

The following article is presented by DP3 to help our membership understand some of the details of pension plans and what happens in the event of a distress termination. This is a supplement to the FAQs found elsewhere on the DP3 web site. (www.dp3.org)

A Pension Primer—Distress Termination and the PBGC

What happens if a company's pension plans are terminated and replaced with other retirement plans?

When a pension plan is terminated, the assets in that plan are transferred to the PBGC, which then is responsible for making pension payments under the "old" plans.

- The PBGC would assume the assets of the company's terminated pension plans.
- Retirees and employees would receive information about their terminated plan from the PBGC.
- The PBGC would pay current retirees some percentage of the pension benefits they were receiving under the terminated plan. The amount depends upon which Priority Category an individual's benefits are assigned to (see below). The Priority Category determines the final amount a participant will receive.
- This would not happen immediately, however. While the Priority Category determination is being made, the PBGC would direct the company to decrease the amount paid to each retiree to no more than the PBGC guaranteed level.
- The PBGC would determine the final amount a participant should receive after it determines the priority category for each active and retired participant's benefit and after it has completed its evaluation of the plan's assets. This process takes one to three years.
- This means that some retirees will receive a "make up" payment once a final determination is made.
- All retirees and employees, with five or more years of service, are entitled to the PBGC guaranteed benefit even if the plan assets are not sufficient, and will receive a higher benefit if the plan assets allow for this.

The PBGC guaranteed benefit for a plan terminating in 2004 is the participant's earned accrued benefit up to a maximum of \$44,386 per year, minus the annuity equivalent of any lump sum benefits received under the plan. This guaranteed amount applies to both retirees and employees, but it is reduced if the retiree is younger than 65 at plan termination or if an active participant begins receiving the benefit before age 65. It is increased if the retiree is older than 65 at plan termination or if the active participant begins receiving the benefit after age 65.

- This means that if an employee retires prior to termination of the plan, and receives a portion of his or her benefit as a lump sum, the PBGC guaranteed benefit would be reduced by the annuity value of the lump sum.

- This PBGC guaranteed benefit amount applies to a participant who is age 65 on the later of (1) the participant's benefit commencement date or (2) the plan termination date. For participants under age 65 on the later of these dates, the guarantee is reduced to account for the fact that the participant will receive the benefit over a longer period of time. For example, for plans terminating in 2004 the maximum annual guaranteed benefit is \$35,065 at age 62, \$28,851 at age 60, and \$19,973 at age 55. For participants who are older than 65 on the later of these dates, the maximum guaranteed benefit is increased.
- The PBGC guaranteed benefit is reduced by any amount that an individual receives from a pension plan of a former employer that the PBGC assumed following the termination of that plan.
- If the PBGC takes over a plan, it will not make lump sum payouts that otherwise would be allowable under that plan.
- Under some pension plans, individuals are allowed to take all or a portion of their total benefit in a lump sum. This option is not allowed after the PBGC takes over such a pension plan.
- In addition, a lump sum that is paid to an individual before plan termination will reduce the guaranteed benefit amount paid to that individual by the PBGC.
- Terminated plan assets would be allocated among six "Priority Categories" of benefits.
- Under the Employee Retirement Income Security Act (ERISA) and PBGC regulations, each participant's accrued benefit at the time of termination is placed into six Priority Categories.
- Priority Categories 1 and 2 (PC-1 and PC-2) cover benefits attributable to voluntary and mandatory employee contributions, respectively. This typically impacts only a handful of employees.
- The benefits of participants are then allocated to Priority Category 3 (PC-3) based on whether the plan participant had begun to receive, or could have begun to receive, his or her benefit at least three years prior to the plan termination date.
- There is no dollar limit on PC-3 annual benefits. Some participants in PC-3 could receive their entire benefit provided there are sufficient assets allocated to that priority category and the individual has been retired for a sufficient period of time (which differs for each plan).

For example, if a pension plan were to be terminated on December 1, 2004, PC-3 would include the benefits of all participants who, as of December 1, 2001, were receiving, or could have received, benefits from the plan as of December 1, 2001 (based on their age, years of participation and salary, if applicable on that date).

- The benefit payable for employees in PC-3 does not require that they actually retire before the plan termination date - only that they would have been eligible to retire three years prior to the plan termination date.
- The benefits allocated to PC-3 are based on the lowest benefit payable under the plan provisions in the last five years.

- If the plan's assets after accounting for PC-1 and PC-2 benefits are not sufficient to cover 100% of all benefits for participants in PC-3, then the benefits under PC-3 will be reduced on a prorated basis.
- If plan assets remain after allocation to PC-1 through PC-3, they are then allocated to PC-4.
- PC-4 covers a participant's vested benefits that have been earned under the plan, as of the plan termination date, whether or not the participant has retired or is eligible to retire. (There is no three-year "look back," as there is under PC-3). There is, however, a dollar limit on PC-4 annual benefits.
- The benefits allocated to PC-4 are guaranteed by the PBGC, whether the assets in the plan are sufficient or not. For purposes of PC-4, and for purposes of applying the PBGC guarantee, the participant's benefit is determined based on the provisions of the plan in effect on the plan termination date. Any plan improvements made within the five years before plan termination, however, are phased in at 20% per year.
- If assets remain after allocation to PC-1 through PC-4, they are then allocated to PC-5, to provide all other vested benefits under the plan, and then to PC-6, to provide all other accrued benefits under the plan.
- A participant's Priority Category is not affected by whether the participant retires before or after the plan termination date.
- Under these Priority Categories, a retired participant has no higher claim on the assets than does an active participant of the same age and service. For purposes of PC-3, a participant's level of priority is determined by whether the participant is eligible to retire as of a certain date, not whether the participant has actually retired.

If a company terminates its qualified pension plans, the PBGC would likely demand that the company also terminate its non-qualified pension plans. These are plans that provide benefits that otherwise exceed Internal Revenue Code limits on the level of retirement benefits that can be paid from a qualified plan. The Internal Revenue Code limits the pay that can be used to determine benefits payable from a qualified plan. This "pay cap" is an annual amount set by law. The limit is \$205,000 for 2004.

- Benefits under certain plans are based on "Final Average Earnings" (FAE). Each year's pay used for this average is limited to that year's pay cap.
- An individual whose final average earnings is limited by the pay cap often receives a non-qualified pension benefit that restores the benefit "lost" because of the pay cap.
- No assets are set aside for these benefits and the PBGC does not guarantee any non-qualified benefits. Moreover, if the qualified plans were terminated, the PBGC would likely require that these non-qualified benefits be terminated.

Although a participant gains no higher claim on assets by retiring before a "distress termination," there may be a difference in the form in which benefits are paid.

- If a participant is already retired and receiving benefits on the plan termination date, the form in which the benefits are being paid will likely be continued by the PBGC after the plan termination date.

- If a participant has not begun to receive benefits as of the plan termination date, the PBGC will allow the participant to select from a range of optional forms of benefit but these options do not allow for a lump sum payout.

Creating a replacement plan.

As part of any plan termination, a company often seeks to establish a replacement retirement program to which current employees and the company would contribute on a going forward basis. A replacement plan usually covers all active employees. A replacement plan is usually a defined contribution plan, such as a 401(k) plan.

Either employee or employer contributions or both usually fund defined contribution plans, and benefits under these plans increase or decrease based on the investment experience under the plan. At the time of the employee's retirement, the benefit available is the amount in his/her account. The retiree would get this benefit in addition to the benefit paid by the PBGC.

- After plan termination, companies usually implement a defined contribution plan to make that company's retirement benefits more consistent with retirement benefits offered at most other U.S. companies. Currently, only 38 percent of large U.S. employers still offer defined benefit pension plans, and most others offer defined contribution plans, such as 401(k) plans.

Pension FAQs

Why are pension plans underfunded?

There are many factors that have contributed to the underfunding of pension funds, including the weak performance of the financial markets, low interest rates, poor investment choices and increases in pension benefits since the late 1990s.

How does a company fund its defined-benefit pension plans?

Corporations make contributions to a trust that is used to fund qualified pension payments. Only a small portion of the money is used to pay pension benefits every month. Most of it is held in reserve and invested in order to increase the plan's assets and fund future benefit payments. Federal legislation governs how much money a company is required to contribute to the trust. The company's contributions vary from year to year, depending on various factors, such as current interest rates, the return on assets and changes to the benefit plans. The assets of the trust are protected from general creditors and cannot be used to pay a company's operating expenses or to meet other corporate financial needs.

What is the process for terminating pensions?

If a company determines that it must terminate its pension plans, it must go through a legally mandated process—one that is different for union than for salaried and management plans.

For a union plan, the company would seek an agreement with the union regarding termination of the plan. Failing that, the company would file a motion under Section 1113 of the bankruptcy code to terminate the Collective Bargaining Agreement (CBA) because pensions are a part of a CBA. In addition, the company must file a motion with the bankruptcy court specifically requesting a factual finding regarding a voluntary distress termination of the pension plans. At the same time, the company files notice with the PBGC, the bankruptcy court, and the plan participants of its intent to terminate the plans

within 60 to 90 days, as required by law. It is ultimately the PBGC that decides whether the company has met the standards for a distress termination, but it generally accepts the bankruptcy court's findings.

After bankruptcy court hearings on the 1113 motion and the motion for a distress termination of the pension plans, the judge has two decisions to make. First, on whether to reject a CBA; specifically, the judge has to rule that the proposed change is fair and equitable; that the termination is required by the company to emerge from bankruptcy, and that the parties have negotiated in good faith.

Second, the judge also must make certain factual findings in connection with the company's distress termination--companies in bankruptcy must meet certain standards to do this. Terminating the pension plans for salaried and management employees is different in that there is no 1113 filing since there is no relevant CBA. The company files a request for factual findings in connection with its distress termination motion with the bankruptcy court and notice with the PBGC and the participants. Then the PBGC decides whether the company has met the standards for a distress termination.

What are the requirements for a "distress termination"?

If a pension plan's liabilities exceed its assets, the company only in a "distress termination" may terminate the plan. A "distress termination" may occur only if the bankruptcy court determines that the entity sponsoring the plan (i.e., the company) satisfies one of four alternate criteria for a "distress termination," as follows:

- The entity is in liquidation (Chapter 7); or
- The entity is in reorganization in bankruptcy (Chapter 11), and the bankruptcy court determines that unless the plan is terminated, the entity will not be able to pay its debts under a plan of reorganization and will be unable to continue in business outside the reorganization process, and the court approves the plan termination; or
- The PBGC determines that termination is required to enable the entity to pay its debts and continue in business; or
- The PBGC determines that termination is required for the entity to avoid pension plan costs that have become unreasonably burdensome solely as a result of a decline in the entity's workforce covered by all of the entity's pension plans.

The PBGC must approve the distress termination but it generally accepts the bankruptcy court ruling.

How would a plan participant be notified if or when a decision is made to terminate a pension plan?

If a decision were made to terminate a pension plan, the participant would receive a notice called the Notice of Intent to Terminate at least 60 days before the "termination" date.

How are the assets of the plan allocated among plan participants?

The PBGC would pay current retirees some percentage of the pension benefits they were receiving under the terminated plan. For plans terminating in 2004, for example, the PBGC guarantees a participant's earned benefit up to a maximum of \$44,386 per

year at age 65 payable as a single life annuity. The amount depends upon which Priority Category an individual's benefits are assigned to. This would not happen immediately, however. While the Priority Category determination is being made, the PBGC would decrease the amount paid to each retiree to no more than the PBGC guarantee level.

The PBGC would determine the final amount a participant should receive after it determines the Priority Category for each active and retired participant's benefit and after it has completed its evaluation of the plan's assets. This means that some retirees will receive a "make up" payment once a final determination is made.

At the same time, as part of any termination, the company would likely seek to establish a replacement retirement program to which current employees and the company would contribute on a going forward basis. Because of PBGC restrictions, this replacement plan cannot be a defined benefit plan.

If pensions are terminated, is it in my financial interest to retire early?

If the pension plan is terminated in a "distress termination," the plan's assets will be allocated among (and in the order of) six Priority Categories. A participant's level of priority is not affected by whether the participant retires before or after the plan termination date. Under these Priority Categories, a retired participant has no higher claim on the assets than does an active participant. Furthermore, for purposes of PC-3, a participant's level of priority is determined based on whether the participant is eligible to retire as of a certain date, not whether the participant has actually retired.

Although a participant gains no higher claim on assets by retiring before a "distress termination," there may be a difference in the form in which benefits are paid. If a participant is already retired and receiving benefits on the plan termination date, the form in which the benefits are being paid will likely be continued by the PBGC after the plan termination date. If a participant has not begun to receive benefits as of the plan termination date, the PBGC may allow the participant to select from the following optional payment forms:

- Straight life annuity
- 5-year certain-and-continuous annuity
- 10-year certain-and-continuous annuity
- 15-year certain-and-continuous annuity
- Joint-and-50%-survivor annuity
- Joint-and-50%-survivor-"pop-up" annuity
- Joint-and-75%-survivor annuity
- Joint-and-100% survivor annuity
- PBGC at its discretion may make other optional annuity forms available.

What happens if a plan's assets run out in one of the Priority Categories?

If a plan's assets do not cover 100% of all benefits, then all benefits covered by the Priority Category in which the assets run out are covered equally. For example, if plan

assets fully cover benefits in PC-1 and PC-2 but run out in PC-3, then all of the plan's assets left for PC-3 will be used to cover an equal percentage of all benefits covered by PC-3. In addition, whether or not any plan assets are allocated to PC-4, the PBGC is required to pay the portion of a participant's benefit that it guarantees, as described above.

How long does it typically take the PBGC to determine Priority Categories?

While there is no set timetable, the PBGC historically has taken anywhere from six months to a few years to complete their calculations and determine Priority Categories breakdowns.

If benefit improvements were made to a plan, would those improvements be reflected in benefits paid by the PBGC?

Benefit improvements made within five years before a plan termination are phased in at a rate of 20% per year since the later of the adoption date or the effective date of the change.

If I'm a retiree currently receiving benefits above the maximum guaranteed amount, will I lose those benefits?

Generally, the PBGC would pay current retirees some percentage of the pension benefits they would have received under the terminated plan. For plans terminating in 2004, for example, the PBGC guarantees a participant's earned benefit up to a maximum of \$44,386 per year at age 65 payable as a single life annuity.

The ultimate amount depends upon which Priority Category an individual's benefits are assigned to. This would not happen immediately, however. While the Priority Category determination is being made, the PBGC would decrease the amount paid to each retiree to no more than the PBGC guarantee level.

The PBGC would determine the final amount a participant should receive after it determines the Priority Category for each participant and retiree's benefit and after it has completed its evaluation of the plan's assets.

This means that some retirees will receive a "make up" payment once a final determination is made.

What are nonqualified pension benefits, and how will these be affected in bankruptcy?

Nonqualified pension benefits are paid from the company's assets rather than a qualified trust. In a bankruptcy, employees due nonqualified pension benefits become general creditors of the company with no special claim on assets. In the event of a plan termination, non-qualified benefit plans would likely be eliminated.

The PBGC's website is www.PBGC.gov and their contact number for general inquiries is 202-326-4000.

A glossary of pension terms

This glossary is meant to help you understand commonly used pension terms.

These are simplified definitions and do not replace or modify any definitions found elsewhere, such as laws, regulations, forms and instructions, or plan provisions.

Accrued Monthly Benefit (AMB) - The monthly pension amount that you have earned through your service with your company.

Annuitant - The person receiving a payment in annuity form.

Annuity - Periodic payments to a person, usually for life.

Beneficiary - A person designated by a pension plan participant to receive all or a portion of the pension benefit after the participant dies.

Benefit Offset - A reduction in a person's pension benefit because he or she owes money to the plan or is also receiving other benefits. Benefit offset rules are set by the provisions of the person's pension plan.

Certain and Continuous - An annuity guaranteed to be paid for a specified number of years. If the annuitant dies prior to the specified number of years, his/her beneficiary will receive the annuity for the remaining years.

Credited Service (CS) - The total time that you spent working that counts toward your benefit. Credited service is most often the number of years you worked for the company, up to the date of plan termination, or the date of plan freeze, whichever is earlier. It could be less for certain plans and for people who worked part-time.

Date of Plan Termination - The date a pension plan ended.

Date of Trusteeship - The date that the Pension Benefit Guaranty Corporation (PBGC) takes over the management of your pension plan and its assets and becomes responsible for making payments to plan participants.

Defined Benefit Pension Plan - A pension plan that promises participants a specified monthly benefit at retirement.

Distress Termination - A company-initiated termination of a defined benefit pension plan when the company is in financial difficulty, continuing the plan would likely force the company to shut down, and the pension plan does not have enough assets to pay all current and future benefits.

Employee Retirement Income Security Act (ERISA) - The federal law that establishes the basic requirements for employee benefit plans. The authority for administering and enforcing ERISA is divided among three federal agencies: The Internal Revenue Service (IRS), the Department of Labor (DOL), and the Pension Benefit Guaranty Corporation (PBGC).

Fiduciary - With regard to a pension plan, a person or organization with control over the plan or its assets.

Flat-Rate Premium - The premium rate plans pay annually to PBGC for each plan participant. The rate is different for multiemployer plans versus single-employer plans.

Fully Funded - A pension plan with sufficient assets to pay all current and future benefits.

Involuntary Termination - A PBGC-initiated termination of an underfunded defined benefit pension plan.

Joint-and-Survivor Annuity - An annuity paying one individual for his or her life and then providing for an annuity for the person's surviving spouse, usually in a reduced amount.

Lump Sum Payment - When a participant receives a benefit all at once, not in regular installments.

Maximum Guaranteed Benefit - Under the law, the largest monthly amount PBGC can pay a participant from its funds.

Multi-employer Plan - A pension plan set up by collectively bargained agreements involving more than one unrelated employer, generally in one common industry.

Participant - A person who is or may become eligible to receive a benefit from a pension plan.

PBGC - The Pension Benefit Guaranty Corporation, a federal government agency that insures private defined benefit pension plans.

Pension Benefit - A benefit payable as an annuity to a participant or beneficiary of a pension plan.

Plan Administrator - The person, committee, or company designated by a pension plan to manage the plan's daily business.

Plan Sponsor (multi-employer plan) - The board of trustees that oversees a multiemployer pension plan.

Plan Sponsor (single-employer plan) - An employer that establishes or maintains a pension plan for its employees.

Qualified Domestic Relations Order (QDRO) - A court order, usually in a divorce case, that meets legal requirements for awarding some or all of a participant's pension benefits to the participant's spouse, former spouse, child, or other dependent.

Single-Employer Plan - A pension plan sponsored by a single employer or a group of companies under common control. (Also, a pension plan sponsored by unrelated companies that is not collectively bargained.)

Single Life Annuity - Periodic payments for the life of the participant with no benefits payable after the participant's death.

Standard Termination - Termination of a plan that has enough assets to pay for all benefits.

Surviving Spouse - The living spouse of a deceased participant. (A Qualified Domestic Relations Order (QDRO) may treat a participant's former spouse as a surviving spouse.)

Termination (for single-employer plans) - When a pension plan ends.

Trustee - A person or organization with a duty to receive, manage, and disburse the assets of a plan.

Underfunded Plan - A pension plan without enough assets to pay all benefits.

Unfunded Benefit Liabilities - The amount of promised pension benefits that exceed a plan's assets.

Variable-Rate Premium (single-employer plans) - Additional premium amount, based on the amount of the plan's unfunded benefit liabilities that an underfunded plan or its sponsor must pay to PBGC.