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Littler Mendelson's Employee Benefits Practice Group:

Steven Friedman, *Practice Chair*
212.583.9600

James Boudreau
267.402.3029

Lisa Chagala
925.932.2468

Phil Gordon
303.629.6200

Michael Hoffman
415.433.1940

G. J. MacDonnell
415.433.1940

Darren Nadel
303.629.6200

Nancy Ober
415.433.1940

Adam Peters
415.433.1940

Michelle Pretlow
202.842.3400

Dan Rodriguez
713.951.9400

Rick Roskelley
702.862.8800

Kate Rowan
415.433.1940

Dan Srsic
614.463.4201

Daniel Thieme
206.623.3300

J. René Toadvine
704.972.7000

Kevin Wright
202.842.3400

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Comprehensive Pension Reform Becomes Law: A Look At Changes Primarily Affecting Defined Benefit Plans

By Kevin L. Wright and J. René Toadvine

After years of political debate and negotiation, the Pension Protection Act of 2006 was signed into law by President Bush on August 17, 2006. This landmark legislation arguably is the most comprehensive pension reform legislation since the enactment of ERISA in 1974. This newsletter summarizes some of the major defined benefit plan components of this new and important legislation and conveys some basic observations regarding them. A separate newsletter summarizes those aspects of the legislation that relate to defined contribution plans (See Comprehensive Pension Reform Becomes Law: A Look At Changes Primarily Affecting Defined Contribution Plans).

Funding Provisions (Single-Employer Plans)

Minimum Required Contribution

Current law measures the adequacy of a plan's funding by reference to a theoretical "funding standard account." The minimum required contribution is generally the greater of the amount required to balance the cumulative charges and credits to that theoretical account, or the amount of so-called "deficit reduction" contributions. Charges to the funding standard account include items like additional service credits, actuarial losses and worse-than-expected investment performance. Certain liabilities are permitted to be amortized over 30 years (more stringent rules are in place for plans that are not at least 90% funded). The new legislation requires generally that the minimum required contribution in a given year be the "normal cost" (the value of new accrued benefits in the given year) plus any previous funding shortfalls and waivers amortized over the next seven years.

Observation: This is an attempt to improve the funding of plans by keeping them on a more current funding basis. For many employers, these provisions will require more contributions in a shorter time frame.

Credit Balances

Under current law, if a sponsor makes a contribution in excess of the minimum required contribution in any year, the excess plus interest is maintained as a "credit balance" that can be credited against future required contributions. These balances were deemed to grow at the plan's expected rate of return, regardless of whether these rates were actually realized. The new legislation tightens these rules somewhat, by requiring that credit balances be adjusted to reflect the actual rate of return experienced by a plan ("marked to market"). Also, the new law restricts the extent to which plans below 80% funded can use credit balances to satisfy minimum contributions.

Observation: This change will prevent employers from taking advantage of "flush" years by pre-funding the plan and then taking a credit against future contribution obligations if the plan is below the 80% funding level. Again, the overall goal is to better and more quickly fund benefit obligations.

Interest Rate Used to Determine Current Liabilities

Before 2004, the interest rate used for determining the present value of a plan's liabilities was a four-year weighted average of the 30-year Treasury bond rate. This rate was seen as artificially low, resulting in the calculation of artificially high liabilities for some plans. For 2004 and 2005, temporary legislation established an interest rate based on investment-grade corporate bonds. The new legislation maintains this same investment-grade bond rate for plan years 2006 and 2007. For plan years 2008 and following, the interest rate is determined using a yield curve based on a 24-month average of corporate bond rates.

Observation: This modification will produce a more realistic interest rate for measuring plan liabilities and will result in more rational "current liability" numbers for some plans.

Plans in "At Risk" Status

Generally, the new legislation defines plans as "at risk" if they are less than 70% funded, although in some instances plans with greater funding ratios could still be considered "at risk." "At risk" plans will be subject to accelerated funding requirements and certain "at risk" assumptions will be imposed (accelerated retirement and payment assumptions).

Restrictions on Benefit Increases

Under the new law, if a plan is less than 60% funded, the plan sponsor must freeze the plan, plant shutdown benefits may not be paid (unless immediately funded to the extent necessary to immediately bring the plan to 60% funding) and lump sum benefits will be prohibited. If the plan is between 60% and 80% funded, only partial lump sums (generally no more than 50% of a participant's accrued benefit) will be permitted. If a plan is less than 80% funded, benefit increases are prohibited unless immediately paid for or funded to the extent necessary to bring the plan to at least 80% funded status.

Observation: This is an obvious attempt to improve funding by precluding plan sponsors from promising benefits the plan may not be able to afford.

Funding Provisions (Multiemployer Plans)

Amortization Periods

Current law permits multiemployer plans to have amortization periods (*i.e.*, the period of time over which benefits obligations must be funded) of 30 years for past service obligations and actuarial gains and losses and 15 years for net experience gains and losses and funding waivers. Under the new legislation, most amortization periods for multiemployer plans would be reduced to 15 years.

Observation: This means that benefit obligations for multiemployer plans will have to be funded more quickly, which translates into either higher contributions, less or no past service awarded, and/or lower benefit accruals going forward.

Extension of Amortization Periods

Current law permits the IRS to extend the amortization periods for plans in financial distress, upon their application, for up to 10 years. Several multiemployer funds have previously taken advantage of this process to avoid a funding deficiency. However, the IRS has ultimate discretion as to whether to grant the waiver. The new legislation *requires* the IRS to grant a five-year extension if certain requirements are met (and gives the IRS discretion to grant another five-year extension upon request).

Observation: This change provides a way to speed up the grant of some relief for funds that desperately need it, and avoid funding deficiencies for those plans (and mandatory additional contributions – and possibly excise taxes – by contributing employers).

Plans in Endangered or Critical Status

Under current law, multiemployer plans may require additional contributions and/or a reduction in benefits if they are in reorganization status or are insolvent. The new law introduces the concept of "endangered" and "critical" status (so-called "yellow light" and "red light" provisions), which would, in the case of a "yellow light" plan, require the plan to adopt a funding improvement plan to improve the plan's funded status by the end of a "funding improvement period." The plan will be required to provide to the bargaining parties options consistent with the funding improvement plan that either (1) reduce future accruals with no contribution increases or (2) increase contributions with no reductions in future accruals. Plans may also provide other options.

For "red light" plans, the new legislation requires that the plan adopt a rehabilitation plan that requires at least an immediate 5% increase in employer contributions (over and above what is required in the collective bargaining agreement). In subsequent years, this surcharge increases to 10%. This "surcharge" cannot be the basis for any benefit accrual increase. Surcharges cease at the time new collective bargaining agreements are negotiated consistent with the rehabilitation plan. Also, trustees may reduce certain previously accrued benefits. During critical status, benefits may not be increased without certification by the plan actuary that the plan can afford the increases.

Observation: These changes are obviously intended to force greater financial health and prudence on multiemployer plans in general.

Withdrawal Liability "Reforms"

Under current law, there are limits on withdrawal liability in the event of employer liquidation or the sale of all of an employer's assets to an unrelated third party. Those limits are modified under the new legislation.

In addition, under current law there is no "partial cessation" (for purposes of partial withdrawal liability determinations) if work is contracted out to a third party. Under the new legislation, this exception to the "partial cessation" rules will be eliminated if the work is contracted out to a third party that is owned or controlled by the employer.

Under current law, the so-called "free look" provisions (where a plan can adopt rules that permit an employer to contribute to a plan for a relatively brief period of time without triggering withdrawal liability obligations) cannot be applied to construction industry plans. The new law removes this exception from the free look provisions.

Observation: Generally, the legislation attempts to close some "loop holes" in withdrawal liability.

Funding Notice

Under current law, multiemployer plans must provide participants an annual notice of the funded status of the plan. Under the new legislation, this notice requirement is accelerated. In addition, the new legislation extends the requirement to single employer plans. Plans with more than 100 participants will be required to issue a funding notice within 120 days after the end of the plan year. Disclosure must include the plan's year-end assets and liabilities, whether the plan was required to make a "4010 filing" with the PBGC, and the plan's funding percentage.

Hybrid Plans

Under current law, the legality of so-called "hybrid" or cash balance defined benefit plans has been called into question. The new legislation amends ERISA, the Internal Revenue Code and the Age Discrimination in Employment Act to specifically provide that cash balance plans in existence on July 29, 2005, are not age discriminatory if, as of any date, a participant's accrued benefit determined under plan terms would be equal to or greater than the benefit of any similarly situated younger participant. Consequently, cash balance plans are not discriminatory so long as pay and annual interest credits for older workers are not less than pay and annual interest credits for younger workers and so long as the interest credits are not greater than a market rate of return. The new law also requires vesting for cash balance plans after three years.

Observation: This is a welcome relief from the legal uncertainty surrounding cash balance plans created by various court decisions considering whether the design of such plans was age discriminatory.

Kevin L. Wright is a Shareholder in Littler Mendelson's Washington, D.C. office. J. René Toadvine is a Shareholder in the Charlotte office. If you would like further information, please contact your Littler attorney at 1.888.Littler, info@littler.com, Mr. Wright at klwright@littler.com, or Mr. Toadvine at rtoadvine@littler.com.