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Single-Employer Pension Plan Terminations

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As the economic fallout from the Covid-19 pandemic continues, many employers with significant single-employer defined benefit pension plan liabilities are revisiting options to mitigate their pension exposure in an effort to reduce their annual expenses and to clean up their balance sheets. One option that is often considered is a termination of the pension plan.

However, terminations are only permitted under certain circumstances and have ramifications that must be carefully considered and managed. In particular, terminating an underfunded pension plan alone does not relieve an employer from liability for the plan, but the resulting liability can be negotiated with the Pension Benefit Guaranty Corporation and potentially reduced based on the employer's financial situation.

Under ERISA, a single-employer pension plan can only terminate in a standard termination, a distress termination, or an involuntary termination. Multiemployer plans and multiple-employer plans—plans with unrelated participating employers—are subject to different rules that are not addressed in this article.

Standard Terminations

A standard termination is only available when a plan has sufficient assets to satisfy all of its benefits liabilities. In a standard termination, the plan either purchases an annuity for each participant from an insurance company and/or pays out all of the plan's benefits in another form permitted under the plan, such as lump sum payments.

If a plan is underfunded, an employer must fund its unfunded liabilities to effectuate a standard termination. In light of today's historically low interest rates, standard terminations are more expensive than ever, but some employers that want finality and certainty with respect to their pension plans are still moving forward with standard terminations. Although standard terminations require certain filings with PBGC and may result in a post-termination audit by PBGC to ensure that the plan's benefits were properly annuitized or distributed, a standard termination does not require approval by PBGC or any other government agency. See, e.g., 29 U.S.C. § 1341(b). However, because this form of plan termination requires the employer to fully fund the plan, it is typically not an option for employers in financial distress.

Distress Terminations

An employer that sponsors an underfunded pension plan can affirmatively seek to terminate the plan through a distress termination under certain circumstances. An employer seeking a distress termination must initiate the distress termination with a notice to participants and a distress termination application to PBGC. However, PBGC offers voluntary pre-filing consultations with employers considering a distress termination, and these consultations can be useful to better understand how PBGC may approach the termination application and whether there are additional steps the employer should take before submitting the application.

After filing, PBGC will determine whether the plan is eligible for a distress termination, which requires that each member of the employer's controlled group individually satisfies at least one of the following four statutory tests. 29 U.S.C. § 1341(c)(2)(B).

Liquidation Test. The entity must have filed, or had filed against it, a petition seeking liquidation under federal or state law which has not been dismissed as of the proposed plan termination date.

Reorganization Test. The entity must have filed, or had filed against it, a petition seeking reorganization under federal or state law which has not been dismissed as of the proposed plan termination date. In addition, the applicable court must determine that the entity cannot pay all of its liabilities under a plan of reorganization without a termination of the plan and that the entity cannot continue in business outside the reorganization process.

Business Continuation Test. The entity must demonstrate to PBGC that the entity cannot pay its debts when due and continue in business without a plan termination.

Pension Cost Test. The entity must demonstrate to PBGC that the entity's costs of providing pension benefits have become unreasonably burdensome solely as a result of declining covered employment.

The only "automatic" grounds for a distress termination is if the employer and each member of its controlled group has filed for liquidation. All of the other tests are subject to the discretion of the bankruptcy court (in the case of the reorganization test) or PBGC (in the case of the business continuation and pension cost tests). In addition, the pension cost test is typically not used in practice, so for struggling employers that are not prepared to file for bankruptcy, the applicable test is generally the business continuation test.

As noted above, each entity in the employer's controlled group must satisfy one of the tests for the employer to qualify for a distress termination. Controlled groups encompass trades or businesses related to each other in "parent-subsidiary" or "brother-sister" relationships. 29 U.S.C. § 1301(b)(1). A parent-subsidiary relationship exists when a group of entities are linked directly or indirectly by at least an 80% common ownership interest. A brother-sister relationship exists when five or fewer individuals, estates, or trusts, directly or indirectly own 80% or more of two or more entities and have effective control over each entity.

A controlled group can include foreign entities. *Pension Benefit Guar. Corp. v. Asahi Tec Corp.*, 979 F. Supp. 2d. 46 (D.D.C. 2013) (holding that a Japanese corporation was a member of an American employer's controlled group). Controlled group determinations also involve certain attribution and constructive ownership rules that are beyond the scope of this article. See, e.g., 26 C.F.R. § 1.414(c)-4.

A distress termination is intended as a last resort, and PBGC closely scrutinizes distress termination applications. For employers with large corporate groups, a challenge in preparing a viable distress termination application is that even though the employer that sponsors the plan may be in dire financial straits, PBGC generally will not approve a distress termination application if a member of the employer's controlled group has the wherewithal to maintain the plan. However, if PBGC determines that a plan termination is in PBGC's best interests, it may elect to proceed with an involuntary termination as described below even if the distress termination criteria cannot technically be met.

Involuntary Terminations

Involuntary terminations are initiated by PBGC. PBGC is required to initiate an involuntary termination when it determines that a plan has insufficient assets to pay benefit liabilities that are currently due. In addition, PBGC has the discretion to initiate an involuntary termination if it makes any of the following determinations. 29 U.S.C. § 1342(a).

Minimum Funding Standards. The plan has not met the minimum funding standards under applicable law.

Future Benefit Liabilities. The plan will be unable to satisfy benefit liabilities in the future.

Preferential Payments. The plan is underfunded and made a lump sum payment in excess of $10,000 to a participant who is a substantial owner of the employer.

Long-Run Loss. PBGC's long-run loss with respect to the plan may "reasonably be expected to increase unreasonably" without an immediate plan termination.

As noted above, in the case of an underfunded plan where the distress termination criteria cannot be met, PBGC could determine to proceed with an involuntary termination if it determines that the foregoing involuntary termination criteria have been met.

Impact of a Distress or Involuntary Termination

Following a distress or involuntary termination, PBGC will assume trusteeship of the terminated plan and pay benefits up to the level guaranteed by PBGC—even if the plan lacks sufficient assets to pay those benefits and PBGC is unable to recover additional assets from the employer. For plans that terminate in 2020, the annual maximum guaranteed benefit for a 65-year old retiree is $69,750. However, the accrued benefits under the plan are subject to certain adjustments before the application of this limit. For example, benefit increases adopted within the five years prior to the plan termination are not fully guaranteed by PBGC. 29 U.S.C. § 1322.

Importantly for employers, a distress or involuntary termination will not relieve an employer from liability for the terminated plan. Instead, the termination will crystallize significant liabilities for the employer and its controlled group members on a joint and several basis. A distress or involuntary termination could also trigger an event of default under credit agreements to which the employer or any of its controlled group members is a party.

Unfunded Benefit Liabilities

The most significant liability with respect to a terminated plan is usually the plan's unfunded benefit liabilities. PBGC calculates unfunded benefit liabilities on a termination basis with a conservative discount rate. As a result, plans that appear reasonably well funded on an ongoing basis often have significant unfunded benefit liabilities on a termination basis. The employer and its controlled group members, as of the plan termination date, are jointly and severally liable for a terminated plan's unfunded benefit liabilities. 29 U.S.C. § 1362(a).

PBGC Termination Premium

PBGC assesses a potentially significant termination premium for plans that terminate through distress or involuntary terminations. The premium is $1,250 per participant, per year, for three years after termination. 29 U.S.C. § 1306(a)(7)(A). The employer and its controlled group members are jointly and severally liable for this premium. In addition, through a special rule for plans terminated in bankruptcy reorganizations, this premium only becomes due after the bankruptcy discharge or case dismissal. As a result, bankruptcy courts cannot discharge PBGC termination premiums. *Pension Benefit Guar. Corp. v. Oneida Ltd.*, 562 F.3d 154 (2d Cir. 2009) (holding that a company is liable to PBGC for termination premiums after it emerges from bankruptcy reorganization).

Missed Minimum Funding Contributions and Unpaid PBGC Insurance Premiums

In addition to the unfunded benefit liabilities and PBGC termination premium, the employer and its controlled group members remain jointly and severally liable for any missed minimum funding contributions and unpaid PBGC insurance premiums with respect to the period prior to the plan termination.

Collection of Termination Liabilities

PBGC will seek to collect all of the foregoing termination liabilities from the employer and its controlled group members following a distress or involuntary termination. However, PBGC is required to prescribe commercially reasonable repayment terms for any portion of a terminated plan's unfunded benefit liabilities that exceeds 30% of the controlled group's collective net worth. 29 U.S.C. § 1362(b)(2)(B). In addition, an employer may be able to negotiate a significant discount to its total liability if the employer can adequately demonstrate to PBGC the extent of the employer's financial hardship and inability to fully satisfy the termination liabilities.

In considering potential outcomes with PBGC, employers should be aware that plan terminations can trigger statutory liens that PBGC will threaten to use in negotiations over the settlement of termination liabilities. Statutory liens can also arise prior to a plan termination if an employer's total missed minimum funding contributions exceed $1 million. 29 U.S.C. § 1083(k).

In the context of a plan termination, if the termination liability remains unpaid after PBGC demands payment, a termination lien automatically arises by statute in an amount equal to the lesser of the plan's unfunded benefit liabilities and 30% of the controlled group's collective net worth. 29 U.S.C. § 1368(a). The lien's amount is the plan's unfunded benefit liabilities, but is capped at 30% of the controlled group's collective net worth.

Conclusion

The termination of a single-employer pension plan can provide a financially struggling employer with significant relief, which could be appealing for many employers in today's economic climate. However, only standard terminations where employers fully fund their benefit liabilities can be executed without PBGC's consent.

All other terminations will require a dialog with PBGC and, most importantly, will ultimately require the employer and its controlled group members to negotiate some form of settlement with PBGC that will typically require the employer and its controlled group members to pay some portion of the plan's unfunded benefit liabilities.