plan's funding exceeds the triggering funding percentage. For plans that cease benefit accruals or stop paying shutdown and unpredictable contingent event benefits, reinstatement of the restricted benefit may require an amendment, as these benefit limitations are not retroactively restored once the restriction is lifted. A plan may require the automatic reinstatement of accruals. If it does so, and accruals have been frozen for at least 12 months, the plan is treated as having adopted an amendment increasing benefits that would be subject to the restrictions on benefit improvement amendments (i.e., the plan would need an adjusted funding percentage of at least 80% after the amendment). Further, any shutdown or contingent event benefit that applied when the participant terminated would continue to apply even if the restriction is lifted at a later date. The plan must be amended to allow such additional payments. This amendment would also be subject to the restriction on benefit improvements.

## Avoiding Benefit Limitations

The proposed regulations outline four options for avoiding the imposition of benefit restrictions. The plan may (1) reduce its funding standard carryover balance and prefunding balance, (2) accelerate required contributions, or make additional contributions that are not credited to the prefunding balance, (3) provide certain types of security, and (4) make contributions specifically designated to avoid benefit restrictions. Each option is discussed below.

(1) A plan that contributes more than the minimum required contribution in any year may credit the excess to either a funding standard carryover balance or prefunding balance (depending on whether the excess predates the PPA rules). These balances can be carried over and reduce minimum funding contributions in the future, but they are also subtracted from the plan's assets in determining the adjusted funding percentage. A plan may reduce its funding standard carryover balance or prefunding balance, which will increase its adjusted funding percentage and possibly avoid benefit restrictions, but may also increase its minimum contribution obligation. Obviously, this is a very technical decision that must be made in consultation with the plan's actuaries. This curative approach is required if doing so would enable a plan to avoid the limitation on lump sum payments, or would enable a collectively bargained plan to avoid any benefit limitations.

(2) A plan sponsor may increase the plan's 2009 funding percentage by making its final minimum contribution for the 2008 plan year, which normally would not be due until September 15, 2009, prior to the earlier date on which the actuary completes the 2009 certification. The plan sponsor could also make additional contributions that exceed its 2008 minimum contribution requirement, but such amounts may need to be contributed prior to the January 1 valuation date, and could not be added to the prefunding balance.

(3) A plan may provide cash, U.S. government bonds, or a surety bond as security and such amounts would be treated as plan assets for determining the plan's adjusted funding percentage. The security must be held in escrow by a bank or insurance company and mature in no more than three years. The security would be paid to the plan in the event of plan termination, a failure to pay the minimum required contribution, or when the plan's adjusted funding percentage remains less than 60% (without considering the security) for a period of seven consecutive plan years.

(4) Finally, a plan may make designated contributions to avoid certain benefit limitations. These are special contributions that are calculated to fund benefits, such as plant closing benefits or benefit increases, that would otherwise be restricted, and do not count toward satisfying the plan's minimum contribution requirement. This contribution is not permitted to cure the limitation on lump sum benefit payments.

## Action Items

- Plan sponsors and fiduciaries should start asking questions regarding the plan's funded status and work through possible scenarios with the plan's actuary. Plans may still have a window to make additional contributions that would raise the plan's 2009 funding percentage.

- Plan fiduciaries should review the plan's investment strategy, and become informed about the plan's funded status. In many cases, no action will be required, but volatility in the global market requires vigilance with the fiduciary process. Investment committees should gather information, document their processes, and make committee decisions based on the information known at the time the decision is made.

- Review documents which may contain a funding level trigger. For example, the company's credit agreement may require notice if a defined benefit plan falls below a certain funding level. In addition, the nonqualified plan may require contributions to the rabbi trust and not address a scenario where the sponsor's defined benefit plan is determined to be at risk.

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