



Pension Guarantees that Work for Retirees

A Proposal for Commonsense PBGC Reforms

EXECUTIVE SUMMARY

The recent economic downturn has highlighted just how vulnerable America's workers and retirees are to the threat of corporate bankruptcy and the dumping of company pension obligations onto the government's pension guarantee system. The Pension Benefit Guaranty Corporation (PBGC) took over 155 failed plans during fiscal year 2012, a 75% increase from 2008. The pace of plan terminations has accelerated greatly since the severe recession that began that year.

As required by the Employee Retirement Income Security Act (ERISA), pension plan sponsors pay a per-participant "insurance premium" to the PBGC – a cost paid from plan assets. Although these premium payments remain below the projected long-term cost of insuring the benefits, retirees are led to believe their benefits are protected, at least up to the statutory maximum (\$57,460 per year for a 65-year-old, in 2013, but substantially less for retirees under age 65). Unfortunately, workers and retirees learn only after plan termination that a number of PBGC policies can leave them with benefits that are permanently reduced by 30% or more.

Arbitrary gaps in ERISA's benefit guarantee program are imposing unanticipated and devastating losses on tens of thousands of retirees and older workers forced into retirement by the bankruptcy of their employer. In some cases corporate transactions and financial engineering spin off weaker business divisions or subsidiaries that end up in bankruptcy and lead to pension plan terminations. Whatever the cause, when an under-funded plan terminates and is taken over by the PBGC, the benefits actually paid by the agency can be much lower than the vested benefits earned. Some limitations on PBGC's guarantee are imposed specifically by ERISA – such as the maximum annual benefit guarantee (which varies based on age). This paper focuses on one *statutory* and two *discretionary* policies that PBGC maintains despite the fact that it leads to unexpected and unfair benefit losses for a large number of older workers and retirees.

First, while ERISA imposes limitations on benefit guarantees, ***the largest loss of earned benefits suffered by most retirees after a plan termination is caused by the PBGC's decision to estimate the future cost of benefits using an unrealistically low interest rate assumption.*** The lower the interest rate, the greater the estimated present value of future benefit obligations. While other qualified pension plans are required by law to calculate their funded status based on the market-based corporate bond yield curve prescribed by the Treasury Department, the PBGC at its discretion uses a much lower discount rate (2.95% in September 2012) that is derived from the prices charged by private insurance companies for fixed and deferred annuities.

The government is confusing and misleading 44 million insured plan participants by requiring companies to send them year after year an Annual Funding Notice that discloses a plan funding level that is substantially rosier than what the PBGC later calculates as “termination liability.” In other words, after a plan terminates the PBGC chooses to use a different – and far more conservative – interest rate assumption in valuing benefit obligations than a plan sponsor is required to use under ERISA’s minimum funding rules. And because the PBGC assumes a much lower discount rate on future benefit obligations (recently under 3%), it allocates plan assets *as if* it will not be offsetting a substantial portion of future benefit costs by investing the plan assets, just as other plan sponsors offset future costs with expected market rates of return on investment.

As a result, the assets recovered from a terminated plan cover the inflated “present value” of guaranteed and non-guaranteed benefit obligations to a much lesser degree than if the PBGC assumed that plan assets would earn a long-term average market rate of return (typically 6% to 8%). Because the present value of benefit liabilities are exaggerated, plan assets rarely cover most of the non-guaranteed vested benefits, such as benefit increases within five years of termination or earned benefits above the PBGC monthly maximum benefit. This results in unnecessarily large and permanent losses for participants. ***Congress should require PBGC to use the same corporate bond yield curve and other assumptions as plan sponsors for the purpose of allocating plan assets to pay non-guaranteed benefits.***

The second discretionary PBGC policy that unnecessarily reduces benefits for a subset of retirees is flatly contrary to the plain language of ERISA. One of the statutory limitations on guaranteed benefits is the five-year phase-in of “any increase in the amount of benefits under a plan *resulting from a plan amendment.*” If such a benefit increase becomes effective within one year of the plan termination date, it is not guaranteed at all; if the amendment made the benefit increase effective more than one year prior to termination, the guarantee phases in 20% per year.

Despite the statutory definition of the five-year phase-in as “*resulting from a plan amendment,*” the PBGC has determined that the annual statutory inflation adjustment of the maximum annual compensation that can be considered in calculating a benefit (the IRC Section 401(a)(17) limit) and the maximum annual benefit payable by a qualified plan (the IRC Section 415(b)(1)(A) limit) is a benefit increase subject to the five-year phase-in. As a result, older workers or retirees whose accrued monthly benefit simply adjusted automatically in line with the statutory inflation adjustment suffer a disproportionate loss of benefits. Although vested, these benefits are rarely paid because the portion not guaranteed under the five-year phase-in is moved to a low Priority Category (PC-5), at which point there are rarely plan assets remaining to pay these “non-guaranteed” claims (and less so because PBGC chooses to use an artificially low discount rate to estimate liabilities, as noted above). ***The PBGC should change this policy or Congress should clarify that a benefit increase triggered by a federal statute is not subject to the five-year phase-in limitation.***

A third indefensible gap in ERISA’s guarantee system is the statutory three-year ‘look-back’ that PBGC applies to determine what benefits are eligible for payment under Priority Category 3. On the date of plan termination (or bankruptcy filing, whichever is earlier), if a plan participant has not been retired (in “pay status”) or eligible to retire for at least three years, then no portion of his or her benefit is eligible for PC-3 prioritization. The guaranteed portion of the benefit will still be paid (under PC-4), but the *non-guaranteed* portion will almost always be unfunded and lost forever. Since all of the non-guaranteed benefits of recent retirees are demoted to PC-5, this group takes a big

reduction whether they have been retired for one month or nearly three years. **Congress should amend Section 4044(a)(3) so that the benefits of all plan participants who are already retired, or eligible to retire, on the date of plan termination are protected equally.**

Finally, the paper addresses the growing concern about the PBGC's ability to deter plan terminations by, or recover assets from, foreign-owned or foreign-based plan sponsors. Actually collecting on a liability in practice requires that foreign entities have sufficient assets within the jurisdiction of U.S. courts. Because of this increased risk, PBGC should add foreign ownership, and proposed sales or spin-offs to foreign owners, to the list of transactions triggering an Advance Notice of Reportable Events, as well as special scrutiny under the PBGC's Early Warning Program. In addition, **Congress should clarify that the PBGC has the authority to enforce a lien against all U.S.-based assets of a foreign plan sponsor and require that plan fiduciaries – particularly a plan's "named fiduciary" – be U.S. citizens subject to the jurisdiction of U.S. courts.**



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I. INTRODUCTION AND BACKGROUND

The current economic downturn has highlighted just how vulnerable America's workers and retirees are to the threat of corporate bankruptcy and the dumping of company pension obligations onto the government's pension guarantee system. The Pension Benefit Guaranty Corporation (PBGC) took over 155 failed plans during fiscal year 2012, a 75% increase from 2008. The pace of plan terminations has accelerated greatly since the market crash and deep recession that began that year.¹

Of course, insuring the earned (vested) benefits of workers and retirees is exactly what Congress established the PBGC to do. Like most landmark legislative reforms, the policy debate that culminated in the Employee Retirement Income Security Act (ERISA) and a pension guarantee system was sparked by scandal: in this case the 1963 bankruptcy of Studebaker, the nation's oldest major auto manufacturer. Studebaker's collapse left 11,000 retirees and workers holding an empty bag of pension promises. Like most companies in that era, Studebaker had not adequately pre-funded its obligations in a pension trust; nor was it required to manage that funding solely in the interest of plan participants; nor did it take any steps to insure its retirees against a corporate bankruptcy or liquidation.

Reacting to the Studebaker scandal, President John F. Kennedy formed a working group to study pension reform. After many years and much debate, the enactment of ERISA established new requirements governing pension plan participation, vesting, funding, fiduciary duties and financial disclosure. It also established a government-run plan termination insurance program: the Pension Benefit Guaranty Corporation (PBGC), which has been one of the fundamental pillars of ERISA since its passage in 1974.

ERISA's Title IV is clear about the three statutory purposes of PBGC, which "are:

- (1) to encourage the continuation and maintenance of voluntary private pension plans for the benefit of their participants;
- (2) to ***provide for the timely and uninterrupted payment of pension benefits*** to participants and beneficiaries ... and
- (3) to maintain premiums established by the corporation ... at the lowest level consistent with carrying out its obligations under this title."²

As required by ERISA, plan sponsors pay a flat rate "insurance premium" to the PBGC for each participant plus a variable premium based on the plan's funded status – a cost paid from plan assets. Although there has long been a legitimate debate about whether these premium payments reflect the true, long-term cost of insuring the benefits, retirees and workers typically assume that their benefits will be protected, at least up to the statutory maximum (\$57,480 per year for a 65-year-old in 2013, but substantially lower – or higher – for individuals younger or older than 65 at the time of plan termination). Unfortunately, large numbers of workers and retirees learn only after their company's

¹ Pension Benefit Guaranty Corporation, *2012 PBGC Annual Report*, November 14, 2012, available at <http://www.pbgc.gov/documents/2012-annual-report.pdf#page=8>. See also Laura Cohn, "The Latest Blow: Smaller Payouts for New Retirees," *The Washington Post*, May 16, 2010 (available at <http://www.washingtonpost.com/wp-dyn/content/article/2010/05/15/AR2010051500043.html>).

² 29 U.S.C. § 1302, ERISA Section 4002(a), emphasis added.

plan has been turned over to the PBGC that a number of PBGC practices – some discretionary, some statutory – can leave them with monthly benefits that are permanently reduced by 30% or more.

Following passage of the Pension Protection Act of 2006, which amended ERISA, then-Secretary of Labor Elaine Chao stated: “The passage of pension reform has affirmed the principle that pension promises made to workers are promises that must be kept.” While imposing stricter funding rules on plan sponsors was an important step, Congress and the Administration need to reconsider the arbitrary gaps in ERISA’s benefit guarantee program that impose devastating losses on tens of thousands of retirees and older workers forced into retirement by the bankruptcy of their employer.

The benefits actually paid by the PBGC are increasingly much lower than the vested benefits earned by a substantial share of participants. Recent airline bankruptcies are indicative.

According to a 2009 General Accountability Office study, the pilots at Delta Air Lines lost nearly \$2.96 billion in non-guaranteed but unfunded benefits (nearly 35% of their total vested benefits) and at U.S. Airways 7,050 participants in the pilots’ plan lost \$1.69 billion in non-guaranteed benefits (20% of their total vested benefits).³

Some limitations on PBGC’s guarantee are imposed specifically by ERISA – with the maximum annual benefit guarantee (which varies based on an individual’s age at the time of plan termination) being the most well-known example. This paper focuses in particular on two other *discretionary* policies that the PBGC has maintained despite the fact that it leads to unexpected and unfair benefit reductions for a large number of older workers and retirees.

PBGC Uses Its Discretion to Undermine Pension Benefit Protections

The most important PBGC policy that imposes a permanent loss of vested benefits on a growing number of retirees is the agency’s decision to allocate plan assets to cover benefit obligations based on an exaggerated estimate of the present value of those future liabilities. The PBGC chooses to estimate a plan sponsor’s “termination liability” using a discount rate derived from the price that commercial insurance companies charge for fixed and deferred annuities. This discount rate is substantially lower than the interest rate, taken from the Treasury Department’s AA corporate bond yield curve, that plan sponsors are required to use to estimate their liabilities and minimum funding requirements under the PPA.⁴ Because the PBGC assumes a much lower discount rate on future benefit obligations (recently just under 3%), it allocates plan assets *as if* it will not be offsetting a substantial portion of future benefit costs by investing the plan assets, just as other plan sponsors offset future costs with expected long-term rates of return on investment (historically 6% to 8%).

As a result, the assets recovered from a terminated plan cover the inflated “present value” of guaranteed and non-guaranteed benefit obligations to a much lesser degree than if the PBGC used the discount rate required by ERISA for plan sponsors. Because of the agency’s unreasonably low

³ General Accountability Office, “Pension Benefit Guarantee Corporation: More Strategic Approach Needed for Processing Complex Plans Prone to Delays and Overpayments,” August 2009, Appendix VI, at p. 69.

⁴ Currently this gap between the funding level calculated by plan sponsors and the termination liability calculated by the PBGC is even greater due to the temporary “funding relief” provisions Congress passed as part of the 2012 highway funding bill. See Conference Report to Accompany the Moving Ahead for Progress in the 21st Century Act (Map-21) Act (H.R. 4348), Public Law 112-141 (enacted July 6, 2012), Section 40211(A)(2)(D). The funding “stabilization” provisions in the Map-21 Act allow plan sponsors to use higher interest rates in valuing their liabilities, which substantially lowers projected liabilities and, in turn, lowers the employer’s minimum required contributions.

interest rate assumption, the assets rarely cover all or even most of the non-guaranteed vested benefits, such as certain benefits above the maximum guarantee, or benefit increases within five years of plan termination. This results in unnecessarily large and permanent losses for participants unlucky enough to have earned benefits subject to the PBGC's guarantee limitations.

Moreover, ***the government is confusing and misleading 44 million insured plan participants*** by requiring companies to send them year after year an Annual Funding Notice that discloses a funding level and projected benefit obligation that are substantially rosier than what the PBGC later calculates as "termination liability." ***For the purpose of allocating plan assets to pay non-guaranteed benefits Congress should require PBGC to use the same corporate bond yield curve and other assumptions that plan sponsors are required to use by the Pension Protection Act.***

The second discretionary PBGC policy that unnecessarily reduces benefits for a subset of retirees is of more recent vintage and contrary to the plain language of ERISA. One of the statutory limitations on guaranteed benefits is the five-year phase-in of "any increase in the amount of benefits under a plan *resulting from a plan amendment.*"⁵ Under ERISA Section 4022(b)(1), if a benefit increase "*resulting from a plan amendment*" becomes effective within one year of the plan termination date, it is not guaranteed at all; if the amendment made the benefit increase effective more than one year prior to termination, the guarantee phases in 20% per year.

Despite this language, the PBGC has determined that the statutory inflation adjustment that automatically adjusts the maximum annual compensation that can be considered in calculating a pension benefit – the IRC Section 401(a)(17) limit – and the maximum annual benefit payable by a qualified plan – the IRC Section 415(b)(1)(A) limit – are benefit increases subject to the five-year phase-in. The result, discussed in more detail below, is that older workers or retirees whose accrued monthly benefit simply adjusted automatically in line with the statutory inflation adjustment suffer a disproportionate loss of benefits. Although these benefits are vested, they are rarely paid because the portion not guaranteed under the five-year phase-in is moved to a low priority category (Priority Category 5), at which point there are rarely plan assets remaining to pay these "non-guaranteed" claims – and roughly 30% less so because the PBGC chooses to inflate the overall cost of its liabilities by using an insurance industry discount rate, as described just above. ***The PBGC or, if not, Congress should clarify that a benefit increase triggered by the automatic inflation adjustment of the Internal Revenue Code 401(a) and 415(b) limit is not subject to the five-year phase-in limitation that applies to benefit increases "resulting from a plan amendment."***

The two final sections of this paper address issues that likewise threaten retirement income security. One is the statutory limit on the protection of benefits earned by plan participants who either retired, or who were eligible to retire, less than three years prior to the date of plan termination. On the date of plan termination (or bankruptcy filing, whichever is earlier), if a plan participant has not been retired (in "pay status") or eligible to retire for at least three years, then no portion his or her benefit is eligible for Priority Category 3 (PC-3) protection. The guaranteed portion of the benefit will still be paid (under PC-4), but the *non-guaranteed* portion will almost always be unfunded and lost forever. Since all of the non-guaranteed benefits of recent retirees are demoted to PC-5, this group takes a big reduction whether they have been retired for one month or nearly three years. ***Congress should amend Section 4044(a)(3) so that the benefits of all plan participants who are already retired, or eligible to retire, on the date of plan termination are protected equally.***

⁵ 29 U.S.C. 1322, ERISA §4022(b)(1).

Finally, the paper addresses the growing concern about the PBGC's ability to deter plan terminations by, or recover assets from, foreign-owned plan sponsors. Although ERISA treats a U.S.-based subsidiary and its foreign parent as jointly and severally liable for pension funding liabilities, it's unlikely that a U.S. court would or could enforce a lien against the assets of a plan sponsor outside the territorial jurisdiction of the U.S. government. Actually collecting on a liability in practice requires that the foreign entities have sufficient assets within the jurisdiction of U.S. courts. Because of this increased risk, ***PBGC should add foreign ownership***, and proposed sales or spin-offs to foreign owners, ***to the list of transactions triggering an Advance Notice of Reportable Events, as well as special scrutiny under the PBGC's Early Warning Program. In addition, Congress needs to clarify that the PBGC has the authority to enforce a lien against all U.S.-based assets of a foreign-owned plan sponsor***, even if those other subsidiaries or assets are not considered part of the controlled group sponsoring the plan.

Congress also should amend ERISA to require that all individuals who serve as plan fiduciaries – particularly the plan's named fiduciary – be U.S. citizens subject to the jurisdiction of U.S. courts. ERISA Section 401(a)(1) requires that employers sponsoring a qualified pension plan identify in plan documents at least one "named fiduciary" (an individual or an office, such as the corporation's directors). Pension plan participants as well as the PBGC have the right to sue pension plan fiduciaries in U.S. courts for breach of fiduciary duty and to recover plan assets. However, the assignment of individuals as fiduciaries who are not U.S. citizens by a foreign corporation, or who may not even be domiciled on U.S. territory, can put the fiduciary beyond the reach of U.S. courts and eviscerate intended protections in ERISA.

A Brief Overview of PBGC Benefit Limits and Allocations

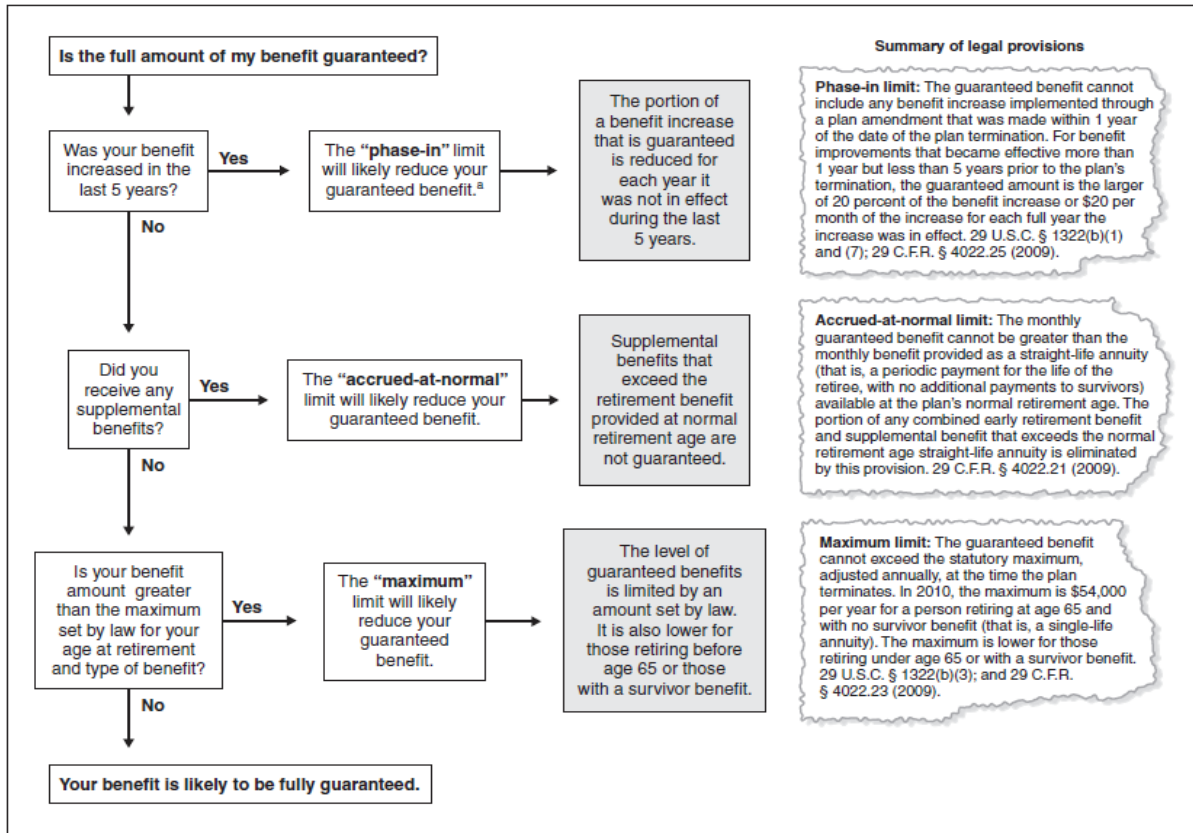
Once a terminated plan is taken over by PBGC, the agency values plan assets and the present value of liabilities as of the termination date.⁶ It also pursues the plan sponsor in bankruptcy and any additional recovery is divided between participants (to cover more non-guaranteed benefits) and the agency (to offset the cost of guaranteed benefits). However, as noted above, not all benefits are guaranteed due to a variety of limitations. The permanent loss of vested but *non-guaranteed* benefits due to various PBGC limitations can be devastating to the individuals affected. The gaps in PBGC's coverage are substantial and impacting a higher percentage of terminated plan participants each year.

For example, a 2009 study by the Government Accountability Office (GAO) identified five plan terminations that *each* resulted in more than \$500 million in permanently lost benefits due to PBGC coverage limitations.⁷ The largest losses occurred among the pilots and other airline employees at United, Delta Air Lines and U.S. Airways. At Delta, plan participants lost \$2.96 billion in unfunded benefits (34.7% of their total vested but non-guaranteed benefits). At U.S. Airways, plan participants lost \$1.69 billion in vested but non-guaranteed benefits (20% of their total non-guaranteed benefits).

⁶ Based on provisions in the Pension Protection Act of 2006, the date that the plan sponsor files for bankruptcy is treated as the plan termination date for purposes of determining the amount of guaranteed benefits and allocating assets, if that date is prior to actual plan termination. See 29 U.S.C. §§ 1322(g) and 1344(e).

⁷ General Accountability Office, "Pension Benefit Guarantee Corporation: More Strategic Approach Needed for Processing Complex Plans Prone to Delays and Overpayments," August 2009, Appendix VI, at p. 69.

Figure 8: Determining If a Participant's Guaranteed Benefit Is Subject to Legal Limits



Source: GAO analysis of ERISA, PBGC's implementation regulations and related documents

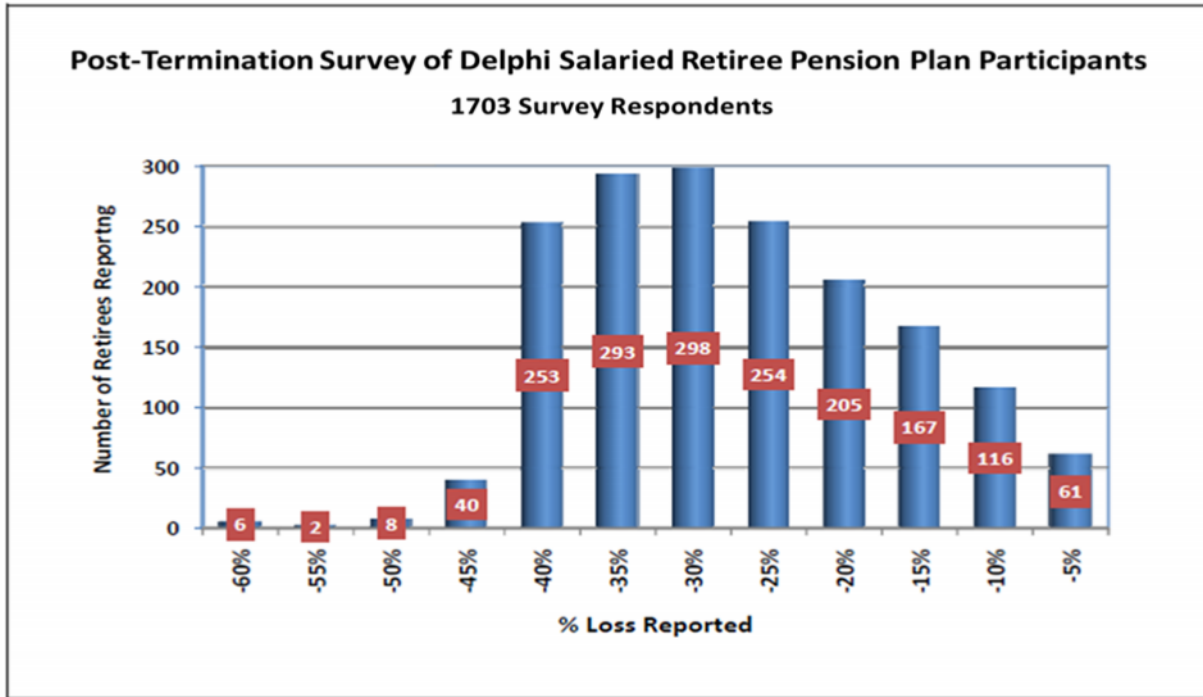
At Delphi Corporation, a now-bankrupt auto parts supplier spun-off by General Motors, the PBGC's controversial decision to terminate the pension plan for the company's salaried workers left a large portion of the participants with a permanent loss of between 20% and 40% of their vested benefits (with some losing more than 40%).⁸

A survey of Delphi plan participants with 1,700 respondents reported the following reductions in vested benefits paid by the PBGC:⁹

Those who lost	0 - 15%	=	344	=	20%	of 1,703 respondents
Those who lost	20 - 40%	=	1293	=	77%	of 1,703 respondents
Those who lost	40% or more	=	56	=	3%	of 1,703 respondents

⁸ Although the PBGC took over all of Delphi's failed plans, Delphi's former parent, General Motors, then under the control of its majority owner, the U.S. Department of the Treasury, decided to make good on an agreement with the United Auto Workers to ensure the benefits of hourly workers in the collectively-bargained plan. Congress is actively investigating possible corruption within the Treasury Department related to the decision to protect only the pensions union plan participants, while excluding the non-union (salaried) pension plans. See also Laura Cohn, "The Latest Blow: Smaller Payouts for New Retirees," *Washington Post*, May 16, 2010 (available <http://www.washingtonpost.com/wp-dyn/content/article/2010/05/15/AR2010051500043.html>).

⁹ Delphi Salaried Retirees' Association, 2010 Survey of 6,700 participants in the Delphi Retirement Program for Salaried Employees. Significantly, 73% of the 1,703 respondents were under the age of 65 at the time of plan termination, with 44% between age 60 and 64. The PBGC's maximum benefit guarantee – \$57,480 in 2013 for a retiree who is age 65 at plan termination – is reduced substantially for each year under age 65 at the time of termination. The PBGC notes that the survey took place prior to the agency's calculation of final benefit amounts, which was substantially delayed.



There are three principal limitations on PBGC’s guarantee of vested benefits, plus a fourth that effectively eliminates the recovery of vested but non-guaranteed benefits for very recent retirees:

- (1) ***The Maximum Insurance Guarantee*** limits the maximum guaranteed benefit based on each individual’s age on the date of plan termination, with a reduced guarantee for ages below 65 (for example, the current maximum at age 65 is \$57,480 annually, but \$35,100 is the maximum for an individual who is age 60 on the termination date);¹⁰
- (2) ***The Five-Year Benefit Increase Limitation*** phases in the guarantee of benefit increases that are adopted or become effective within five years of plan termination or sponsor bankruptcy (whichever is earlier); and
- (3) ***The Accrued at Normal Limitation*** reduces the guarantee of temporary early retirement supplements to the extent that the total benefit would exceed the amount payable at normal retirement age.

Any earned benefits that fall within these limitations become non-guaranteed. Non-guaranteed benefits cannot be paid from PBGC assets, but can be paid in whole, in part, or not at all, depending on the amount of assets recovered from the plan sponsor and where the benefit fits within the PBGC’s prioritization category system described just below.

¹⁰ The PBGC’s “Maximum Monthly Guarantee Tables,” showing the maximum guaranteed benefit based on a plan participant’s age on the date of plan termination, are available at <http://www.pbgc.gov/wr/benefits/guaranteed-benefits/maximum-guarantee.html#2010>. For participants not yet receiving benefits when the plan is terminated, the maximum guarantee is based on the participant’s age at the time he or she begins receiving benefits from PBGC, using the guarantee table corresponding to the year the plan terminated (or firm filed for bankruptcy, if earlier).

In addition to these three limits on benefit guarantees, if a plan participant has not been retired or eligible to retire for at least three years prior to the plan termination date, then the non-guaranteed portion of their vested benefit is relegated to a low payment priority (Priority Category 5). Because all or most plan assets are allocated to offset the cost of benefits in higher priority categories (PC-1 to PC-4), the non-guaranteed benefits of these very recent retirees are typically not covered at all. As discussed in more detail below, the all-or-nothing effect of this three-year look-back limitation can be particularly harsh and inequitable when comparing individuals who may have retired just months apart, yet one could lose a third or more of their vested benefits because he or she became eligible to retire just less than three years prior to plan termination.

While the majority of retirees are not impacted by the three guarantee limits bulleted above, a study by the PBGC shows that *the proportion of participants negatively impacted has tripled over the past decade – and that the share of vested benefits permanently lost has risen substantially to 28% on average per participant*. The PBGC’s 2008 study, based on all plans terminated in 2006, compares the results to the agency’s 1999 study:

- 16% of participants had benefits reduced by one or more of the limitation provisions in the current study compared to less than 6% in the 1999 study;
- benefits were reduced by 28% for those affected, compared with an average reduction of only 16% in the earlier study; and
- more than 80% of the plans in this study and more than 75% in the 1999 study had at least one participant whose benefits were reduced by one or more of the limitation provisions.¹¹

How PBGC Prioritizes the Allocation of Plan Assets to Pay Non-Guaranteed Benefits

While the guarantee limits described above reduce the share of vested benefits that the PBGC is obligated to pay, if necessary, from the agency’s own assets, some portion of non-guaranteed benefits are paid depending on the total amount of plan assets recovered and how an individual’s non-guaranteed benefits are prioritized under ERISA’s Priority Category system. Pursuant to ERISA Section 4044, plan assets available to pay for benefits are allocated to participant benefits according to six priority categories, summarized in the Table below. Assets are allocated to each priority category in succession, beginning with Priority Category 1 (PC-1). If the plan has sufficient assets to pay all the benefits in a priority category, the remaining assets are allocated to the next lower Priority Category. This process is repeated until all benefits in PC-1 through PC-6 have been covered (which virtually never happens), or until all plan assets have been allocated.

According to the PBGC, plan assets are typically sufficient only to cover all (or a portion) of the non-guaranteed benefits in Priority Category 3. In practice this means that although the *guaranteed* benefits in PC-4 will be paid, **non-guaranteed benefits that fall down into PC-5 are typically not paid and become a permanent loss to plan participants**. These lost PC-5 benefits are characterized mostly by the benefit limitations described in Section III of this paper, *viz.*, the five-year phase-in limit on certain benefit increases and the three-year eligibility limit on recent retirees.

¹¹ “PBGC’s Guarantee Limits: An Update,” Pension Benefit Guarantee Corporation, September 2008, available at <http://www.pbgc.gov/docs/guaranteelimits.pdf>.

Priority Categories for Allocating Plan Assets to Pay Non-Guaranteed Benefits

Priority Category 1: Accrued benefits derived from voluntary employee contributions. Such benefits are “extremely rare” among private sector defined benefit plans, according to PBGC.

Priority Category 2: Accrued benefits derived from mandatory employee contributions. Such benefits are “quite uncommon” among private sector defined benefit plans, according to PBGC.

Priority Category 3: Annuity benefits that have been in pay status for at least three years before the plan’s termination date, or could have been in pay status for at least three years before the plan’s termination date had the participant chosen to retire at his or her earliest possible retirement date. However, benefits subject to the phase-in limitation (that is, benefit increases made within the last five years) are excluded. These benefits can be either guaranteed (to the extent phased-in at 20% per year prior to date of termination) or non-guaranteed. The non-guaranteed portion is placed in PC-5 and payable only if plan assets are sufficient, which is not common.

Priority Category 4: Other guaranteed benefits, including the guaranteed portion of benefits excluded from PC-3 because they were not in “pay status” at least three years prior to the plan’s termination. This includes the entire guaranteed benefit of participants not retired, or eligible to retire, at least three years prior to the plan’s termination date.

Priority Category 5: Other vested but nonguaranteed benefits that a participant is entitled to under the plan, including benefits excluded by the three-year eligibility requirement for PC-3 prioritization and by the five-year phase-in limit (which receive the very lowest priority for payment). However, benefits resulting solely due to termination of the plan—which are deemed “forfeitable”—are excluded.

Priority Category 6: All other benefits under the plan, including those contingent on future service. Category includes non-vested benefits and “grow-in” benefits, which are benefits provided in some situations where the company continues to operate after plan termination.

Source: NRLN from PBGC documents and GAO analysis.

It is also important to consider PBGC’s institutional bias as an insurer of last resort. The insurance premium the PBGC is allowed to charge (by statute) does not reflect the actual economic cost of the underlying risk the agency is insuring. And although, as explained below, the PBGC exaggerates its projected actuarial deficit by at least 20% to 30%,¹² even a more reasonable estimate of its future benefit obligations would project a long-term deficit. The agency is therefore under constant pressure to reduce costs. Because the PBGC is liable for the payment of all *guaranteed* benefits in PC-3 and PC-4, it has a tremendous incentive to use its discretion to minimize the cost of non-guaranteed benefits that are placed in Priority Category 3. The reason is that while recovered plan assets typically offset all or most of the guaranteed and non-guaranteed paid in PC-3, plan assets are typically not sufficient to offset the cost of the *guaranteed* benefits in PC-4. If plan assets are exhausted, then the PBGC must use its own assets (from insurance premiums and investment returns) to cover those benefits.

¹² Industry groups representing plan sponsors argue that the \$34 billion long-term actuarial deficit reported by the PBGC at the end of fiscal 2012 is almost entirely attributable to a combination of “current historically low interest rates” and to “PBGC using an interest [discount] rate that is materially lower than the rates employer-sponsored plans are required to use by the Financial Accountability Standards Board (FASB) and pursuant to the Pension Protection Act of 2006.” American Benefits Council, “Ten Reasons to Doubt PBGC’s Reported Deficit” (Nov. 13, 2012).

II. PBGC INTEREST RATE ASSUMPTIONS UNDERMINE RETIREMENT SECURITY

While ERISA imposes limitations on the benefits guaranteed by PBGC, the largest loss of earned benefits suffered by most retirees after a plan termination is caused by the PBGC's decision to estimate the future cost of benefits using an unrealistically low interest rate assumption. Like ongoing pension plans, the PBGC calculates the present value of plan liabilities using a discount rate (interest rate assumption) that converts future expected payments (based on mortality assumptions) into today's dollars. The lower the interest rate, the greater the estimated present value of future benefit obligations. But while other qualified plans are required, pursuant to the Pension Protection Act of 2006, to calculate their funded status based on the AA corporate bond yield curve prescribed by the Treasury Department,¹³ the PBGC uses a much lower discount rate (currently about 3%) that is derived from the prices charged by private insurance companies for fixed and deferred annuities.¹⁴

In other words, PBGC chooses to use a different – and far more conservative – interest rate assumption in valuing benefit obligations than a plan sponsor is required to use under ERISA's minimum funding rules.¹⁵ A plan reporting a 75% funding level in its Form 5500 filing may upon termination be deemed by the PBGC to be only 55% funded on a "termination basis." As a result, a much smaller portion of the plan's assets will be available to pay non-guaranteed benefits under Priority Categories 3 or 5. This makes it far more likely that plan participants will permanently lose reductions under the three-year and five-year discount provisions described above, and also lose a larger share of any other vested but non-guaranteed benefits (such as supplemental early retirement benefits, or benefits exceeding the PBGC maximum guarantee).

In addition to greatly reducing the vested benefits that PBGC actually protects, there is also a problem of disclosure and basic fairness. Retirees and plan participants receive from the plan sponsor each year an Annual Funding Notice that discloses a pension funding level based on a PBO (projected benefit obligation) calculated using ERISA-mandated assumptions that are wildly different than the assumptions PBGC uses to calculate "termination liability." ***The government is confusing and misleading 44 million insured plan participants*** by requiring companies to send them year after year an Annual Funding Notice that discloses a funding level and projected benefit obligation that are substantially rosier than what the PBGC later calculates as "termination liability."

¹³ As noted above, at least temporarily plan sponsors have the option under the funding relief enacted in 2012 as part of the MAP-21 Act to use an even higher discount rate based on averaging interest rates over prior years when they were substantially higher, thereby reducing current required contributions. See Note 4, *supra*.

¹⁴ The PBGC interest rate as of September 2012 was 2.95% (the "select" rate used to value benefits expected to be paid within 20 years) and 3.66% (the "ultimate" rate used to value benefit for years thereafter). The PBGC's Monthly Interest Rate Statements are posted on the PBGC's website at <http://www.pbgc.gov/prac/interest/monthly.html>.

¹⁵ See ERISA Section 303(h)(2); Internal Revenue Code Section 430(h)(2). The Pension Protection Act defines the interest rate for determining "the present value of the plan's accrued or earned benefits" and, based on this, the plan's Adjusted Funding Target Attainment Percentage (AFTAP) – or funding status – which is also disclosed to plan participants on the Annual Funding Notice. The PPA amendments to ERISA section 101(f) apply to plan years beginning after December 31, 2007, with special rules for disclosing "funding target attainment percentage" or "funded percentage" with respect to any plan year beginning before January 1, 2008. See U.S. Dept. of Labor, EBSA Field Assistance Bulletin No. 2009-01, Memorandum from Robert J. Doyle, Director of Regulations and Interpretations (Feb. 10, 2009).

Harmful Impacts of the PBGC's Low Discount Rate Assumption

Promises to Keep, a 2005 study commissioned by the American Benefits Council, an industry association, noted how the PBGC's low discount rate assumption has a variety of adverse impacts:¹⁶

- When PBGC takes over a terminated plan, the vested benefits of many retirees and older workers are reduced unnecessarily. By overstating the “present value” of guaranteed and non-guaranteed benefit obligations, plan assets cover far less of the cost of vested but non-guaranteed benefits, such as benefits subject to PBGC's various limits and discounts.
- The PBGC's stated deficit is greatly exaggerated compared to the agency's likely actual cost to meet benefit obligations, encouraging critics of the defined-benefit pension system. For example, ABC calculated that using the high-grade corporate bond yield curve used by plan sponsors to calculate minimum funding requirements under ERISA would have reduced PBGC's reported deficit for 2004 from \$23.3 billion to between \$14 and \$18 billion.¹⁷
- Healthy plans are made to look far more financially precarious than they are in reality, adversely affecting the credit rating of the plan sponsor and making insolvency more likely. For example, the PBGC prematurely terminated the Delphi Salaried Retirees plan, claiming it was 55% funded on a termination basis, when in fact company actuaries reported it was 85.6% funded using ERISA-mandated assumptions.¹⁸
- Triggering extraordinary contribution requirements and variable rate PBGC premiums, which make cash-strapped firms more likely to enter bankruptcy and terminate their pension plans.¹⁹

These negative policy implications have generated widespread support among both industry and retiree income security advocates for moving to a consistent interest rate for valuing pension obligations by both plan sponsors and the PBGC – at least for the purpose of allocating plan assets across the benefit protection Priority Categories.

In a November 2012 issue brief (“Ten Reasons to Doubt PBGC's Reported Deficit”) the American Benefits Council stated:

Almost 80% of the Pension Benefit Guaranty Corporation (PBGC) self-reported deficit is directly attributable to the current historically low interest rates. . . . Much, if not all, of the remaining 20% of the deficit results from PBGC using an [insurance industry] interest rate that is materially lower than the rates employer-sponsored plans are required to use by the Financial Accounting Standards Board (FASB) and pursuant to the Pension Protection Act of 2006. **There is no logic for the government to use one rate, and to require private employers to use another.**²⁰

¹⁶ “Promises to Keep: The True Nature of the Risks to the Defined Benefit Pension System,” Optimal Benefit Strategies, LLC, a report prepared for the American Benefits Council, September, 2005. Available at: <http://www.americanbenefitscouncil.org/documents/pbgcdraft092205.pdf>

¹⁷ *Ibid* at pp. 4-5.

¹⁸ Declaration of Jim Degrandis, filed in *Dennis Black, et al. vs. PBGC*, U.S. District Court for the Eastern District of Michigan (May 24, 2010).

¹⁹ “Promises to Keep,” *supra* note 13, at p. 9.

²⁰ American Benefits Council, “Ten Reasons to Doubt PBGC's Reported Deficit,” November 13, 2012.

The NRLN has discovered firsthand that it is unfair and misleading the federal government to maintain contradictory discount rates to measure the same set of pension benefit obligations. Under the Pension Protection Act, companies are required to calculate and disclose to workers and retirees the funded status of their pension plans based on the AA corporate bond yield curve prescribed by the Treasury Department.²¹ This ERISA measure of future benefit liabilities is provided to plan participants in the Annual Funding Notice. The plan's funding attainment percentage – based on the interest rate and actuarial assumptions specified by PPA – is what retirees and workers are told is reality. In addition, a third and different estimate of projected benefit obligations is disclosed by public company plan sponsors in their annual financial report on Form 10-K, using assumptions mandated by the Financial Accounting Standards Board.

Retirees and workers are therefore surprised and confused to learn – often only on the brink of their employer's bankruptcy – that the PBGC is using *an entirely different measure* to value the same benefit obligations – and does so in a manner designed to minimize the PBGC's cost to cover guaranteed benefits, while ensuring that many participants lose most of their non-guaranteed benefits.

The PBGC's Flawed Methodology

A July 2009 letter from PBGC Acting Director Vince Snowbarger to the National Chrysler Retirement Organization, a member of the NRLN, provided a description of the valuation process:

PBGC's value of benefits is based on the market cost of annuities (net of benefit administration expenses) that a private insurance company would charge to pay the plan's promised benefits in annuity form. . . . PBGC gathers annuity pricing data from private insurance companies through a quarterly survey, . . . by the American Council of Life Insurers. The survey asks insurers to provide the price, net of administrative expenses, on annuity contracts for terminating plans. . . . PBGC has used the same methodology for many years, ensuring that termination values are consistently determined.²²

²¹ Internal Revenue Service, "Final Regulations: Measurement of Assets and Liabilities for Pension Funding Purposes; Benefit Restrictions for Underfunded Pension Plans," 26 CFR Parts 1 and 602, Fed. Reg., Vol. 74, No. 198 (October 15, 2009), at p. 53005. The IRS final regulations summarize the statutory interest rate requirement as follows:

Section 430(h)(2) specifies the interest rates that must be used in determining a plan's target normal cost and funding target. Under section 430(h)(2)(B), present value is determined using three interest rates (segment rates) for the applicable month, each of which applies to benefit payments expected to be paid during a certain period. . . .

Section 430(h)(2)(C) defines each segment rate as a single interest rate determined for a month by the Treasury Department on the basis of the corporate bond yield curve for the month. Under section 430(h)(2)(D), the corporate bond yield curve for a month is to be prescribed by the Treasury Department and is to reflect the average, for the 24-month period ending with the preceding month, of yields on investment grade corporate bonds with varying maturities that are in the top three quality levels available. Section 430(h)(2)(D)(ii) provides an alternative to the use of the three segment rates, under which the corporate bond yield curve (determined without regard to the 24 month average) is substituted for the segment rates.

More recently, on July 6, 2012, President Obama signed into law temporary pension funding relief that gives plan sponsors the flexibility to use an even higher discount rate, reducing the level of current required contributions. Moving Ahead for Progress in the 21st Century (MAP-21), Public Law 112-141 (enacted July 6, 2012), available at <http://www.govtrack.us/congress/bills/112/s1813/text>.

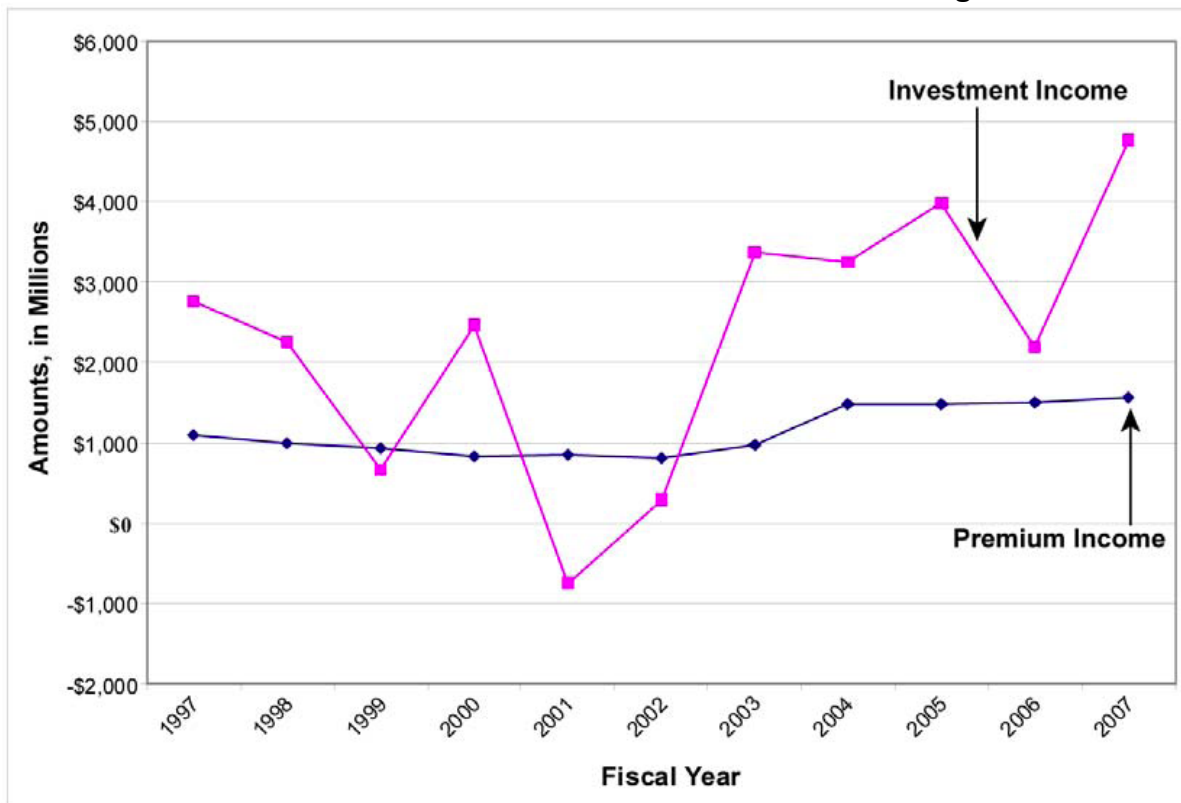
²² PBGC, Letter from Vincent K. Snowbarger, Acting Director, to Chuck Austin, President, National Chrysler Retirement Organization, July 13, 2009. See also PBGC, "Understanding the Financial Condition of the Pension Insurance Program, at pp. 4-5 (available at <http://pbgc.gov/media/key-resources-for-the-press/content/page15247.html>).

However, although Snowbarger states that the survey of insurers by ACLI creates a “market-based measurement,” the agency concedes that “[t]hese derived interest factors are not market interest rates.”²³ In Final Rules adopting an updated (and more conservative) set of mortality assumptions (the GAM-94 Tables), the agency explained that it used its discretion to adopt not a market interest rate, but a proxy for what a for-profit insurance company expects to charge for *profitable* annuity contract sales after subtracting many costs that the PBGC doesn’t have (including marketing, advertising and income taxes):

These derived interest factors [from the ACLI survey of private insurers] are not market interest rates. The *factors stand in for all the many components used in annuity pricing* that are not reflected in the given mortality table – *e.g., assumed yield on investment, margins for profit and contingencies, premium and income taxes, and marketing and sales expenses.*²⁴

As a result, the PBGC’s discount rate is driven by the pricing trends among commercial life insurance companies (or at least among the unknown subset that complete the ACLI’s survey), rather than a more stable, consistent and transparent interest rate like the AA corporate bond yield curve provided

PBGC Income from Premiums and Investment Earnings: 1997-2007



Source: PBGC annual reports, 1997-2007, compiled by Congressional Research Service.

²³ Pension Benefit Guarantee Corporation, Final Rule, “Valation of Benefits; Mortality Assumptions,” 29 CFR Part 4044, Fed. Reg. Vol. 70, No. 231 (Dec. 2, 2005), at p. 72205.

²⁴ *Ibid.*

by the Treasury Department for the calculation of pension funding status under PPA. For example, for fiscal 2009 the PBGC used a 25-year select interest factor of 5.17% -- a huge divergence from the 6.66% select interest factor it used the previous year (fiscal 2008).²⁵ Thanks to historically-low interest rates, the PBGC's single-employer plan deficit projection swelled to \$29.1 billion by fiscal year-end 2012, an estimate rejected by leading business associations and retiree advocates as doubly misleading.²⁶

Lost in all these details about interest rate factors is the additional fact that the PBGC itself never actually purchases private annuity contracts to cover the benefit obligations of the plans it takes over and trustees. The agency continues to invest a terminated plan's assets, just as a pension plan would (albeit with a more cautious asset allocation in recent years), and it pays participants' benefits from an aggregated pool of plan assets and the market-rate investment return they earn year after year. For example, PBGC's most recent annual report reveals that in fiscal year 2012, the agency paid out a total of \$5.38 billion in benefits, while earning \$8.79 billion in investment income and \$2.64 billion in insurance premiums.²⁷ Unstated in PBGC's pessimistic press releases about a projected deficits is the fact ***the agency actually earned a 12.6% rate of return on its pension investment portfolio*** in 2012 – while continuing to use a discount rate for allocating recovered plan assets to benefits that assumes returns of less than 3% in perpetuity.²⁸

As the graph just above illustrates, investment income from the plans it takes over is increasingly and by far the PBGC's largest source of income. For the five-year period ending September 30, 2009, PBGC's return on total invested funds was 5.2% *despite* the stock market collapse during the first half of that fiscal year and *despite* the Obama administration's decision to freeze the agency's equity (stock) holdings at a comparatively low 30% allocation.²⁹ And, as noted above, in fiscal year 2012 the PBGC had \$8.79 billion in pension investment income, a 12.6% rate of return.

²⁵ PBGC 2009 Annual Management Report, Management Discussion and Analysis, Note 6, pp. 68-69. In contrast, the PBGC "select" interest factor (discount rate) in September 2012 had fallen to 2.95%. See PBGC, "Monthly Interest Rate Factors," available at <http://www.pbgc.gov/prac/interest/monthly.html>.

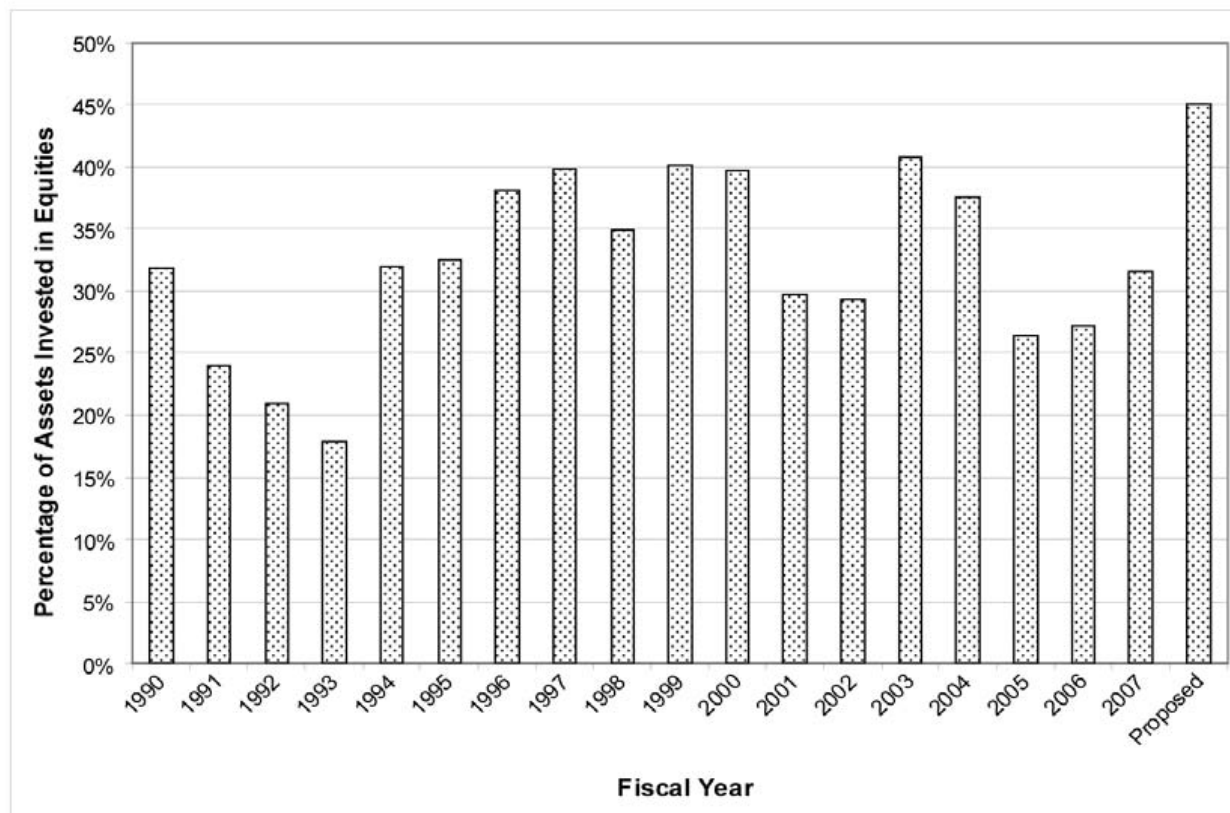
²⁶ See, e.g., American Benefits Council, "Ten Reasons to Doubt PBGC's Reported Deficit," Fact Sheet, Nov. 13, 2012, available at http://www.americanbenefitscouncil.org/documents2012/pbgc-deficit_10reasons111312.pdf; U.S. Chamber of Commerce and ERISA Industry Committee, "PBGC Deficit: A Non-Event on the Horizon," Nov. 11, 2011. On a cash flow basis, in 2012 the agency earned \$11.43 billion with expenses of \$5.43 billion, creating a positive cash flow of over \$6 billion. PBGC turned this positive cash flow into a reported operating loss by taking a charge of \$10.72 billion based on a reduction in their assumed rate of investment return from 4.31% to 3.28%.

²⁷ See *2012 PBGC Annual Report*, *Supra* Note 1, Financial Summary, at page 22.

²⁸ *Ibid.* PBGC had a positive cash flow of \$6 billion in 2012, but reported an operating loss due to a \$10.72 billion charge due to lower market interest rates (which inflates the present value of future benefit obligations) and by reducing their assumed rate of investment return from 4.31% to 3.28%. The *Annual Report* stated: "The primary factors in the single-employer program's net loss included a charge of \$10.72 billion due to a substantial reduction in interest factors, . . .

²⁹ The PBGC's allocation to equities has varied between a low of 18% to more than 40% since 1990, with shifting investment philosophies depending on the Administration in power. See Congressional Research Service, "Pension Benefit Guaranty Corporation Investment Policy: Issues for Congress," September 2008, at pp. 11-15 (WikiLeaks Document Release available at <http://crs.wikileaks-press.org/RL34656.pdf>).

Percentage of PBGC Assets Invested in Equities, 1990-2007



Source: Congressional Research Service from PBGC Annual Reports for 1990-2007.

Because a plan sponsor would need to purchase annuity contracts to carry out a voluntary (standard) termination, the PBGC argues that this ultra-conservative discount rate assumption is justified as an appropriate point-in-time measure of the *plan sponsor's* liability. PBGC staff emphasizes the concern that using a more generous discount rate for allocating assets to cover non-guaranteed benefits could undermine their ability to recover assets from firms in bankruptcy. However, most bankruptcy courts have ruled that the PBGC's methodology is not the best measure of its ultimate liability. Federal courts of appeal are split concerning whether this private annuity discount rate is appropriate even in the context of measuring a claim against a plan sponsor in bankruptcy. The prevailing precedent among federal Circuit Courts of Appeal is that since the PBGC retains and invests plan assets – and does not purchase annuity contracts to meet its obligations – a “prudent investor” rate of return – and not the PBGC discount rate – is the most appropriate rate for measuring pension liabilities.³⁰

³⁰ The Sixth and Tenth U.S. Circuit Courts of Appeals adopted the “prudent investor rate” as the appropriate rate for discounting pension liabilities, an approach followed by a number of bankruptcy courts. The notable exception is the *In re U.S. AirwaysGroup* decision by the U.S. Bankruptcy Court in the Eastern District of Virginia (December 29, 2003). That court held that under the Supreme Court's decision in *Raleigh v. Illinois Dept of Revenue* (2000), the validity and amount of a liability in bankruptcy must initially be determined by the underlying substantive law or regulation – not by the discretion of the bankruptcy court – and that the PBGC's method not only complies with ERISA, but is reasonable from an economic standpoint as well.

Yet even if a discount rate derived from insurance industry annuity contracts is most appropriate to value the termination liability *of a plan sponsor* in bankruptcy proceedings, there are important policy reasons why this unrealistically-low discount rate should not be used to reduce the allocation of plan assets to protect earned but non-guaranteed benefits of older workers and retirees.

The PBGC's Statutory Discretion

Although ERISA is notably specific about the benefit guarantee limitations and the six Priority Categories that govern the pecking order for the allocation of plan assets, it is silent on the question of how PBGC should value future benefit obligations. ERISA implicitly gives the agency unfettered discretion to determine the discount rate that in practice determines if plan assets will be sufficient to cover a larger or smaller share of vested but non-guaranteed benefit claims. Unfortunately, since the PBGC's focus has been on maximizing its recovery from bankrupt plan sponsors, the inadvertent victims of the agency's decision to inflate the estimated future cost of termination liability are the plan participants who lose more benefits than they reasonably should.

ERISA directs the PBGC to measure the plan sponsor's benefit liability and the market value of plan assets at a single point in time – which under PPA is the earlier of the termination date or bankruptcy. In calculating the “recovery ratio,” ERISA gives wide discretion to PBGC to (a) determine the market value of the assets as of the termination date; and (b) to determine the “amount of unfunded benefit liabilities.” PBGC calculates this benefit obligation in present value terms based on published mortality tables, an estimate of average expected retirement age, and (at its discretion) the discount rate used by private insurers to price group annuity contracts. PBGC then allocates the current market value of the assets based on that calculation. ERISA Section 4062(b) specifies that the plan sponsor's liability to the PBGC shall be the “amount of ***unfunded benefit liabilities*** . . . calculated . . . in accordance with regulations ***prescribed by the corporation.***”

In addition, ERISA Sec 4001(a)(18) defines the “amount of unfunded benefit liabilities” as

- (A) the value of the benefit liabilities under the plan (determined . . . on the basis of assumptions prescribed by the corporation for purposes of section 4044), over
- (B) the current value . . . of the assets of the plan.

The statute does not specify any accounting assumptions – such as the discount rate or mortality assumptions – that the PBGC uses to calculate the present value of the benefit obligations by priority category. Instead it clearly gives PBGC fairly wide discretion to determine the value of assets and benefit liabilities “as of the termination date.” Section 4044(f)(4) further states:

Determinations under this subsection shall be made by the corporation. Such determinations shall be binding unless shown by clear and convincing evidence to be unreasonable.

Accordingly, PBGC regulations based on Section 4044 specify mortality and interest rate tables (appendix A and B to reg §4044.41), which govern the “valuation of benefits” for plans trusted by the agency.

Thus, although ERISA gives the agency wide discretion to adopt a reasonable methodology for valuing the present value of future benefit liabilities, the NRLN believes that the use of an ultra-low

discount rate for the purpose of allocating plan assets to cover the vested but non-guaranteed benefits of individual workers and retirees should be discarded. Whether or not the PBGC continues to use a set of commercial insurance industry pricing factors to estimate the liability of plan sponsors, we believe that for purposes of allocating plan assets to cover benefits, the PBGC should use the same corporate bond yield curve and other funding assumptions that the PPA requires of other qualified pension plans.

III. THE NEED TO REFORM PBGC’S BENEFIT PROTECTION LIMITS

A. Misapplication of the Five-Year Phase-In of Plan Benefit Increases

As noted above, under ERISA the PBGC does not guarantee the full payment of benefit increases “resulting from a plan amendment” adopted within five years prior to plan termination.³¹ Any benefit increase adopted by a plan within five years of a plan termination is phased in (at the rate of 20% per year); and any increase within the 12 months prior to termination is not guaranteed at all. The remaining, non-guaranteed portion of the benefit increase is placed in Priority Category 5, which typically means it will not be paid at all, since in most major distress terminations the plan assets recovered by PBGC are exhausted after paying Category 3 and/or 4 benefits. The presumed purpose of Section 4022(b)(1) is to preempt the moral hazard of corporate officers or owners adopting large benefit increases with the knowledge that the company is likely to declare bankruptcy and turn its obligations over to the PBGC.

In recent years a debate has arisen around whether this five-year phase-in limit should apply to benefit increases that result not from a plan amendment, but from statutory inflation adjustments in the rules governing the overall limits on qualified plan benefits. Although neither ERISA nor any PBGC regulation specifically addresses it, for the purpose of allocating plan assets to cover non-guaranteed benefits the PBGC treats the annual inflation-adjustment of the overall benefit limits in IRS Sections 401(a)(17) and 415(b) *as if* they are an increase in benefits “resulting from a plan amendment” under Section 4022(b)(1) – and therefore subject to the five-year phase-in discount.

This PBGC’s decision to ignore the plain language and purpose of ERISA Section 4011(b)(1) – viz., the limitation applies only to “any increase ... resulting from a plan amendment” – has had devastating consequences for certain workers whose salaries in the years just prior to retirement are bumping up against the Section 401(a) limit. The PBGC’s interpretation of the five-year phase-in limit has substantially reduced the benefit recoveries of pilots and others in the airline industry in the wake of the bankruptcies that followed the tragedy of September 11, 2001. For example, when the pilot’s defined-benefit plan at Delta Air Lines was terminated in 2006, the annual 401(a) limit on the earnings that could be used to calculate a qualified pension payout was \$220,000. That limit is statutory and increases automatically based on inflation in order to prevent it from declining in real terms (that is, in terms of purchasing power). Although the current Section 401(a) limit was \$220,000 in 2006, when the plan terminated and many pilots were forced to retire, the PBGC calculated their protected benefit using the statutory limit from 2001 (\$170,000), which by itself resulted in permanent losses of up to \$30,000 annually for many individuals.

³¹ 29 U.S.C. 1322, ERISA §4022(b)(1).

Because Section 4022(b)(1) of ERISA specifies that the five-year phase-in applies to “any increase in the amount of benefits under a plan *resulting from a plan amendment*,” the NRLN believes this limitation should not apply where the benefit increase occurs automatically due to a statutory inflation adjustment, particularly in cases where there has been no change in the terms of the plan. The statutory inflation adjustment of the maximum earnings that can be used to calculate a qualified pension benefit is conceptually indistinguishable from an increase in an individual’s salary during the five years prior to plan termination, which is explicitly excluded from the five-year phase-in limit.³²

While the PBGC or its primary overseer, the Department of Labor, could revisit its expansive interpretation of the five-year phase-in rule, a statutory fix may be needed due to the PBGC’s inherent self-interest in reducing its obligations at the expense of its mission to protect the reasonable reliance interest of retirees on defined-benefit pension promises. By reducing the non-guaranteed benefits that are prioritized for payment from recovered plan assets under Priority Category 3, those plan assets are then available to help the PBGC offset its (inflated and unrealistic) estimate of the cost of guaranteed benefits payable under Priority Category 4. Since PC-4 guarantees are paid from PBGC funds if the terminated plan’s assets have been exhausted paying out PC-3 obligations, the PBGC has a self-interest in pushing as many vested benefit obligations as possible below PC-4 (and into PC-5), where they are rarely paid and if they are paid it will be exclusively from plan assets (and not from PBGC premiums or investment earnings).

Section 401(a) and 415(b) Limits Adjust Automatically With Inflation

It’s important to understand why a pension benefit increase attributable solely to a statutory adjustment to the qualified plan benefit limits is the equivalent of an increase in salary – and not remotely the sort of benefit increase anticipated under ERISA Section 4022(b).

Under Sec. 401(a)(17), the maximum annual compensation that currently can be considered in calculating a pension benefit is \$250,000. Tax-qualified pension plans also cannot pay benefits in excess of the limits established under Internal Revenue Code Sec. 415(b)(1)(A). The maximum annual benefit payable under a qualified DB plan in 2012 is \$200,000.³³

In practice, this means that a plan with a formula that pays retirees 2% per year of service (which would be unusually generous), would hit this limit only with respect to individuals who have 40 years of service and average final earnings of \$250,000 or higher. More commonly, as was the case for many Delta pilots, after 30 years service – and at the then-mandatory retirement age of 60 – an individual could qualify for a maximum pension of \$132,000 (in 2006). While generous, these qualified benefits pale in comparison to executive pension benefits. Companies that want to pay pension benefits in excess of these limits must establish a separate, non-qualified plan, such as a defined-benefit SERP or a defined-contribution SRIP.

Section 401(a) and 415(b) limits are automatically adjusted annually for inflation by the IRS under a statutory formula (announced early each year). Since certain highly-compensated employees, such as pilots, could have a final average wage that adjusted due to the operation of these statutory limits

³² See PBGC regulation §2022.2, which is discussed further just below.

³³ Internal Revenue Service, “IRS Announces Pension Plan Limitations for 2012,” IR-2011-103 (Oct. 20, 2011), available at <http://www.irs.gov/uac/IRS-Announces-Pension-Plan-Limitations-for-2012>.

during the five years prior to plan termination, treating the annual inflation adjustment of this limit as if it is an amendment increasing plan benefits causes a reduction in guaranteed benefits.

ERISA's Five-Year Phase-In Is Limited to Increases from "Plan Amendments"

ERISA Section 4022(b) describes the "basic benefits" that are prioritized up to the guarantee limit. It discounts benefit increases adopted or effective less than five years prior to the termination date. However, it explicitly applies only to benefit increases "resulting from a plan amendment." Sec. 4022(b) states:

Article 4022(b)(1) – Except to the extent provided in paragraph (7) –

(A) . . .

(B) any increase in the amount of benefits under a plan ***resulting from a plan amendment*** which was made, or became effective, whichever is later, within 60 months before the date in which the plan terminates shall be disregarded.

. . .

(7) Benefits described in par. (1) are guaranteed only to the extent of the greater of –

(A) 20% of the amount which . . . would be guaranteed under this section, or

(B) \$20 per month

Multiplied by the number of years (but not more than 5) the plan or amendment has been in effect.

PBGC's own regulations on this point are ambiguous. On the one hand, PBGC §4022.2 defines a "benefit increase" as "arising from the adoption of a new plan or an increase in the value of benefits payable ***arising from an amendment*** to an existing plan." But then, in the following sentence, the PBGC states that "[s]uch increases include, but are not limited to, a scheduled increase in benefits under a plan or plan amendment, such as a cost-of-living increase"

Although automatic COLAs are partially (but not fully) reduced by the five-year phase-in rule (see discussion just below), the annual adjustment in the Section 415 maximum benefit amount seems far more akin to the benefit increases attributable each year to an increase in salary, or in years of eligible service, which are both explicitly excluded from the five-year phase-in reduction. Indeed, the Section 401(a) inflation adjustment is conceptually indistinguishable from an increase in the salary base in the formula used to calculate the final annuity benefit. PBGC's own regulations make this commonsense distinction between a benefit increase attributable to a plan amendment and an increase due to an increase in the wage base used to calculate the benefit. PBGC §4022.2 states:

In the case of a plan under which the amount of benefits depends on the participant's salary, and the participant receives ***a salary increase***, the resulting increase in benefits to which the participant becomes entitled ***will not***, for the purpose of this part, ***be treated as a benefit increase***. Similarly, . . . [when] the participant becomes entitled to increased benefits solely because of ***advancement in age or service***, the increased benefits . . . ***will not***, for the purpose of this part, ***be treated as a benefit increase***.³⁴

Moreover, the policy purpose of the five-year phase-in is not served by treating an upward adjustment in the Section 401(a) limit as if it was a plan amendment increasing benefits. Like annual

³⁴ PBGC §4022.2 (emphasis added).

increases in salary or eligible years of service, the statutory inflation adjustment under Sections 401(a) and 415(b) do not create a “moral hazard” whereby a plan sponsor increases liabilities (and taxpayer exposure) knowing that the plan might be headed toward a distress termination and PBGC bailout.

Presumably most plans simply calculate the monthly benefit under an annuity formula (viz., years of service multiplied by a percent of average final five-year wages), but reduce actual payment (if necessary) to the Section 415 limit. Therefore, except possibly in cases where a plan has been amended within five years prior to the termination date *explicitly* to provide for a benefit increase tied to Section 401(a) inflation adjustments, it appears that PBGC’s practice violates Section 4022(b)’s requirement that the five-year phase-in apply only to benefits increases “resulting from a plan amendment.”

Treatment of “Automatic Benefit Increases” in Priority Category 3

In defense of its interpretation, PBGC staff notes that agency regulations defining Priority Category 3 benefit guarantees specifically address the question of “plan provisions” that “provide for automatic increases in the benefit formula.” The PBGC regulation defining the Priority Category 3 guarantee states:

§4044.13 – Priority Category 3 Benefits.

(a) *Definition.* . . . Benefit increases that were effective throughout the five-year period ending on the termination date, ***including automatic benefit increases*** during that period to the extent provided in paragraph (b)(5) of the section, shall be included in determining the priority 3 benefits.

. . . .

(5) *Automatic benefit increase.* If plan provisions adopted and effective on or before the first day of the five-year period ending on the termination date provide for automatic increases in the benefit formula . . . ***the lowest annuity benefit payable*** during the five-year period ending on the termination date . . . ***includes the automatic increases scheduled during the fourth and fifth years preceding termination***, subject to the restriction that benefit increases for active participants in excess of the increases for retirees shall not be taken into account.

However, this regulation clearly contemplates plan provisions, such as Cost of Living Adjustments (COLAs), granted at the discretion of the plan sponsor, and *not* inflation adjustments dictated by statute (viz., the Section 401 and 415 limits). Moreover, the PBGC’s regulation discounts these “automatic” benefit increases *less than* the five-year phase-in that applies to other plan amendments. Thus, even if a plan provision allowing for the automatic statutory adjustment in the Section 401(a) limit is properly viewed as the equivalent of a COLA, the PBGC should reduce the benefit protected under PC-3 no more than it does a COLA under §4044.13 of its regulations (as described just above). In other words, if the plan has a longstanding provision stating that the maximum payable benefit will increase each year to reflect the inflation adjustment of the Section 415 limit, then at a minimum the PBGC should include within PC-3 the benefit increase given during the fourth and fifth year prior to the termination date (and phase-in only increases within three or fewer years prior to termination).

OBRA 1993 Reductions in Qualified Plan Limits

The punitive results of applying the five-year look-back reduction to statutory increases in the 401(a) limit have been magnified by the Omnibus Budget Reconciliation Act of 1993 (OBRA '93), which raised tax revenues by lowering the limits on benefits payable by qualified pension plans (and thus the corporate income tax deductions plan sponsors take for making plan contributions). In 1992, the maximum qualified pension earnings limit was \$235,840. OBRA '93 *temporarily* reduced the limit to \$150,000 in 1993, but with a phase-in process designed to eventually restore the limits. As the table just below illustrates, Congress scheduled the OBRA '93 limits to adjust automatically each year. By using the OBRA '93 limit in effect *five years prior* to a plan termination to determine a retiree's PC-3 benefit, the PBGC magnifies the impact of OBRA '93 on retirees by imposing a **permanent reduction** on benefits that is stripped of the most recent five years of upward adjustments legislated by OBRA '93.

Impact of the OBRA 1993 reductions to Section 401(a) qualified pension limits:
(Data between years 1993 and 1999 is omitted, but is consistent with other data)

Year	2010	2008	2006	2004	2002	2001	1999	1993
Unreduced 401(a)17 limits	360,000	345,000	325,000	305,000	295,000	285,000	270,000	235,840
OBRA 93 reduced limits	245,000	230,000	220,000	205,000	200,000	170,000	160,000	150,000

One irony of the PBGC's interpretation of the five-year phase-in rule in this context is that the 1993 OBRA's substantial reduction in the 401(a)(17) limit has already mitigated any real "moral hazard" that executives will seek to pass a costly, pre-bankruptcy benefit increase on to the PBGC. Indeed, the OBRA's reduction in the value of qualified plan benefits to very highly-compensated executives has been a major factor in fueling the proliferation of supplemental, *non-qualified* executive pension and saving plans (SERPs and SRIPs). Since top executives and owners no longer receive the largest portion of their own retirement benefits from the qualified plan, the original purpose of the five-year phase-in may no longer be relevant. Top executives are far less likely to amend a plan to increase *qualified* plan benefits during the years prior to bankruptcy when they can benefit far more (and at lower cost with fewer legal constraints) by increasing *non-qualified* benefits. In any event, a qualified plan that merely allows the average final earnings component of the benefit formula to adjust for inflation in line with IRC Sections 401(a) and 415(b) is not increasing the benefit in real terms (in purchasing power), but holding it constant by using an inflation adjustment determined by the Internal Revenue Code.

Two Options for a Regulatory Reform 'Fix'

The most straightforward "fix" to this problem would be for PBGC to clarify (in §4022.2 and/or §4044.13) that "automatic increases" resulting from statutory inflation adjustments, including Section 401(a) and 415(b) limits, will be treated the same as an increase in salary and *not* be treated as a "benefit increase" under §4022.2. An even larger benefit could be protected by instead amending Section 4044(a)(3), which defines limitations to Priority Category 3, to state that any statutory limitation on the value of a benefit, including Section 401(a) and 415(b) limits, should apply only based on the limit in effect as of the termination date. Thus, even though Section 4044(a)(3) prioritizes only the lowest benefit in pay status subsequent to three years prior to the termination date,

at least those calculations would be based on the highest Section 15 limit (the limit as of the termination date).

Alternatively, at a bare minimum the PBGC should clarify §4044.13(b)(5) to state that upward adjustments of the Section 401(a) and 415(b) limits are, like a COLA provision, an “automatic benefit increase” that is fully guaranteed up to three years prior to the termination date (that is, any increase during the 4th and 5th year prior to termination is not discounted). Absent any other change, this would presumably give Priority Category 3 protection to the benefit based on the Section 401(a) and 415(b) limits three years prior to termination.

B. The Harsh Three-Year Look-back Limitation Needs Reform

A second limitation that inflicts a substantial and permanent loss of benefits on many recent retirees is the statutory three-year look-back that PBGC applies to determine what benefits are eligible for payment under Priority Category 3. On the date of plan termination (or bankruptcy, whichever is earlier), if a plan participant has not been retired (in “pay status”) or eligible to retire for at least three years, then no portion of his or her benefit is eligible for PC-3 prioritization.³⁵ The guaranteed portion of the individual’s benefit will still be paid (under PC-4), but the *non-guaranteed* portion will almost always be unfunded and lost forever. As noted above, while annuity benefits in pay status are guaranteed up to the maximum insurance limit (currently \$57,480 annually for participants age 65 on the date of plan termination), non-guaranteed benefits that are not eligible for PC-3 are placed down in Priority Category 5 – and almost always are left unfunded since plan assets are typically exhausted covering PC-3 and, if feasible, PC-4 benefits.

The fairest, most incremental reform would be to protect the vested benefits of very recent retirees to the same extent as the benefits of participants who were retired, or eligible to retire, for more than three years prior to plan termination. ***Congress should amend Section 4044(a)(3) so that the benefits of all plan participants who are already retired, or eligible to retire, on the date of plan termination are protected equally.*** There may be a justification for prioritizing the non-guaranteed benefits of *retirees* (or those who could be retired) over the non-guaranteed benefits of younger workers who are not yet retirement age and arguably have more time and opportunity to replace lost benefits through additional service and saving. But there is simply no rational or equitable basis for making a distinction between individuals who have been retired two years versus three years, for example.

The PBGC maintains that there is a trade-off to eliminating the three-year look-back: Increasing the non-guaranteed benefits eligible for PC-3 prioritization in most cases will reduce the overall percentage of non-guaranteed benefits in PC-3 that under current law are recovered by other (typically older) retirees. In other words, elimination of the three-year eligibility limit would pull more liability up into PC-3 (more retirees and more liabilities) compared to current law. The total amount of plan assets available to allocate for non-guaranteed benefits would remain the same (unless, of course, the PBGC began using the more reasonable PPA interest rate assumptions to estimate the future cost of the benefit liabilities, as proposed above). Assuming that plan assets are insufficient to pay off all PC-3 benefits under current law (which is often the case), some possibly

³⁵ 29 U.S.C. 1344, ERISA Section 4044(a)(3).

larger number of participants with non-guaranteed benefits – and who have been retired more than three years – will necessarily recover a somewhat lower percentage of their non-guaranteed benefits to make up the difference. For example, if under current rules the assets will cover 90% of PC-3 benefits, elimination of the three-year discount could mean the assets cover only 85% -- and so participants retired (or eligible to retire) for more than three years who have non-guaranteed benefits will receive a lesser recovery.³⁶

This argument seems to assume that the limitation would be eliminated altogether – that is, not only for those retired less than three years prior to termination, but for *all* participants who are not even eligible to retire on the date of plan termination. However, the NRLN’s proposal is far more narrow and modest. It would only change the categorization of benefits for individuals who are retired (or eligible to retire) on the date of plan termination – but who have been in that status less than three years. Under current law *none* of their vested benefits would be placed in Priority Category 3. Under the reform advocated here, this group of recent retirees would simply be treated the same as all other retirees, no better, no worse.

Moreover, even PBGC staffers have acknowledged that the current three-year rule has a “cliff effect” that produces harsh and anomalous results. For example, if a manager with 30 years' service becomes eligible for retirement 2 years and 10 months prior to the date of plan termination (which he cannot foresee), typically due to his age – and becomes eligible for a monthly benefit well in excess of the PBGC guarantee – he will likely end up with a lower benefit than someone with considerably less service and a lower final average salary who happened to be a few months older (and thus became eligible more than three years prior to termination). More troubling, perhaps, is the fact that an employee who retired one day short of three years prior to the firm’s bankruptcy filing could lose all of his or her non-guaranteed benefits; whereas someone with the same age and service, but who qualified two days earlier, could recover all of their benefits.

At a bare minimum, Congress should eliminate this “cliff effect.” While “retired or not” on the date bankruptcy is filed (or of plan termination, if earlier) would be the most clear, fair and defensible place to draw the line on Priority Category 3 prioritization – thereby treating all participants retired or eligible to retire alike – a phase-in (or ‘phase-out’ of the limitation) could also be considered. This would be consistent with recent tax reforms that have altered eligibility thresholds from cliffs to phase-outs. For example, both the Savers Credit (which provides low-income savers with a refundable tax credit) and the Earned Income Tax Credit phase-out over an income range rather than falling off a cliff – a flawed design economists consider both distorting and unfair.

³⁶ It’s important to note that the Priority Categories are relevant only if a portion of your vested benefit is *not* guaranteed, typically for one of four reasons: (i) your total benefit exceeds PBGC’s maximum guarantee; (ii) you received a benefit increase within the past 5 years, subject to phase-in; (iii) you retired, or became eligible to retire, less than three years prior to plan termination (or bankruptcy, whichever is earlier); or (iv) you receive a supplemental early retirement benefit that would exceed your “normal” benefit if it continued past age 65 (typically these supplements are given as a bridge to Social Security eligibility at 62, then discontinued).

IV. FOREIGN OWNERSHIP: PBGC NEEDS INCREASED AUTHORITY AND TOOLS

As globalization and the acquisition of American companies by foreign investors becomes steadily more common, there is growing concern about the PBGC's ability to deter plan terminations by, or recover assets from, foreign-owned plan sponsors. Although ERISA treats a U.S.-based subsidiary and its foreign parent jointly and severally liable for pension funding liabilities, it's unlikely that a U.S. court would or could enforce a lien against the assets of a plan sponsor outside the territorial jurisdiction of the U.S. government. Actually collecting on a liability in practice requires that the foreign entities have sufficient assets within the jurisdiction of U.S. courts.

ERISA makes no distinction between U.S. and foreign-based companies with respect to a plan sponsor's funding obligations, fiduciary duty and potential liability for vested benefits. Foreign-owned plan sponsors and foreign firms that are part of a plan's "control group" are subject to precisely the same obligations and scrutiny as U.S.-based companies (including the reportable events rules and Early Warning Program monitoring described just below). The PBGC has stated that to date there has been no major problem with a foreign company successfully evading its pension obligations and shielding itself from enforcement overseas.

Nevertheless, PBGC and Treasury Department lawyers concede that although ERISA treats a foreign-based parent of a plan sponsor, and even other foreign-based subsidiaries that are part of the same "control group," as jointly and severally liable for pension funding liabilities, it is not clear whether U.S. courts could or would enforce a lien against the assets of a plan sponsor located outside U.S. territory. For example, prior to the transfer of Chrysler assets, the PBGC perfected liens against the U.S.-based assets of Daimler, a German company. This served to put pressure on Daimler to negotiate pension funding levels. However, PBGC believes it would have needed the cooperation of the German government to enforce liens against Daimler assets in Germany, for example. Thus, although ERISA and the PBGC treat domestic and foreign controlled group members the same (and as jointly and severally liable as a "single employer"), actually collecting on a liability in practice requires that the foreign entities have a U.S. presence and sufficient assets within the jurisdiction of U.S. courts.

The PBGC takes the position, correctly, that all members of a controlled group, including subsidiaries located completely outside the U.S., are treated under ERISA as jointly and severally liable for pension benefit liability.³⁷ However, according to the PBGC's General Counsel, ERISA is not explicit – and it has not been tested in a U.S. court – whether PBGC liens against *other* U.S.-based assets or subsidiaries of a foreign company, which are outside the controlled group sponsoring the pension plan, would be enforced by either a U.S. or foreign court. For example, the foreign parent of a U.S. subsidiary could have other unrelated assets or subsidiaries located within the jurisdiction of U.S. courts. With respect to reaching the overseas assets of a foreign-based company that defaults on pension funding, it's unlikely that the foreign courts would apply U.S. law unless there is a bilateral treaty in effect. While the U.S. maintains many bilateral treaties with countries with similar interests in mutual law enforcement, that is a major undertaking unlikely to occur for such a narrow purpose within the foreseeable future.

³⁷ See PBGC, Opinion 97-1 (May 5, 1997).

Because of this increased risk, **Congress needs to clarify that the PBGC has the authority to enforce a lien against all U.S.-based assets of a foreign-owned plan sponsor, even if those other subsidiaries or assets are not considered part of the controlled group sponsoring the plan.**

Foreign Ownership and the PBGC's Early Warning Program

The PBGC's Early Warning Program (EWP) monitors financially weak companies and corporate transactions that appear to pose a risk of long-run loss to the pension insurance program.³⁸ The EWP generally receives high marks for monitoring companies with significant underfunding. It currently monitors roughly 1,100 companies with more than \$50 million in underfunding. It also screens for and monitors companies with below-investment-grade bond ratings and underfunding in excess of \$5 million. In addition, the PBGC monitors notifications of a wide range of "reportable events," the most potentially significant of which (e.g., a liquidation, bankruptcy, loan default, or change in contributing plan sponsor) are required to file notification of the corporate transaction with the PBGC at least 30 days in advance of the closing date.

According to the PBGC staff managing the EWP, the agency is particularly on the lookout for material transactions (including spin-offs, LBOs, extraordinary dividends, asset divestitures) that could down the road make an already-underfunded plan much more vulnerable to a distress termination.³⁹ PBGC staff emphasizes that by using two different screens (one based on reportable transactions, irrespective of underfunding; the other based on underfunding and deterioration of credit agency bond ratings) they believe that they are monitoring most companies with a heightened risk of termination.

The EWP is not mandated by ERISA, but created and recently expanded at the PBGC's initiative under its authority to initiate a preemptive plan termination.⁴⁰ Although the PBGC has no authority to veto a transaction, it can and has extracted concessions that seek to shore up underfunding or protect the PBGC's position as part of the transaction. An example would be the spin-off of a profitable division while leaving under-funded pension liabilities with the now less profitable plan sponsor.⁴¹ Under this authority, the PBGC has leverage because it can threaten a company with involuntary termination. It can also make public statements that result in negative media coverage and potentially weaken the company's position. In the past couple years the agency has also begun using Section 4062(a), which authorizes the PBGC to take a lien on a company that downsizes more than 20% without improving its pension funding. For example, the threat of this caused Visteon Inc. (an auto parts supplier to Ford) to back down and increase its contribution to the plan. In a separate white paper, the NRLN reports on a number of these incidents and proposes that Congress give the

³⁸ See PBGC, "Early Warning Program Fact Sheet," available at <http://www.pbgc.gov/res/factsheets/page/early-warning.html>; "Technical Update 00-3: PBGC's Early Warning Program," July 24, 2000 (updated Jan. 4, 2008), available at <http://www.pbgc.gov/practitioners/law-regulations-informal-guidance/content/tu12795.html>.

³⁹ See National Retirees Legislative Network, "Pension Spin-Offs: Protecting Retirees from Financial Engineering and Foreign Acquisition," White Paper Series (updated December, 2012).

⁴⁰ Under ERISA section 4042(a)(4), the PBGC "may institute proceedings . . . to terminate a plan whenever it determines that the possible long-run loss of the corporation with respect to the plan may reasonably be expected to increase unreasonably if the plan is not terminated."

⁴¹ The NRLN documents a number of examples of these practices and proposes more flexible and potent tools for the PBGC to prevent distress terminations stemming from spin-offs and other corporate restructurings in a companion white paper. See National Retirees Legislative Network, "Pension Spin-Offs: Protecting Retirees from Financial Engineering and Foreign Acquisition," White Paper Series (updated December, 2012).

PBGC more flexible and potent tools to prevent distress terminations stemming from spin-offs and other corporate restructurings.⁴²

In order to head off problems as early as possible, ***PBGC should add foreign ownership, and proposed sales or spin-offs to foreign owners, to the list of transactions triggering an Advance Notice of Reportable Events, as well as special scrutiny under the PBGC's Early Warning Program.***

In addition, ***Congress should amend ERISA to require that all individuals who serve as plan fiduciaries – particularly the plan's "named fiduciary" – be U.S. citizens subject to the jurisdiction of U.S. courts.*** ERISA requires that the employer sponsoring a qualified pension plan identify in plan documents at least one "named fiduciary" (an individual or entity, such as the corporation's directors) with overall fiduciary responsibility for the plan.⁴³ The named fiduciary can be identified by name or by office. Other persons (or entities) can be fiduciaries for more limited roles or duties, such as asset management or administration. Pension plan participants as well as the PBGC have the right to sue pension plan fiduciaries in U.S. courts for breach of fiduciary duty and to recover plan assets.

The PBGC has on many occasions exercised its authority to seek judgments from individuals who acted as fiduciaries of pension plans where they have breached their fiduciary responsibilities, resulting in a loss of plan assets. However, the assignment of individuals as fiduciaries who are not U.S. citizens by a foreign corporation, or who may not even be domiciled on U.S. territory, can put the fiduciary beyond the reach of U.S. courts and eviscerate intended protections in ERISA. Congress should ensure that ERISA fiduciaries, especially named fiduciaries, are subject to the jurisdiction of U.S. courts.

V. SUMMARY OF POLICY RECOMMENDATIONS

As this paper has demonstrated, arbitrary gaps in ERISA's benefit guarantee program are imposing unanticipated and devastating losses on tens of thousands of retirees and older workers forced into retirement by the bankruptcy of their employer. The benefits actually paid by the PBGC are often substantially lower than the vested benefits earned by participants. These losses disproportionately fall on very recent retirees, particularly those who earned a pension exceeding the PBGC maximum guarantee and/or who received benefit increases within five years of plan termination.

This paper has focused in particular on two *discretionary* policies that the PBGC has maintained despite the fact that it leads to unexpected and permanent benefit reductions for a large number of older workers and retirees. These benefit coverage gaps – addressed in recommendations one and two below – can be remedied either by an agency decision to change its policies, or by Congress adopting an amendment to ERISA (and, in parallel, the Internal Revenue Code). The third issue addressed – relating to the arbitrary and unfair three-year lookback limitation that effectively excludes any payment of non-guaranteed benefits to very recent retirees – will require a statutory amendment. The final issue relates to retirees' growing anxiety about foreign ownership or control of

⁴² *Ibid.*

⁴³ ERISA Section 401(a)(1), 29 C.F.R. § 2509.75-5.

firms with under-funded pension obligations. The government can prevent a serious failure attributable to the potential inability to recover liabilities from foreign firms through a combination of expanded scrutiny on the part of the PBGC, as well as Congressional action to give the agency more authority and more effective tools to hold foreign-based firms accountable for meeting the full cost of their pension promises.

In sum, the National Retiree Legislative Network is advocating the following five commonsense policy reforms to strengthen the nation's pension benefit guarantee system:

1. **For the purpose of allocating plan assets to pay non-guaranteed benefits, Congress should require PBGC to use the same interest rate (currently the AA corporate bond yield curve prescribed by the Treasury Department) and other assumptions that plan sponsors use to calculate their funded status pursuant to the Pension Protection Act.**
2. **The PBGC or, if not, Congress should clarify that a benefit increase triggered by the automatic inflation adjustment of the Internal Revenue Code 401(a) and 415(b) limit is not subject to the five-year phase-in limitation that applies to benefit increases “resulting from a plan amendment.”**
3. **Congress should amend Section 4044(a)(3) – the three-year eligibility limitation – so that the benefits of all plan participants who are already retired, or eligible to retire, on the date of plan termination are protected equally under Priority Category 3.**
4. **PBGC should add foreign ownership, and proposed sales or spin-offs to foreign owners, to the list of transactions triggering an Advance Notice of Reportable Events, as well as special scrutiny under the PBGC's Early Warning Program. In addition, Congress should clarify that the PBGC has the authority to enforce a lien against any and all U.S.-based assets of a foreign-owned plan sponsor.**
5. **Congress should amend ERISA to require that all individuals who serve as plan fiduciaries – particularly the plan's named fiduciary – be U.S. citizens subject to the jurisdiction of U.S. courts.**