



Back Door Reversions:

Draining Pension Assets for Severance and Other Corporate Purposes Threatens Retirement Security

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Executive Summary

The use of pension assets to make severance payments during a corporate restructuring is the largest and most widespread “back door reversion” by which some companies are seeking to circumvent the Congressional policy against reverting pension assets for corporate purposes. When pension funds were used to finance hostile takeovers and the mass layoffs that typically followed, in 1990 Congress stopped the practice by imposing a 50 percent excise tax on pension reversions. But today’s “back door reversions” are more insidious. Although ERISA explicitly prohibits the use of qualified pension assets for “layoff benefits,” companies can amend a plan at any time not merely to offer older

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workers enhanced early retirement benefits (by awarding extra years of service credit), but even to offer lump sum severance payments equal to a year's salary or more as part of a corporate restructuring.

The 2006 Pension Protection Act tightened up on this practice somewhat by requiring plan sponsors to pre-fund a plan amendment that increases benefit liabilities to the extent the plan's funding level would fall below 80 percent (after taking account of the new benefit liability). However, as the 2008 stock market meltdown demonstrated, a plan that is only 80 percent funded during a bull market could easily end up below 60 percent funded in a bear market – and in default with the PBGC if the plan sponsor declares bankruptcy. Moreover, any significant reduction below full funding not only leaves all plan participants insecure, it also reduces the ability of the plan to build a surplus that could be used to grant cost-of-living adjustments to longtime retirees, whose fixed monthly benefits erode with inflation, or to offset the cost of retiree health benefits through a Section 420 transfer.

The trend toward distressed companies using employee pension assets to pay severance costs – instead of relying on a restructuring reserve or other corporate assets – is not new to the current financial crisis. Lucent, United Airlines, AT&T, Verizon, Qwest, Federal Express, Delta and Delphi are among the other companies that have tapped pension assets to pay corporate restructuring costs. Some of these companies drained pension assets for severance payments as they spiraled downhill toward bankruptcy and an eventual taxpayer bailout courtesy of the PBGC. Other companies, left under-funded, cut other retiree benefits across the board. And some others, although their plans remained solvent, used up “surplus” assets that could have benefitted the vast majority of plan participants if used instead for cost-of-living adjustments or offset the cost of retiree health care benefits. In the current crisis, General Motors used pension assets to pay for billions in severance payments during 2008 – and ended up with such a dangerous degree of under-funding that in early 2009 the Treasury Department restricted the practice as a condition of the federal bailout loan package.

The most effective way for Congress to protect plan participants (and taxpayers) from unfunded liabilities from severance, layoff or any other benefit increase is simply to increase the target funding level threshold required for unfunded benefit increases and lump sum payouts from the 80 percent level, currently required under the PPA, to 120 percent. Severance or other benefit increases to selected individuals that are not funded should be paid out of the company's operating expenses, not from the pension trust. This would not limit the ability of plan sponsors to enhance benefits. What it does do is require companies to currently fund lump sum payouts or other benefit increases that would otherwise cause the plan to become under-funded or worsen its level of under-funding. Amendments increasing benefits that are collectively bargained or negotiated between a plan sponsor and bona fide union representatives, or in the context of a jointly-trusted Taft-Hartley plan, should be exempted from this more restrictive funding level.



Back Door Reversions:

Draining Pension Assets for Severance and Other Corporate Purposes Threatens Retirement Security

I. Introduction & Background

The stock market crash of 2008 demonstrated just how vulnerable the nation’s pension funds – and the retirement security of millions of retirees – are to market volatility. Corporate pension plans at the nation’s largest companies ended the year underfunded by \$409 billion, with funding levels sufficient to cover only 75 percent of their projected benefit obligations. Just a year earlier, at the top of the bull market, these same S&P 1,500 pension plans were \$60 billion in surplus.¹

Meanwhile, the government’s Pension Benefit Guarantee Corporation, which insures benefits promised by defined-benefit plans, sent urgent Letters of Inquiry in November to Detroit’s Big Three. The PBGC demanded details about the auto makers’ plans to tap their remaining island of solvency – their pension funds – to cover the cost of billions of dollars in severance and early retirement buyout payments. By January the automakers’ pension under-funding had deteriorated to the point that the Treasury Department’s bailout loan program included restrictions on GM’s ability to continue to use pension assets to pay for lump-sum severance payments to terminating workers.² GM used \$2.9 billion in pension assets to make lump sum severance payments during 2008 – and ended the year with a \$12.4 billion deficit (\$20 billion by PBGC calculations).³

“Each of these plans is significantly underfunded,” PBGC Executive Director Charles E.F. Millard stated in January 2009.⁴ According to the PBGC, the three automakers were \$41 billion underfunded at year-end 2008 and had enough money in their pension funds

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to cover only 76% of their pension obligations. The PBGC estimated that GM's plan is \$20 billion, or about 20 percent, underfunded; while Chrysler's is 34 percent under-funded, a \$9 billion shortfall. Millard warned that as many as 1.3 million workers and retirees could see their pension benefits slashed if the companies defaulted and the plans were taken over by the PBGC.⁵ "I've got a retiree club that's absolutely sick about it," Paul Heller, a GM salaried retiree, told the *Detroit Free Press*. "They [management] robbed it blind to pay off the people to get them to leave."⁶

Earlier in 2008, the *Free Press* reported an admission by GM and Chrysler that for the first time in their history, the companies were using pension assets to fund lump sum severance payments, ranging from \$45,000 to \$62,500, that would be paid in addition to workers' accrued retirement benefit. Although Ford had no public comment, its most recent annual 10-K filing with the SEC indicates that the company charged \$2.44 billion to its U.S. pension plans in 2007 for "amendments" and "separation programs" related to restructuring.⁷ After taking billions out of its pension funds to pay for restructuring, Ford reported in a January, 2009 earnings release that the stock market downturn had left the company with a \$4.1 billion pension deficit at year-end 2008.⁸

In his November 28 letter to General Motors, the PBGC Executive Director stated that "GM's public statements suggest that the present value of these new [attrition program] obligations, including lump sums, exceeds \$5 billion."⁹ In his letter to Ford's CFO, Millard noted:

By their very nature, benefits under these new attrition programs are not pre-funded, were not taken into account in previous funding determinations, may increase future funding requirements and may not be fully guaranteed under ERISA. These factors increase the risk of loss to plan participants and to the PBGC in the event of plan failure.¹⁰

PBGC's Millard later told the *Wall Street Journal* that "we see a continued use of the pension plans for other corporate purposes, including restructuring, and we worry that if it continues, the scenario could be much worse." The PBGC is concerned that "with each passing year, the cost of funding buyouts will pose a greater threat to the pension funds."¹¹ Since the PBGC reported a deficit of \$11.15 billion last September, before the worst of the stock market meltdown, the threat is to taxpayers as well. A default by the Big Three alone could more than triple the agency's deficit.

"We're taking advantage of the overfunded status [of the pension plan], and it certainly helps with regard to not having to tap into corporate cash," GM Spokesman Dan Flores told the *Free Press* in March, 2008, before the stock market meltdown. "However they choose to take it [the severance], whether it is in cash or annuity or a rollover, it is coming out of the pension fund," he explained.¹²

Gerald Meyers, the former Chairman of American Motors and now professor of business at University of Michigan, was among those alarmed at how the trend toward tapping pension assets to pay corporate restructuring costs endangered pension security. "I disagree with

doing that [using pension assets for severance pay]. . . . The [Chrysler] fund is probably overfunded [only] because of the over-inflated value of the stock or securities that have been invested. . . . The pension fund value fluctuates. Now that the stock market and the real estate market is going down, it's not unlikely it will be underfunded in short order."¹³

According to SEC filings, GM claimed its pension funds were overfunded by \$18.8 billion at the end of 2007. However, the combination of withdrawing billions for severance payments and the market downturn more than erased the surplus. GM reported a \$1.8 billion shortfall as of October 31, 2008, a deficit that had swollen far larger by February 2009.¹⁴

A sad irony, of course, is that the catalyzing scandal that led to the enactment of ERISA and the creation of the PBGC was the 1963 bankruptcy of the Studebaker auto company in South Bend, Indiana, which left 4,000 workers with only 15 percent of their promised pensions and another 2,900 with zero. As it spiraled down, Studebaker drained its already under-funded pension assets attempting to offset other costs and remain in business.¹⁵

Is this history repeating itself? Conventional wisdom is that ERISA's funding and fiduciary requirements are intended to prevent companies from using plan assets to pay corporate operating expenses. Is this a return to "reversions" – the removal of surplus assets from pension funds? When pension funds were used to finance hostile takeovers and the mass layoffs that typically followed, Congress stopped the practice by imposing a 50 percent excise tax on pension reversions in 1990.

But today's "back door reversions" are more insidious. Although ERISA explicitly limits the use of pension plans for "layoff benefits,"¹⁶ companies can amend a plan at any time not merely to offer older workers enhanced early retirement benefits (by awarding extra years of service credit), but even to offer lump sum severance payments equal to a year's salary or more as part of a corporate restructuring. The 2006 Pension Protection Act tightened up on this practice somewhat by requiring companies to pre-fund a plan amendment that increases benefit liabilities to the extent the plan's funding level would fall below 80 percent (after taking account of the new benefit liability). However, as we've seen in recent months, a plan that is only 80 percent funded during a bull market could easily end up below 60 percent funded in a bear market – and in default with the PBGC if the plan sponsor declares bankruptcy. The risk of pension under-funding is greater than it appears since most plans are underestimating improvements in longevity among plan participants¹⁷ and because of the PBGC's experience that "termination liability" is consistently far greater than the pension liability projections companies are permitted to use as ongoing concerns.

The concluding section of this paper recommends that this funding level threshold for plan amendments that increase an unfunded liability be raised from 80 to 120 percent (the same level of surplus required for section 420 transfers from surplus pension assets into a retiree health trust) and that, at a minimum, no new unfunded lump sum payment obligations should be permitted if it results in the plan falling below full funding.

A Broader Trend Toward Back Door Reversions

Emboldened by the government's failure to put reasonable limits on the ability of companies to shift corporate restructuring costs onto the pension plans, pension consultants and lobbyists have been pushing other strategies to get access to pension plan assets. While the use of pension assets to pay for corporate restructuring is the largest and most widespread "back door reversion," there are a number of other means by which some companies are seeking to circumvent the Congressional policy against reversions:

- ***Qserp Transfers:*** As the *Wall Street Journal* revealed last year, a growing number of companies are abusing an ERISA tax loophole to "move hundreds of millions of dollars in obligations for executive benefits into rank-and-file pension plans. This lets companies capture tax breaks for pensions of regular workers and use them to pay for executives' supplemental benefits and compensation."¹⁸ The *Journal* investigation concluded that "the maneuver, besides being a dubious use of tax law, risks harming regular workers. **It can drain assets from pension plans and make them more likely to fail.**"¹⁹
- ***Section 420(h) End Runs:*** Last year General Motors engineered a brazen abuse of the one major exception that Congress created to the excise tax on pension asset reversions, so that companies more than 120 percent funded could transfer the surplus to offset company expenditures on retiree health benefits. GM announced that it would cancel retiree health coverage (for retirees 65 and older), as of January 1, 2009) and to compensate increase retirees' pension benefit by \$300 per month. This maneuver cost the GM plan \$8.7 billion in new liabilities – and accounted for the majority of the plan's reported \$12.4 billion shortfall as of year-end 2008.²⁰ Since GM's management did this as two separate transactions, it appears technically legal. Nevertheless, the effect is to use pension plan assets to pay for retiree health care obligations, while avoiding the "maintenance of benefit" conditions imposed on similar multi-year transfers under the 2006 Pension Protection Act amendments to ERISA Section 420(h). Under PPA, a company can only make a "big bang" 420 transfer if it commits to maintain its health cost contributions at the same level for the length of the transfer period plus four years. GM substituted a pension increase for its health contribution while dodging this commitment entirely.
- ***Selling Pension Plan Assets to Hedge Funds:*** In late 2007, at the top of the last bull market, Wall Street firms sought regulatory approval for an idea in financial engineering first proposed by Bear Stearns: Corporations that froze their pension plans (so that no new benefit liabilities accrued) would sell the assets to hedge funds and other investment firms, which would pay a premium for the option value of "running the money" more aggressively than stodgy old pension plan administrators would believe is prudent. In the past, only employers could be plan sponsors (in partnership with unions in the case of Taft-Hartley Act plans); and a plan could be terminated, ending the employer's liability for vested benefits, but only if the plan had assets sufficient to fully-fund its benefit obligations by purchasing insurance company annuities guaranteed against default.²¹ Although the Bush Treasury

Department concluded that selling plan assets and liabilities to an investment firm with no employment relationship to plan participants would violate current law, it suggested how Congress could amend ERISA to allow the practice.²²

This white paper focuses on the abuse of pension trusts to pay severance costs because that is by far the largest and most immediate threat to the retirement security of millions of retirees. Unfortunately, the trend toward distressed companies using employee pension assets to pay severance costs – instead of relying on a restructuring reserve or other corporate assets – is not new to the current financial crisis. Lucent, United Airlines, AT&T, Verizon, Qwest, Federal Express, Delta and Delphi are among the other companies that have tapped pension assets to pay corporate restructuring costs – in some cases doing so on the way to bankruptcy and/or a federal pension bailout courtesy of the PBGC.

For example, in 2001 and 2002 a struggling Lucent Technologies charged \$2.2 *billion* in lump sum “termination benefits” to its various employee pension plans. As the *Wall Street Journal* reported, “Lucent used its pension fund for severance. For example, in 2001, to induce older employees to take early retirement, Lucent offered them beefed-up pensions. Doing so raised Lucent’s pension liability by \$1.95 billion.”²³ The Lucent Retirees Organization opposed what it called a “pension raid,” but to no avail.

Although Lucent’s pension plans were substantially overfunded at the outset, the combination of severance payments and the stock market downturn left the management and salaried workers’ plan with a \$2.6 billion deficit by 2003.²⁴ The company also teetered on bankruptcy during this period, shedding 80 percent of its active workforce. Its stock price fell from \$82 to less than \$1 in late 2002. In early 2003 Lucent eliminated its traditional death benefit, effectively cutting benefits in its rank-and-file management and salaried workers plan by \$400 million. Ultimately, the stock market recovered and struggling Lucent was acquired by Alcatel. However, had Lucent declared bankruptcy and dumped its pension plan on the PBGC, both retirees and taxpayers would have been the losers. (See the further discussion of Lucent below, on page 10.)

Powerful Incentives

It is widely recognized that companies use severance pay to encourage older, more expensive workers to leave the payroll, particularly when layoffs are inevitable. In exchange for a buyout, older workers in particular are typically required to sign a waiver of claims under the Age Discrimination in Employment Act (ADEA). To pay these separation costs, plan sponsors have powerful incentives to tap pension assets, rather than corporate assets, whenever possible. A recent Towers Perrin white paper (“Managing Pension Surplus: A New Playbook for a New Era”) makes this explicit:

Pension surplus can be used to enhance retirement benefits for existing participants in lieu of other reward elements, such as ... severance and retiree medical benefits. While the value of the additional pension benefits would reduce the surplus, using excess surplus to fund additional retirement plan benefits can ... free up working capital for use elsewhere in the organization.²⁵

Towers Perrin also advises clients that paying severance and other ancillary benefit payments from qualified pension assets “provide distinct tax advantages, such as the ability to roll over certain [lump sum] distributions to IRAs.”²⁶ Indeed, last year GM cited the fact that many older workers objected to paying income tax on their lump sum severance payments as one motivation for making the payment through the pension trust instead.²⁷ Under the tax code, income taxes on lump sum pension payouts can be deferred by rolling it over into an Individual Retirement Account, whereas the same payment from corporate assets would be treated as ordinary income. Pension payouts also escape payroll taxes, both FICA (Social Security and Medicare) and FUTA (federal and state unemployment taxes), which saves the company more than 8 percent of the payout compared to using corporate assets. Younger workers who are not yet eligible to receive pension benefits typically receive taxable severance payments from corporate assets (although their severance is also exempt from FICA and FUTA if received while they are eligible for state unemployment compensation).

“There’s a trend toward using pension assets for that purpose [severance],” Bob Walter, a principal at Buck Consultants told *Pensions & Investments* magazine. “We’ve seen quite a bit of it among our clients and other organizations.” He noted that although the tax code and old IRS regulations suggest that severance should not be paid from pension assets, “that can be worked around by listing severance as ‘supplemental pension credits,’ ‘transitional pension credits’ or ‘shutdown benefits,’” according to *P&I*.²⁸

Finally, and most worrisome, the strongest incentive to pay attrition costs from pension assets occurs at companies in financial distress. As GM and Chrysler spokesmen conceded, before 2008 the big automakers never resorted to charging billions of dollars in restructuring costs to their pension trusts; but as bank robber Willy Sutton famously stated, that’s where the money is. Similarly, other massive “back door reversions” to offset severance costs occurred primarily at companies – such as Lucent, Delta, Delphi, United Airlines and Consolidated Freightways – during times they were in a downward spiral. The results were disastrous for retirees, even if it allowed the companies executives to hang onto their own levels of compensation a few months or years longer.

II. The Growing Problem of Paying Severance from Pension Assets

It’s critical to keep in mind that pension plan assets represent the financial obligations of plan sponsors to their workers and retirees for earned benefits. Plan sponsors are required by ERISA to pre-fund their promises in a legally-separate trust and to manage the assets for the “exclusive benefit” of plan participants. Although a fully-funded pension fund can be terminated – and any surplus reverted after the purchase of annuities to guarantee the payment of vested benefits for all participants – while in operation even the assets in a plan frozen to new benefit accruals cannot be used to pay for corporate operating expenses.

Despite these general strictures, and as explained in the next section, ERISA and its corresponding regulations are ambiguous about the extent to which plan sponsors can use qualified pension plan assets to make lump sum or other severance payments to terminating

plan participants on top of their regular accrued benefits. Traditionally, large firms, particularly in cyclical manufacturing industries, maintain a restructuring reserve fund to pay layoff benefits and severance during hard times. Many firms also establish separate severance plans that are governed by ERISA, but not subject to funding, vesting and anti-cutback rules. In both cases, restructuring reserves and severance plans use *general* corporate assets to make severance payments – not pension plan assets. However, as noted above, thanks to ERISA’s ambiguity and lax regulatory enforcement, an increasing number of distressed firms, as well as firms wanting to offset current operating expense to bolster short-term earnings reports, are substituting pension fund assets for general assets when it comes time to finance a corporate downsizing.

Reducing Funding Levels Harms Retirees and Threatens Taxpayers

“In ongoing, health companies, an increase in the amount of underfunding can affect how secure workers feel about their pension benefits, even when the actual risk of loss maybe low in the near-term,” Steven Kandarian, former Executive Director of the PBGC, told Congress in testimony back in 2003.²⁹ He also warned of the “moral hazard” of funding rules that permitted plan sponsors to substitute benefit increases for wage increases, or to otherwise increase pension liabilities, or stop making pension contributions, during the months or years before a distressed company declared bankruptcy and defaulted ultimately on its pension obligations. For example, under current law new severance benefit liabilities can be incurred via plan amendment, and not funded, as long as the plan remains at least 80 percent funded. While some workers might benefit in the short run from a lump sum payout or benefit increase, a far larger number of plan participants could in the longer term lose future benefit accruals and/or lose vested benefits entirely if they exceeded the level guaranteed by PBGC.

Retirees are, of course, the primary victims of “backdoor reversions” that diminish plan assets. A downward spiral into bankruptcy is the worst case scenario. Since PBGC only insures benefits up to a maximum \$54,000 at normal retirement age – and pays reduced early retirement benefits, depending on the retiree’s age – a default termination can cause a permanent loss of earned benefits for retirees. But even when a company and plan continues on after reducing its funding level to pay for severance benefits, it becomes far more vulnerable to a market downturn – and may react by cutting benefits for all retirees. As described just below in more detail, this is exactly what happened at Lucent Technologies and at Qwest Communications. In both cases, the companies were downsizing after the tech stock bubble burst; they used huge withdrawals of pension assets to pay lump sum severance benefits; and then, with their plans dropping below full funding and a determination to avoid making pension contributions, they cut whatever pension benefits they believed they legally could (Lucent eliminating the retiree death benefit and Qwest cutting retiree life insurance).

Even if a plan is fully-funded – and severance payments are made using “surplus” assets – there is risk to the plan and harm to retirees. As any actuary will concur, a “fully funded” plan today – particularly during good economic times – could just as easily have large unfunded obligations tomorrow if either financial markets *or* the plan sponsor’s own

business prospects worsen. Plan fiduciaries have little control over these external shocks – and like any prudent entity can best prepare to cover future obligations by maintaining a “surplus.” Second, what ERISA deems to be full funding is *not* remotely enough assets to cover all obligations on a termination basis. For one thing, some companies are not valuing all of their assets (such as private equity and corporate bonds) at current market prices. More broadly, the PBGC’s consistent experience is that at termination plans prove to be about 20 percent less well funded than they appear under ERISA’s rules for ongoing plans. Both the PBGC and the GAO have for years recommended that Congress base minimum funding rules on plan termination liabilities rather than on current liabilities (i.e., projected benefit obligations).³⁰ As a number of the company examples just below demonstrate, allowing a plan sponsor to drain an already-underfunded plan to pay for corporate restructuring costs can just increase the ultimate cost to taxpayers if the employer defaults and dumps the plan’s now larger liabilities onto the PBGC.

Finally, although the ultimate ownership of plan assets has been an issue of considerable controversy, there is no question that under ERISA the assets in an ongoing pension trust must be managed for the “exclusive benefit” of plan participants. To the extent that a plan reaches 120 or 130 percent funding levels or greater (PPA now permits deductions for contributions up to 150 percent funding), any use of “surplus” assets should be of benefit to the majority of plan participants. Increasingly, retirees are living longer on fixed incomes that decline in purchasing power each year due to inflation – particularly medical inflation, which has run 2 to 3 percentage points higher than general price inflation for many years. Granting a periodic cost-of-living adjustment can help offset this steady decline in the real economic value of the defined benefit.

Similarly, both fixed-income retirees and the corporation benefit when pension surplus can be used to fund retiree health benefits through a co-called “420 transfer,” named for the ERISA tax code section authorizing it. The PPA now permits firms to transfer assets in excess of 120 percent of pension liabilities to cover retiree medical benefits for up to 10 years. “This ‘big bang’ 420 transfer can utilize a very significant portion of any surplus and enhance corporate cash flow,” according to a Towers Perrin white paper. Thus, even a true “surplus” can usually be used to benefit the majority of participants and not only a small group.

Examples of Companies Making Reversions to Pay Severance

As noted above, the Big Three automakers may well be draining pension assets to pay restructuring costs for the first time in their history, but some other major U.S. firms have been pushing the envelope of what’s allowable since at least the period just after the stock market downturn of 2001-02.

As the examples sketched below indicate, the circumstances vary considerably. Most troubling are companies such as GM, Delphi, Lucent, Qwest, United and Delta Airlines and others that began siphoning off pension assets to pay for downsizing in desperation. These companies were in a downward spiral and – in the case of United Airlines, the Delta Pilots fund, Consolidated Freightways, Bethlehem Steel and Polaroid – left the taxpayers, via

PBGC, holding the larger liabilities and diminished assets. In all of these cases large numbers of early retirees and high-wage retirees lost earned benefits, since PBGC guarantees on average only 80 percent of the vested benefits that plans would have paid had they not defaulted.

Other companies, such as Lucent and Qwest, spiraled dangerously close to bankruptcy but managed to find a way up. These two companies are instructive because of the direct damage to non-represented retirees: After paying out more than \$2 billion and \$400 million, respectively, in pension assets for lump sum severance payments early this decade, the Lucent and Qwest plans turned from surplus to deficit – and management at both companies, rather than make a contribution to the plan, reacted by cutting and threatening to cut, respectively, the death benefit that retirees had considered an earned benefit and had counted on for decades.

Companies such as Verizon represent perhaps the most benign scenario, yet still a negative one for retirement security. These are companies that appear to pay downsizing costs using pension assets only when the plan is more than fully-funded. However, as explained just above, a plan that is “fully-funded” today (at or just above 100 percent of its projected benefit obligation under PPA), may be substantially under-funded within months if the markets head south. As we’ve seen, Ford and GM tapped billions in “surplus” pension assets to pay severance costs during 2007 and early 2008 – only to end up with large pension shortfalls by the end of 2008. Moreover, even if plan sponsors legally have discretion over the use of plan “surplus,” their fiduciary duty – and federal policy – ought to steer them toward tapping that surplus for a purpose that benefits participants, such as granting an occasional cost-of-living adjustment to longtime retirees, or making a section 420(h) transfer to offset corporate costs for retiree health benefits. These uses of plan assets are clearly within the legislative intent of Congress, whereas using the pension plan as a corporate restructuring reserve is not.

Finally, policymakers should be aware that it is nearly impossible for the typical retiree, or even most reporters, to figure out what share of a company’s restructuring costs are drawn from pension plan assets. In some cases, such as at AT&T in 2002, it comes to light because a union (in that case CWA) is in a position to find out and blows the whistle in public. However, as best we can tell it is not clearly disclosed in Form 5500 filings at the Department of Labor (which, in any event, are filed far too long afterward); and even SEC filings rarely make clear distinctions about the source of the funds used to pay severance. The companies below typically did make that clear in Notes to Consolidated Financial Statements in their Annual Reports filed on Form 10-K (and available to citizens through the SEC’s free EDGAR system online). But there were many other companies, particularly those that later declared bankruptcy and dumped their pension liabilities onto the PBGC, where there was little clear disclosure even in SEC filings. Certainly plan participants should be informed – and Congress should seriously consider a requirement to add a disclosure of such payments to the Summary Plan Document that is required to be sent periodically to participants.

Qwest Communications

The Labor Department conducted a nearly three-year investigation in connection with Qwest paying more than \$400 million of severance benefits from rank-and-file pension plan assets between 2000 and 2003. Although a Labor Department investigator told Qwest's director of compensation and benefits, Felicity O'Herron, that the company would likely be charged with violations of ERISA, no charges were ultimately filed, according to the *Rocky Mountain News*.³¹ Qwest reportedly made as much as \$480 million in severance payments out of the pension fund to more than 12,000 employees, including top managers, between August 2000 and June 2003 as part of a downsizing.

Although Qwest reported a \$4.1 billion pension surplus at the end of 2000, by year-end 2002 Qwest's pension plan was underfunded by \$314 million. The struggling company later threatened to reduce its pension obligations by cutting retirees' death benefit and also reduced life insurance obligations from one year's pay to a flat \$10,000. The company hasn't given longtime retirees a COLA since 1996.³²

United Airlines

United is an example of a company that amended its pension plan to pay substantial amounts for severance payments just prior bankruptcy – and, ultimately, lost its employees and retirees more than \$3 billion of uninsured benefits when it turned its grossly underfunded plan over to the PBGC. Reeling from the travel slump after 9/11, according to SEC filings, during 2002 United increased its pension obligations by \$544 million to help fund buyouts for terminating workers. Combined with lower investment returns and lower interest rates (which raise projected benefit obligations), United's pension plan ended 2002 underfunded by \$4.7 billion.³³ United declared bankruptcy in December 2002. According to Bradley Belt, then PBGC Executive Director, United continued to increase benefits for separation payments in 2002, just prior to declaring bankruptcy, even though the financial health of the company and its pension plans had been steadily deteriorating since 2000.³⁴

In 2005 “the bankrupt airline dumped nearly \$10 billion in pension obligations on the federal government, making it the largest corporate pension default in U.S. history,” the *New York Times* reported.³⁵ In fact, as is typically the case, United's termination deficit was twice as large as it reported in 2003. While the carrier was able to emerge from bankruptcy by terminating plans that covered 120,000 active and retired workers, by then its plan was \$9.8 billion underfunded on a termination basis. Because of its guarantee limits, the PBGC covered only \$6.6 billion, meaning United's retirees ultimately paid the price. Indeed, one of the most devastating reductions in benefits occurs in the airline industry because pilots must retire at age 60 and at that age the PBGC will only pay 72 percent of the benefit due at ‘normal’ retirement age (age 65).

Lucent Technologies

Lucent provides a striking example of how using pension assets to pay lump sum severance payments, coinciding with a stock market downturn, pushed a distressed company to cut benefits soon after for *all* non-represented retirees. In 2001 and 2002 Lucent charged \$2.2

billion in lump sum “termination benefits” to its rank-and-file pension plans. Although Lucent’s plans (both management and non-management) reported a cumulative \$20 billion surplus at the beginning of this period, by 2002 the management plan had become under-funded due to the combination of the attrition costs, 401(h) transfers for health care payments, and the dot.com stock market downturn. The chart immediately below details how Lucent’s management plan – the Lucent Retiree Income Plan – slid rapidly from healthy surplus to deficit.³⁶

Reduction in Lucent Management Pension Plan Assets (LRIP) in Millions			
<i>Abstracted from Lucent Technologies 10-K SEC filings for FY 2001, 2002 and 2003</i>			
Item	FY 2001	FY 2002	Total
Loss on Plan Assets	\$3,429	\$1,241	\$4,670
Transfer to 401 health account	\$301	\$389	\$690
Plan amendments for “termination benefits”	\$383	\$37	\$420
Totals	\$4,113	\$1,667	\$5,780

With the company in a downward spiral – and its pension plans now under-funded – Lucent decided to avoid making a contribution by cutting the death benefit that for decades had provided one year’s pay to retirees’ surviving spouses and dependent children. In early 2003 Lucent eliminated its traditional death benefit paid from its pension fund, effectively cutting benefits in its rank-and-file management and salaried workers plan by \$400 million. In March 2003 retirees received the following explanation from Lucent CEO Pat Russo:

[W]e have made the very difficult decision to eliminate the death benefit for management retirees...Eliminating the death benefit reduces the management pension plan’s funding obligations by about \$400 million.. Most important, it reduces the likelihood that we would have to make a contribution in the near future.³⁷

Delphi Corporation

Delphi charged \$1.9 billion in lump sum severance and other “special attrition program” costs to its pension plan in 2006, even as the plan became increasingly under-funded and the bankrupt company claimed it could not afford to make contributions to it.³⁸ Delphi’s pension plan covers more than 75,000 active and retired workers and was roughly \$2.5 billion under-funded on a termination basis last year, according to the PBGC.³⁹ Under bankruptcy protection since 2005, the company has been able to avoid making contributions to its plans and said it had no way to pay the \$2.4 billion in contributions due by late 2008. PBGC Executive Director Millard said last August, before the stock market downturn, that since the company has diminished its pension assets and failed to make contributions, “the hit to the PBGC could well be in excess of \$2.5 billion.”⁴⁰ In February,

2009, a U.S. bankruptcy judge granted Delphi's request to cancel retiree health care and life insurance benefits earned over decades by 15,000 salaried retirees.⁴¹

Delta Airlines

Shortly after the terrorist attacks of 2001, already struggling Delta Airlines implemented a mass layoff affecting nearly 12,000 employees. According to Delta SEC filings, in 2001 alone the company used pension plan assets to pay out \$185 million in "special termination benefits" and adopted enhanced early retirement benefit amendments increased plan liabilities an additional \$262 million.⁴² In January 2007, Delta turned its Pilots' pension plan over to the PBGC. The plan was underfunded by about \$3 billion, with \$1.7 billion in assets and \$4.7 billion in benefit obligations (35 percent funded). Because of benefit guarantee limits, the pilots lost a large portion of their earned benefits. The PBGC became liable for about \$920 million, its sixth-largest loss up to that time.⁴³

Anheuser-Busch

Within weeks after announcing it had agreed to be acquired by InBev SA, the Belgian-based beermaker, Anheuser-Busch revealed an "enhanced retirement program" that will pay 1,300 workers 55 and older an early retirement buyout that includes severance pay worth up to 12 months salary. The company said the enhanced retirement and severance costs would be between \$400 and \$525 million, with at least two-thirds paid from the company's pension plan, according to new reports and a preliminary SEC filing.⁴⁴

AT&T Inc.

In March, 2002, after harsh public criticism from a union representing 28,000 of its workers, AT&T said it would not in fact use the \$4 billion surplus in the company's pension plan for represented employees to make severance payments to thousands of employees expected to be laid off. Ralph Maly, Vice President of the Communications Workers of America (CWA), called AT&T's plan to use pension surplus for severance "a raid on our members' pension fund, enabling the company to push downsizing costs onto the workers."⁴⁵ The company backed down and negotiations over the layoffs proceeded. What CWA did not mention, or perhaps did not know, was that AT&T had already taken more than \$1 billion from the pension plan for its management and salaried employees to pay severance over the preceding two years. Buried in a footnote to its financial statements in SEC filings, AT&T reported that in October 2000:

[W]e implemented a voluntary enhanced pension and retirement program (EPR) to reduce the number of management employees. . . . Enhanced pension benefits related to this program were recognized as an expense of \$1.1 billion in 2000. . . . We anticipate additional lump sum payments will be made in 2002 in connection with the force reductions . . .⁴⁶

Verizon Communications

Verizon Communications reported that up to \$2 billion was removed from its pension fund for severances in 2002: “Total pension, benefit and other costs related to severances were \$2,010 million ... in 2002, primarily in connection with the separation of approximately 8,000 employees.”⁴⁷ Although Verizon’s pension plan remains healthy, retirees have long complained that the company has not granted a cost-of-living adjustment to longtime retirees for more than decade.

III. ERISA: The Law, the Loopholes, and How to Close Them

Although ERISA was never intended to permit the use of pension assets, in place of corporate assets, to pay lump sum and other severance benefits, some large and distressed companies have become increasingly bold in exploiting loopholes in the law that allow plan amendments increasing benefits in general for selected subgroups of plan participants. As *Wall Street Journal* reporters Ellen Schultze and Theo Francis have revealed in front page investigative reports, companies exploit the ambiguity of ERISA to adopt plan amendments that transfer liabilities for supplemental, nonqualified senior executive (SERP) liabilities onto the rank-and-file (tax-qualified) plan whenever the non-discrimination formula can be manipulated to arguably permit it.⁴⁸ In a profile of Lucent, they also were among the first to reveal the practice of some companies forsaking the traditional mechanisms of a corporate restructuring reserve, or of a separately constituted ERISA welfare plan for severance benefits, to instead draw down billions of dollars in qualified pension assets to make lump sum severance payments.

This section explores both the legal loophole and the practices of a sample of distressed companies in more detail.

The Law and the Loopholes

Top ERISA regulators at both Treasury and the Department of Labor, interviewed for this paper, agreed that although Congress clearly did not intend to allow companies to adopt ad hoc, unfunded amendments to qualified pension plans for the purpose of making severance payments to terminating employees – and particularly not lump sum payments unrelated to the plan’s accrued benefit formulas – neither does ERISA specifically prohibit the practice. Plan amendments that increase benefits are allowed at any time, limited mainly by the funding rules (e.g., under PPA, an amendment that would diminish plan funding below 80 percent be funded to that degree) and anti-discrimination tests (to prevent grossly disproportionate payouts to the most highly-compensated employees).

The use of surplus plan assets to pay corporate restructuring costs have become increasingly common only since a 1999 U.S. Supreme Court decision that weakened ERISA’s fiduciary safeguards concerning the allowable uses of plan assets. In *Hughes Aircraft Company v. Jacobson* the Supreme Court reversed the Ninth Circuit Court of Appeals, ruling that Hughes, the plan sponsor, did not violate ERISA when it amended its pension plan to divert surplus pension assets to fund an early retirement program and a new

pension benefit structure for its employees.⁴⁹ Plan participants argued that Hughes violated its fiduciary duties under ERISA, which requires that plan assets be managed for the “exclusive benefit” of plan participants. The key holding made by the Court was that the plan sponsor was not acting in a fiduciary role. The Supreme Court stated that “as long as an amendment does not violate a specific provision of ERISA, the act of amending a pension plan does not trigger ERISA’s fiduciary provisions.”⁵⁰ Subsequently, corporate ERISA counsel have used the *Hughes* rationale to justify their position that a corporation's use of surplus pension assets to fund severance or special retirement payments is lawful except as specifically limited by ERISA. In fact, this was the sole legal basis used by Qwest, in response to the Department of Labor investigation noted above, after it used its pension surplus to pay special termination payments to thousands of employers during 2000 through 2003.

The problem of large ad hoc, unfunded severance payments has been addressed to a modest degree in a 2007 Notice and request for comment issued by the Treasury and IRS.⁵¹ Although the Notice lays dormant (since staff have been preoccupied with drafting regulations to implement the PPA), it could lead to a notice of proposed regulations limiting the ability of plan sponsors to make unlimited severance payments to select employees merely by adopting an ad hoc plan amendment. Unfortunately, according Treasury Department officials, the staff (under the control of Bush administration appointees) was considering limits on the relative size of payments to individuals, to prevent egregious abuse, but not general restrictions on the ability of companies to amend plans to make lump sum severance payments.

The Treasury regulations governing ERISA appear to prohibit the use of ad hoc amendments to pay severance – or any other “layoff benefit” – from qualified plan assets. The 2007 IRS Notice begins by citing the applicable ERISA tax code regulations that describe the nature of the benefits permitted to be provided in qualified DB plans under Section 401(a):

Under § 1.01-1(b)(1)(i), a qualified pension plan must be established and maintained by an employer primarily to provide systematically for the payment of definitely determinable benefits for employees over a period of years, usually for life, after retirement.

Retirement benefits in a qualified defined benefit plan usually are measured by, and based on, factors such as years of service and compensation. A qualified defined benefit plan . . . also may provide certain non-retirement benefits, such as disability benefits and incidental death benefits. ***Under § 1.401-1(b)(1)(i), a qualified pension plan is not permitted to provide for the payment of benefits not customarily included in a pension plan, such as layoff benefits.***⁵²

Indeed, these ERISA regulations governing the tax qualification of defined-benefit pension plans emphasize that permissible benefits should be retirement-type benefits that are “definitely determinable” and therefore subject to adequate pre-funding. The text of the Section 401(a) regulation described in the Treasury Notice likewise states:

However, a plan is not a pension plan if it provides for the payment of benefits not customarily included in a pension plan *such as layoff benefits* or benefits for sickness, accident, hospitalization, or medical expenses . . .⁵³

This does not preclude employers from establishing a *separate* welfare plan to pay severance or layoff benefits or, alternatively, adopting and at least partially pre-funding promises to pay plant shutdown benefits as an ancillary benefit. However, neither of these two permissible alternatives contemplates draining DB plan assets by means of the sort of ad hoc, lump sum severance-type benefits that companies such as Lucent, Qwest and, most recently, GM and Chrysler have adopted by plan amendment.

First, ERISA regulations promulgated by the Department of Labor specify ‘safe harbor’ rules for the creation of a separate welfare plan to provide severance-type benefits which is not subject to ERISA pre-funding, vesting and anti-cutback requirements. Under Labor Code regulation § 2510-3.2(b), governing “severance pay plans,” an employer can establish a such a plan – and not fund it – provided, among other criteria, provided that its purpose is the “payment of severance benefits o account of the termination of an employee’s service” and “not contingent, directly or indirectly, on the employee’s retiring.”⁵⁴

Second, under I.R.C. Section 411(d), ERISA’s anti-cutback rules, a qualified pension plan can provide certain specified ancillary benefits that are not retirement-type benefits, and therefore “are not protected from reduction or elimination under § 411(d)(6)(B).”⁵⁵ The corresponding Treasury regulation defines the term “ancillary benefit” as including:

(6) a plant shutdown benefit or other similar benefit in a defined benefit plan that does not continue past retirement age and does not affect the payment of the accrued benefit, but only to the extent that such plan shutdown benefit or other similar benefit is permitted in a qualified pension plan.⁵⁶

Top regulatory counsels at Treasury, the PBGC and the Department of Labor agreed that ERISA regulations are very unclear about the extent to which benefits conditioned on the termination of employment can be paid from qualified pension plan assets. Plan sponsors argue that while the prohibition on “lay-off benefits” might conceivably limit a plan from promising severance payouts entirely unrelated to retirement, that “plant shutdown” benefits are permitted and nothing in ERISA explicitly limits a plan amendment that increases benefit and is not characterized as being solely contingent on non-retirement termination of service.

Nevertheless, it’s clear that some companies are abusing ERISA’s lack of clarity on this issue – and thereby endangering the benefit security of all other plan participants. In its Notice 2007-14, the Treasury Department states that it has:

become concerned that certain qualified defined benefit plans may include nontraditional benefits that are not subject to the protections of § 411 and other qualification rules of § 401(a). Examples include (1) **benefits that are payable**

only upon the involuntary termination of an employee or in other limited circumstances that are unrelated to retirement; . . .⁵⁷

The Treasury Notice seemed particularly concerned about limiting severance payments contingent on involuntary termination:

Benefits payable only upon an employee's involuntary separation from service . . . may not be among the type of benefits that are intended to receive the tax benefits generally applicable to qualified plan benefits.⁵⁸

Despite the apparent intent of the law to limit the payment of ad hoc severance or lay-off benefits from qualified pension plan assets, since ERISA's adoption there has been relatively little controversy around the practice of companies using *surplus* plan assets to offer "window benefits," in the context of a voluntary buyout, that allow older workers to qualify for immediate payment of early retirement benefits – or to enhance the formula for early retirement benefits. While these traditional "window" benefits would diminish plan over-funding, they were typically modest and not commonly used by plans in deficit.

Far more troubling, at least to the PBGC and to retiree protection advocates, is the sort of practice described above whereby liabilities for corporate restructuring costs – or for executive Qserp benefits – are transferred to rank-and-file plans that are not even "fully" funded. At a minimum, it is this practice that the reforms proposed below address. (Note, as explained above, even a plan fully funded on a going-forward basis is likely to be underfunded on a termination basis – and in any event subject to downdrafts in financial markets.)

The Legislative Change Needed

Ultimately, the primary danger of giving plan sponsors unlimited discretion to adopt ad hoc plan amendments to pay severance or related restructuring costs from pension plan assets is funding. A virtual blank check to diminish plan funding levels to offset what should be a corporate operating expense is a "moral hazard" with a two-fold impact:

First, it endangers the benefit security of all plan participants, including even those receiving the lump sum or other buyout bonus. In the worst case scenario, if the company is distressed and later slides into bankruptcy, many early retirees and higher-income and/or long-service retirees could lose a substantial portion of their benefits not guaranteed by PBGC (which only replaces 80 percent of accrued benefits on average in plans it takes over). Even in the most benign scenario, where a financially healthy company uses up the plans "surplus" and funding levels end up at 90 to 100 percent, retirees are still harmed. A subsequent market downturn could more easily push funding levels down to dangerous levels. Recall that last fall's market crash by itself pushed S&P 1500 firms with DB plans from 104 percent to 75 percent funding, on average. Moreover, even if the plan is left fully funded, the surplus is no longer available to help the company fund its retiree health benefit promises (under Section 420) and/or to pay periodic COLAs that can help offset the

inflation's diminution of real benefit levels, a problem that is growing worse as retirees live longer on average.

Second, the "moral hazard" endangers taxpayers and the stability of the federal pension guarantee system. Even before the recent stock market crash, taxpayers were on the hook for a PBGC actuarial deficit that exceeded \$11 billion. When the agency sent its formal Letters of Inquiry to the Big Three automakers, described above, it warned that the failure of General Motors by itself could double the PBGC's current deficit due to the combined impact of the market downturn, the apparent \$5 billion cost to the automaker's pension plans to pay for severance, and the questionable quality of the plans' assets (which included considerable GM stock).⁵⁹

Unfortunately, there is no very narrowly-tailored amendment to ERISA that would be an effective means to prevent only plan amendments that fund severance benefits and substantially reduce funding levels. Amendments to pay severance-type benefits can easily be characterized as a plain-vanilla (albeit selectively-paid) benefit increase; and can take different forms. Therefore, the most straightforward remedy is to focus on the harm, which is an ad hoc and unfunded increase in plan liability that leaves a plan less than fully funded. The Pension Protection Act mitigated the risk of new, unfunded liabilities by amending Section 436 to tighten the funding-based limits on increases in benefit liabilities, as well as on the payment of plant shutdown and other "contingent event" ancillary benefits.

However, we believe that Congress must go further and **amend Section 436(c) to require that any new amendment increasing a plan's liability for benefits be immediately funded if the plan's adjusted target funding level is (a) less than 120 percent, or (b) would be less than 120 percent after taking into account the cost of the amendment.** If Congress is serious about full funding and protecting the promised benefits of all participants, a 120 percent threshold is justified considering that during the 2001-02 and current (2008-09) bear markets, pension funding levels dropped by 20-to-25 percentage points, on average. A 120 percent threshold would also be consistent with the 120 percent trigger point that allows IRS Section 420 transfers of surplus to 401(h) trust accounts and maintenance of cost requirements.

Currently Section 436(c) provides:

(c) LIMITATIONS ON PLAN AMENDMENTS INCREASING LIABILITY FOR BENEFITS.—

(1) IN GENERAL. No amendment to a defined benefit plan which is a single-employer plan which has the effect of increasing liabilities of the plan by reason of increases in benefits, establishment of new benefits, changing the rate of benefit accrual, or changing the rate at which benefits become nonforfeitable may take effect during any plan year if the adjusted funding target attainment percentage for such plan year is—

(A) **less than 80 percent**, or

(B) would be **less than 80 percent** taking into account such amendment.

(2) EXEMPTION. Paragraph (1) shall cease to apply with respect to any plan year . . . upon payment by the plan sponsor of a contribution (in addition to any minimally required contribution under section 430) equal to—

(A) in the case of paragraph (1)(A), the amount of the increase in the funding target of the plan . . . attributable to the amendment, and

(B) in the case of paragraph (1)(B), the amount sufficient to result in an adjusted funding target attainment percentage of **80 percent**.⁶⁰

The most effective way to protect plan participants (and taxpayers) from unfunded liabilities from severance, layoff or any other unfunded benefit increase is simply to **increase the target funding threshold in Section 436(c)(1)(A) and (B) above, and in (2)(B) above, to “120 percent.”**

It’s important to note that this change, like current Section 436(c), does not in any way limit the ability of plan sponsors to enhance benefits. It also does not limit the ability of plan sponsors to use funding in excess of 120 percent to enhance benefits. Indeed, it does not even overturn the Supreme Court’s *Hughes Aircraft* precedent that has emboldened plan sponsors to divert surplus plan assets to pay severance and other restructuring costs. What it does do is limit benefit enhancements in the current plan year that are not funded *if* that would cause the plan to be under-funded or worsen its level of under-funding.

This amendment should explicitly exempt qualified plans that are subject to collective bargaining, since in that case the participants are represented and the employer’s discretion (and conflict of interest) is at least mitigated. Indeed, when Congress struck the balance it did in selecting the 80 percent target funding threshold, it was thinking primarily of the situation where unions negotiate – or at least strongly influence – buyout provisions.

For example, in 2002 when AT&T moved to fund \$4 billion in severance payments for thousands of employees from pension plan assets, the Communications Workers of America publicly attacked the idea and forced AT&T to back off. AT&T’s plan to use the company’s pension surplus for severance was “a raid on our members’ pension fund,” argued Ralph Maly, the union’s vice president for communications and technologies. “Our members would be financing their own job loss,” Maly explained.⁶¹

Therefore, the legislative amendment of § 436(c) from 80 to 120 percent should also add an additional “Exemption,” at § 436(c)(4), stating in effect that **“this subsection (c) does not apply to defined benefit plan amendments that are negotiated pursuant to a collective bargaining agreement between one or more employers and one or more unions representing a substantial number or plan participants.” In other words, collectively bargained plans – whether they are single-employer or multiemployer, jointly-trusted plans – would be exempt.**

Congress adopted this same exemption for bargained benefits in the multi-year Section 420(h) transfer provision in the Pension Protection Act Section 420(a) provides that if there is a qualified transfer of any excess pension assets from a defined benefit plan to a health

benefits account which is part of such a plan, to avoid being treated as a reversion, the minimum cost requirements of § 420(c)(3) must be satisfied. Under § 420(c)(3)(D), the cost maintenance period is the period of five (5) taxable years beginning with the taxable year in which the qualified transfer occurs. However, the PPA exempted multiemployer plans entirely from this provision; and included an exception for collectively-bargained plans that allows the “minimum cost requirements” to be determined by bargaining between the plan sponsor and bona fide labor union representatives.

A parallel situation pertains to Section 436(b), which limits the ability of plans to pay plant “shutdown benefits and other unpredictable contingent event benefits” (which are ancillary, non-vested benefits) if that would result in the plan’s target funding level falling below 60 percent.⁶² Industrial unions in the auto and steel industries in particular fought to retain this low 60 percent threshold during the legislative debates over the PPA. However, where plan participants are non-represented, a company’s ability to define and pay “shutdown” or other “unpredictable contingent event benefits” under § 436(b) could easily become an end-around the limitations proposed above on unfunded benefit increases.

Therefore, the legislative amendment of § 436(b) should parallel the changes suggested for § 436(c) above: The “adjusted funding target attainment percentage” (AFTAP) should be increased from 60 to 120 percent; and an additional “Exemption” for collectively-bargained amendments should be added, providing that that “this subsection (b) does not apply to defined benefit plan amendments that are negotiated pursuant to a collective bargaining agreement between one or more employers and one or more unions representing a substantial number or plan participants.”

In addition to increasing the funding target attainment thresholds in § 436(b) and § 436(c) to full funding, as described just above, Congress might consider amending § 436(d) to prohibit any unfunded lump sum payment at a time when the plan’s funding level is below 100 percent. This approach has generally been advocated by the PBGC, since the agency believes that lump sum payments, whether intended to provide additional severance benefits or simply as an alternative form of payment to a monthly life annuity, accelerate under-funding and can even (as occurred with the Delta Airlines pilots pension plan) cause a “run” on the plan. Because the PBGC did not guarantee the full amount of the monthly annuity benefit accrued by many pilots in Delta’s plan, at signs of the company’s distress many rushed to withdraw their vested benefit in a lump sum. The plan lost liquidity and had to close.

A smaller but equally dramatic example is Kaiser Aluminum. As the company teetered on bankruptcy in 2002, departing salaried employees took lump sum payouts so quickly that it set off the equivalent of a bank run. By the time the company stopped the practice, the plan had only 21 cents left for each dollar it owed in benefits – and with the company declaring bankruptcy, the remaining participants and their obligations were defaulted to the PBGC.⁶³

According to PBGC officials, simply prohibiting lump sum payments, particularly from plans that are not fully funded, would greatly mitigate the problem of companies funding

attrition programs from plan assets. Although this reform would certainly deter plan sponsors from using pension assets to pay severance benefits, prohibiting unfunded lump sum payments would still allow companies to adopt a more traditional “window benefit” that provides an equivalent economic value to the laid-off or retiring worker through an increase in his or her accrued life annuity formula.

IV. CONCLUSION

The use of pension assets to make severance payments during a corporate restructuring is the largest and most widespread “back door reversion” by which some companies are seeking to circumvent the Congressional policy against reverting pension assets for corporate purposes. Although ERISA explicitly prohibits the use of qualified pension assets for “layoff benefits,” companies can amend a plan at any time not merely to offer older workers enhanced early retirement benefits (by awarding extra years of service credit), but even to offer lump sum severance payments equal to a year’s salary or more as part of a corporate restructuring.

The 2006 Pension Protection Act tightened up on this practice somewhat by requiring plan sponsors to pre-fund a plan amendment that increases benefit liabilities to the extent the plan’s funding level would fall below 80 percent (after taking account of the new benefit liability). However, as the 2008 stock market meltdown demonstrated, a plan that is only 80 percent funded during a bull market could easily end up below 60 percent funded in a bear market – and in default with the PBGC if the plan sponsor declares bankruptcy. Moreover, any significant reduction below full funding not only leaves all plan participants insecure, it reduces the ability of the plan to build a surplus that can finance cost-of-living adjustments to longtime retirees, whose fixed monthly benefits erode with inflation, or to offset the cost of retiree health benefits through a Section 420 transfer. Severance or other benefit increases to selected individuals that are not funded should be paid out of the company’s operating expenses, not from the pension trust.

The most effective way for Congress to protect plan participants (and taxpayers) from unfunded liabilities from severance, layoff or any other benefit increase is simply to **amend ERISA code Section 436(c) to increase the target funding level threshold required for unfunded benefit increases and lump sum payouts from the 80 percent level, currently required under the PPA, to 120 percent.** This would not limit the ability of plan sponsors to enhance benefits. What it does do is require companies to currently fund lump sum payouts or other benefit increases that would otherwise cause the plan to become under-funded or worsen its level of under-funding. Amendments increasing benefits that are collectively bargained or negotiated between a plan sponsor and bona fide union representatives, including those adopted by jointly-trusted multiemployer plans, would be exempted from this more restrictive funding level.

ENDNOTES

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- ² John D. Stoll and Jeff Bennett, "GM, Chrysler Offer New Buyouts," *The Wall Street Journal*, Feb. 4, 2009.
- ³ Tim Higgins, "Questions Arise from GM's Use of Pension for Buyouts, VEBA Trust," *Detroit Free Press*, March 1, 2009.
- ⁴ John D. Stoll, "Agency Raises Concerns About Car Makers' Pensions," *The Wall Street Journal*, Jan. 9, 2009.
- ⁵ *Ibid.* Ford Motor Co. reported in its fourth quarter financial disclosures to the SEC that it may need to contribute up to \$4 billion by 2010 to cover its year-end 2008 shortfall, a deficit the PBGC estimates is far larger when measured on a termination basis. See Keith Naughton, "Ford May Need to Put \$4 billion Into Pension, Spurring Aid Bid," *Bloomberg.com*, Feb. 6, 2009.
- ⁶ Tim Higgins, "Questions Arise from GM's Use of Pension for Buyouts, VEBA Trust," *Detroit Free Press*, March 1, 2009.
- ⁷ Ford Motor Company, Annual Report on SEC Form 10-K for FY ending Dec. 31, 2007, Note 24 to Consolidated Financial Statements ("Retirement Benefits"), filed Feb. 27, 2008.
- ⁸ Keith Naughton, "Ford May Need to Put \$4 Billion Into Pension, Spurring Aid Bid," *Bloomberg.com*, Feb. 6, 2009; available at www.bloomberg.com/apps/news?pid=newsarchive&sid=aDEsmY5awSrw.
- ⁹ Letter from PBGC Executive Director to Frederick A Henderson, President and CFO, General Motors Corporation, November 26, 2008. Letters available on request from PBGC.
- ¹⁰ Letter from PBGC Executive Director to Alan Mulally, President and CEO, Ford Motor Company, November 26, 2008. See also Letter from PBGC Executive Director to Robert L. Nardelli, Chairman and CEO, Chrysler LLC, November 26, 2008.
- ¹¹ John D. Stoll, "Pension Agency Sounds Alarm on Big Three," *Wall Street Journal*, November 28, 2008.
- ¹² Tim Higgins, "Pension Funds Used for Retirement Offers, Unusual Move Irks UAW Members," *Detroit Free Press*, March 22, 2008.
- ¹³ Marlene Post, "Using pension Funds for Buyouts," *Human Resource Executive Online*, March 31, 2008; available at <http://www.hreonline.com/HRE/story.jsp?storyID=84109087>.
- ¹⁴ Naughton, *supra note 5*.
- ¹⁵ See James A. Wooten, "'The Most Glorious Story of Failure in Business,' The Studebaker-Packard Corporation and the Origins of ERISA," *Buffalo Law Review*, vol. 40 (Buffalo, NY: 2001), at 731.
- ¹⁶ Cite to IRC
- ¹⁷ See Cecilia Valente, "Longer Life Spans Strain Pension Needs," *Bloomberg.com*, Jan. 23, 2009, available at <http://www.reuters.com/article/pensionsNews/idUSLNE50M00I20090123>. The Reuters report highlighted a Hewitt Associates study that longer life spans could add up to 15% to the estimated pension liabilities currently anticipated by most defined benefit plans.
- ¹⁸ Ellen E. Schultz and Theo Francis, "Companies Tap Pension Plans to Fund Executive Benefits; Little-Known Move Uses Tax Break Meant for Rank and File," *The Wall Street Journal*, August 4, 2008, page A1.
- ¹⁹ *Ibid.* A subsequent *Journal* report revealed that while the American Benefits Council and other lobbies for corporate plan sponsors had succeeded in raising the interest rate used to calculate the lump sum value of rank-and-file pension payouts, a change adopted as part of the Pension Protection Act of 2006, many companies are using the lower interest rate to boost the lump sum value of SERP payouts for CEOs and other senior executives by millions of dollars in some cases. See Mark Maremont, "How Some Firms Boost the Boss's Pension," *The Wall Street Journal*, Jan. 23, 2009.
- ²⁰ Tim Higgins, "Questions Arise from GM's Use of Pension for Buyouts, VEBA Trust," *Detroit Free Press*, March 1, 2009.
- ²¹ Under existing ERISA and U.S. Tax Code rules, there are two means to effectively and legally defease pension obligations: One means is through the purchase of lifetime annuities from a highly-rated domestic insurance company. This is generally an expensive option since insurers use very conservative interest and other assumptions in valuing a plan's liabilities for these purposes. As a variation of the annuity purchase and distribution approach, a plan may satisfy its obligations through the distribution of lump sums, but only if

elected by a participant. The other means for a sponsor to defease liabilities is to transfer them (along with associated assets) to another company in a business transaction.

²² Doug Halonen, "Ex-PBGC Chief Seeking Frozen Plans," *Pensions & Investments*, October 29, 2007.

²³ Ellen E. Schultz and Theo Francies, "Fringe Benefits: How Lucent's Retiree Programs Cost it Zero, Even Yielded Profit; Trusts Paid the Tab – A Handy Tool for Downsizing," *The Wall Street Journal*, March 29, 2004, page A1.

²⁴ Lucent Technologies Inc., Annual Report to on Form 10-K for 2002, Note 12 to Consolidated Financial Statements, December 12, 2002 (available on SEC's free EDGAR system).

²⁵ Towers Perrin, "Managing Pension Surplus: A New Playbook for a New Era," white paper, August 2008, at page 6.

²⁶ *Id.*

²⁷ Tim Higgins, "Pension Funds Used for Retirement Offers, Unusual Move Irks UAW Members," *Detroit Free Press*, March 22, 2008.

²⁸ Chris Clair, "Surplus Assets Issue Surfaces Over Layoffs; AT&T Says it Never Planned to Use Excess for Severance Pay Despite Charges of Union; Communications Workers of America Cries Foul," *Pensions & Investments*, March 4, 2002.

²⁹ Steven A. Kandarian, Testimony before House Committee on Education and the Workforce, September 4, 2003.

³⁰ *Id.* and David Walker, "Single-Employer Pension Insurance Program Faces Significant Long-Term Risks," Testimony before the House Committee on Education and the Workforce, September 4, 2003, at 33-34.

³¹ Jeff Smith, "Feds Took a Look at Qwest; Labor Dept. Probed Severance Payments Out of Pension Fund," *Rocky Mountain News*, July 8, 2005.

³² The 1996 COLA was a graded increase that depended on how long a person had been retired. The relatively small number who retired prior to 1969 received a 12 percent increase. All persons who retired since the break-up of AT&T (after January 1984) received less than 3 percent. See *Jarvis v. U S WEST*, Case No. 97-N-2189 (D. Colo). See also Janet Forgrieve, "Getting Shareholder Approval of Severance Packages Would Hurt Recruiting, Firm Says," *Rocky Mountain News*, March 17, 2001.

³³ United Airlines, Annual Report on SEC Form 10-K for FY ending December 31, 2002, at Note 20 to Consolidated Financial Statements (filed March 2003).

³⁴ Rachel Beck, "Pension Systems in Need of Major Overhaul," *The New York Times*, June 17, 2005.

³⁵ *Id.*

³⁶ Lucent Technologies Inc., Annual Report on SEC Form 10-K for FY ended Sep. 30, 2002, Note 12 to Consolidated Financial Statements, filed December 12, 2002 (available on SEC's free EDGAR system). In a separate communication to the Lucent Retirees Organization, Lucent Board member Henry Schacht stated: "First, as disclosed in our Fiscal 2001 Annual report, Lucent booked \$2.1 billion in 'termination benefits,' \$1.954 billion for pension and \$197 million for postretirement health and group life. . . . In addition, of the \$2.1 billion stated, approximately 27 percent was drawn from the management and occupational pension trusts to fund lump sum payments to employees upon their termination." Thus, \$567 million in lump sum severance payments were reimbursed from the pension trusts. Assuming that two-thirds of this 27 per cent was applied to management, because of their generally higher salaries, the management plan was depleted by roughly the same \$400 million amount the company saved by eliminating the pension death benefit.

³⁷ Patricia Russo, Chairman & CEO of Lucent Technologies, Letter "To Retirees" dated March 5, 2003. See also Lucent Technologies, Inc., Annual Report filing on Form 10-K, for the Fiscal Year ended Sep. 30, 2005, filed Dec 10, 2005.

³⁸ Delphi Corporation, Annual Report filed on SEC Form 10-K for FY ending 12/31/06, Note 17 to Consolidated Financial Statements (filed Feb. 27, 2007).

³⁹ Mary Williams Walsh, "U.S. is Pressuring Delphi Over Pension Obligations," August 15, 2008.

⁴⁰ *Id.*

⁴¹ David Shepardson, "Judge Grants Delphi Request to End Benefits for 15,000 Retirees," *Detroit News*, Feb. 24, 2009; Thomas Hartley, "Judge Says Delphi Can Cancel Retiree Benefits," *The Business Journal of Milwaukee*, Feb. 25, 2009.

⁴² Delta Air Lines Inc., Annual Report on SEC Form 10-K for FY ending 12/31/01, Note 12 to Consolidated Financial Statements (filed March 28, 2002).

⁴³ Gerry Geisel, "PBGC Takes Over Delta Pilots Pension Plan," *Workforce Management*, January 5, 2007.

⁴⁴ Associated Press, “Anheuser-Busch Ups Retirement Plan for Key Workers,” August 12, 2008. *See also* Anheuser-Busch, SEC 10-Q for quarter ending Sep. 30, 2008 (filed Nov. 6, 2008).

⁴⁵ Chris Clair, “Surplus Assets Issue Surfaces Over Layoffs; AT&T Says it Never Planned to Use Excess for Severance Pay Despite Charges of Union; Communications Workers of America Cries Foul,” *Pensions & Investments*, March 4, 2002.

⁴⁶ AT&T Inc., Annual Report on SEC Form 10-K for FY ending 12/31/01, Note 11 to Consolidated Financial Statements (filed Feb. 28, 2002).

⁴⁷ Verizon Communications Inc., Annual Report on SEC Form 10-K for FY ending 12/31/03, at page 75.

⁴⁸ Ellen E. Schultz and Theo Francis, “Companies Tap Pension Plans to Fund Executive Benefits; Little-Known Move Uses Tax Break Meant for Rank and File,” *The Wall Street Journal*, August 4, 2008, page A1; Schultz and Francis, “Fringe Benefits: How Lucent’s Retiree Programs Cost it Zero, Even Yielded Profit; Trusts Paid the Tab – A Handy Tool for Downsizing,” *The Wall Street Journal*, March 29, 2004, page A1.

⁴⁹ *Hughes Aircraft Company v. Jacobson*, 525 U.S. 432, 119 S.Ct. 755 (1999).

⁵⁰ 119 S.Ct. 763-64. *See also Lockheed Corp. v. Spink*, 517 U.S. 882, 891 (1996) (holding that “the act of amending a pension plan does not trigger ERISA’s fiduciary provisions”).

⁵¹ U.S. Department of Treasury and Internal Revenue Service, Notice 2007-14, “Description of Benefits Permitted to be Provided in Qualified Defined Benefit Plans, published Feb. 12, 2007 in Internal Revenue Bulletin 2007-7.

⁵² *Id.*

⁵³ Internal Revenue Code Regulation § 1.401-1(b)(1)(i).

⁵⁴ Labor Code Regulation § 2510.3-2(b)(1). *See also* § 2510.3-1(a)(3), defining “employee welfare benefit plans,” which provides that: “Thus, the effect of section 3(1)(B) of the Act is to include within the definition of ‘welfare plans’ those plans which provide holiday and severance benefits, and benefits which are similar (for example, benefits which are in substance severance benefits, although not so characterized.”

⁵⁵ Treasury Notice 2007-14, *supra note* 16, at 3.

⁵⁶ I.R.C. Regulation § 1.411(d)-3(g)(2).

⁵⁷ Treasury Notice 2007-1, *supra note* 16 at 6.

⁵⁸ *Id.* At 7.

⁵⁹ John D. Stoll, “Pension Agency Sounds Alarm on Big Three,” *Wall Street Journal*, November 28, 2008.

⁶⁰ I.R.C. Section 436(c).

⁶¹ Chris Clair, “Surplus Assets Issue Surfaces Over Layoffs; AT&T Says it Never Planned to Use Excess for Severance Pay Despite Charges of Union; Communications Workers of America Cries Foul,” *Pensions & Investments*, March 4, 2002.

⁶² I.R.C. Section 436(b) provides in relevant part:

(b) FUNDING-BASED LIMITATION ON SHUTDOWN BENEFITS AND OTHER UNPREDICTABLE CONTINGENT EVENT BENEFITS UNDER SINGLE-EMPLOYER PLANS.—

(1) IN GENERAL. If a participant of a defined benefit plan, which is a single employer plan, is entitled to an unpredictable contingent event benefit payable with respect to any event occurring during the plan year, the plan shall provide that such benefit may not be provided if the adjusted funding target attainment percentage for such plan year—

(A) is **less than 60 percent**, or

(B) would be **less than 60 percent** taking into account such occurrence.

(2) EXEMPTION. Paragraph (1) shall cease to apply with respect to any plan year . . . upon payment by the plan sponsor of a contribution (in addition to any minimally required contribution under section 430) equal to—

(A) in the case of paragraph (1)(A), the amount of the increase in the funding target of the plan . . . attributable to the occurrence referred to in paragraph (1), and

(B) in the case of paragraph (1)(B), the amount sufficient to result in a funding target attainment percentage of **60 percent**.

⁶³ Mary Williams Walsh, “U.S. Cancels Pension Plan at Kaiser,” *The New York Times*, Dec. 18, 2003.