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Underfunded Pension Liability: Lenders and Buyers Beware

<u>Introduction</u>

Underfunded defined benefit pension plans have always carried a certain amount of risk. With the current uncertainty and downturn in the markets, low interest rates and the impact of new pension rules, pension plan sponsors with underfunded pension plans, and those who seek to acquire companies with defined benefit plans or lend to such companies, have a heightened exposure to risk. Underfunded pension plans appear to be significantly impacting the ability in certain cases to get financing in today's tough financial markets. Although the new FASB Statement No. 158 requires a company to recognize the underfunded status of defined benefit plans as a liability on its balance sheet and to recognize changes in that funded status in the year such changes occur, the ultimate liability is still uncertain. The company's consolidated balance sheet and the footnotes to its financials provide certain historical information based on assumptions made as of the date of such statements and do not have sufficient detail to make an exact determination as to the company's potential liability. Furthermore, members of a company's controlled group are joint and severally liable for Pension Benefit Guaranty Corporation ("PBGC") claims. Therefore, significant due diligence as to the scope of the company's pension liabilities needs to be performed by a lender or buyer.

Lenders obviously need to examine carefully all pension liabilities before they make loans. Even a company with a fully funded plan in prior periods may now be significantly underfunded, due to the dislocation of various markets.[1] For existing credits, lenders should regularly examine the pension funding requirements, particularly for troubled credits. Given the recent economic turmoil, the amounts required to satisfy underfunding may be significantly greater than the amounts anticipated when the loan was entered into. Lenders may also want to make sure that their loans are guaranteed by subsidiaries of the parent company, so they are not structurally subordinated to any PBGC claims due to controlled group liability. Even more beneficial for

[1] The Wall Street Journal reported on October 30, 2008, that at the end of 2007, the combined pension-plan surplus of all the S&P 500 companies was $60 billion, but that by late September of this year it had become a $75 billion deficit.

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lenders would be security for borrower's obligations, which would make their claim senior to any PBGC claims with respect to the lender's collateral.

Companies looking to purchase other companies also need to take particular note of potential pension liabilities. Underfunded pensions can be a critical issue when examining the costs and risks of an acquisition, since potential liabilities cannot be determined with certainty at the time an acquisition is made.

The Pension Protection Act of 2006 (the "PPA") added new funding requirements that were designed to ensure that pension plans become fully funded within seven years. These funding rules became effective for plan years beginning in 2008; all pension plans will need to be fully funded by 2015. This memorandum explains briefly the contours of these funding rules and their requirements with respect to underfunded pension plans in the United States. It also covers the impact of bankruptcy on those pension plans whose underfunded pension plan obligations generally rank equal to any unsecured financing of the parent entity (if those underfunded pension obligations are obligations of the parent entity). This memorandum also discusses similar issues in other countries, focusing especially on France, Germany (where pension liabilities are not always prefunded), and the United Kingdom. This memorandum also suggests how to mitigate against additional plan liabilities in the current volatile market.

New Funding Rules for US Underfunded Pension Plans

Effective for plan years that start in 2008, plan sponsors must begin making funding contributions sufficient to meet full funding targets and to eliminate funding shortfalls over a seven-year period, so that all plans are fully funded within seven years. For existing plans, the new funding requirements went into effect in 2008; all existing pension plans will need to be fully funded by 2015.

The PPA also adopted new requirements for plan funding assumptions, including interest rates and mortality tables. Under the new funding rules, plan sponsors must make minimum required contributions to plans where the value of plan assets is less than the funding target (the present value of all benefits accrued or earned as of the beginning of the plan year). Benefit limitations and participant notice requirements may also apply to certain underfunded plans.

There are additional funding requirements and a higher funding target for "at-risk" plans. If a plan is at risk for the current year and two out of the previous four years, an additional "loading factor" of 4% of the funding target, plus $700 per participant, is added to the at-risk liability. Plans will be considered at risk generally when (i) the plan's funding target attainment percentage (the ratio of the plan's assets to the plan's funding target for the year), determined without using special at-risk assumptions, is less than 65% in 2008, 70% in 2009, 75% in 2010, and 80% thereafter and

(2) the plan's funding target attainment percentage, determined using the special at-risk assumptions, is less than 70%.

Plan sponsors are subject to penalties if they fail to make the required minimum funding contributions to their plans. A sponsor is generally subject to an excise tax of 10% of the aggregate unpaid minimum required contributions if the required contributions are not met. If the deficiency is not corrected in a specified period, a tax of up to 100% of the unpaid minimum required contribution can be imposed.

Accordingly, lenders and acquirers of businesses need to take the underfunding amount, and the period over which it must be funded, into account when determining how much to lend to, or pay for, a company. In the current market, at times when stock and asset values are falling precipitously, significantly greater amounts than anticipated may be needed, and it will be difficult to determine the actual amounts that may be required to be paid in the future. Businesses will need to have sufficient liquidity available each year, in the form of a line of credit or otherwise, to make sure they can make the required payments and not be subject to the penalties described above.

Bankruptcy of Plan Sponsors and Underfunded Pension Plans

In bankruptcy, while claims arising from pension plan obligations may have priority over general unsecured claims in particular circumstances and with certain monetary limits, they are usually treated as general unsecured claims without any priority or subordinated status in connection with any distributions in bankruptcy. Therefore, they usually rank equal with any unsecured lender and senior to subordinated lenders who have agreed to be subordinated to pension liabilities. Many subordinated lenders do not agree to be subordinated to pension liabilities and agree to subordinate themselves only to indebtedness for borrowed money. Accordingly, a secured lender will be entitled to recover its allowed claims in full to the extent of the value of its interest in the collateral, while the claims of an unsecured creditor, including those arising from a pension plan, will have lower priority. Pension plans are not automatically terminated in bankruptcy and can sometimes survive the bankruptcy process intact. When a pension plan is terminated in bankruptcy, the PBGC steps in and uses its own assets to ensure that participants do not lose all their benefits.

A pension plan can be terminated in bankruptcy in one of two ways; either the company can voluntarily terminate its plan in a distress termination or the PBGC can terminate the plan in an involuntary termination. A distress termination may occur only if certain notice requirements are met and the PBGC determines that the plan sponsor and its corporate affiliates meet any one of four tests relating to the financial state of the company. In an involuntary termination, the PBGC terminates a plan on its own initiative if certain tests are met, regardless of the intentions of the plan sponsor. A plan cannot be voluntarily terminated in violation of a collective bargaining agreement, although the PBGC can impose an involuntary termination. In bankruptcy, collective bargaining agreements can be rejected (thus removing the barrier to a voluntary distress termination) only if the debtor leaps significant hurdles imposed by the Bankruptcy Code.

If the pension plan is terminated in bankruptcy, the PBGC has three primary types of claims in the bankruptcy case: (1) the unfunded benefit liability, which is the difference between the present value of the plan's liabilities and the fair market value of the plan's assets (although bankruptcy courts do not agree on the appropriate methodology for determining funded status), (2) the unpaid minimum funding contributions that the plan sponsor owes the pension plan and (3) the unpaid pension plan termination insurance premiums owed to the PBGC.

Pursuant to the Employment Retirement Income Security Act of 1974, the members of a sponsor's "controlled group" are jointly and severally liable for PBGC liabilities. A controlled group generally consists of a parent company and its 80%-owned subsidiaries, as well as any brother-sister corporations of a common parent. Because of joint and several liability, a lender should receive, if possible, guarantees from all members of a controlled group in order not to be structurally subordinate to PBGC claims. In that way, a lender would be *pari passu* to PBGC claims. Of course, it would be desirable for a lender to have a security interest in order to be senior to the PBGC's unsecured claims with respect to the lender's collateral.

<u>Foreign Underfunded Pension Plans</u>

In addition to the US underfunding issues described above, multinational companies will have similar issues in each of the countries in which they operate. Every country has its own pension schemes. Below, we summarize those of France, Germany, and the United Kingdom. Buyers and lenders will need to consult experts in the countries in which borrowers or targets (or their subsidiaries) have pension obligations in order to understand the ultimate pension liability.

- France

In France, defined benefit pension plans have been gradually phased out for new employees and progressively replaced by defined contribution pension plans, known as PERCOs (Plan d'Epargne Retraite Collectif) or "Article 83" retirement accounts. A number of large-cap French companies have nevertheless accumulated significant retirement liabilities through historical underfunded defined benefit pension plans or through their ownership of subsidiaries with such plans in foreign jurisdictions.

In light of the relatively small weight attributed to defined benefit pension plans in the overall French pension scheme, the funding of these plans is not heavily regulated. French corporations that do not report their financial statements using International Financial Reporting Standards may elect either to book pension liabilities as provisions on their balance sheet or to disclose them in notes to their financial statements. As a consequence, plans may be unfunded, with plan sponsors contributing to them on a "pay as you go" basis. In light of the significant risks associated with this approach, corporations often book provisions on their balance sheet to cover future liabilities. They increasingly turn to insurance companies that set funding targets to eliminate funding shortfalls and manage the plans on the corporation's behalf. Such group insurance plans do not, however, entirely remove the risk that those funding targets, as determined by the insurer's actuarial analysis, might not be sufficient to cover the plan's future funding needs.

- Germany

The German system has five basic types of occupational pension schemes that an employer can implement: pension promise, relief fund, direct insurance, pension plan and pension fund. The essential differences between these schemes are in whether they are funded or unfunded, the asset classes that are available for investment, and certain other features. It is, within certain limits, up to the employer to elect the pension scheme it intends to offer an employee. The pension scheme may be funded by employer contributions, employee contributions or a mixture of both.

Of the five pension schemes, four are externally funded, and one, the pension promise, is a pure payment obligation that is not externally funded. Under certain limited circumstances, a semi-public institution exists that may provide relief to employees and may assume certain occupational pension scheme obligations of the employer in the case of an employer insolvency. Correspondingly, employers who engage in pension promises are obliged to make contributions to this semi-public institution. Such contributions do not constitute the funding of pension obligations but rather a mandatory contribution to a semi-public institution. Otherwise, as a general principle, employee entitlements from occupational pension schemes are not given preference in employer insolvency proceedings and are treated as equal to those of other unsecured creditors.

- United Kingdom

A UK pension plan must be sufficiently funded to meet plan liabilities on an ongoing basis, as determined by the plan's trustees and based on criteria set by the UK Pensions Regulator. As a general rule, a plan's funding standard is often significantly higher than the liabilities shown on a company accounting basis, so corporate accounts often are not a true reflection of the costs associated with a plan. As in the US, insolvent pension plans in bankruptcy are generally treated as unsecured creditors with no priority status. However, commencement of a UK insolvency procedure results in: (1) a debt on the employer, calculated by reference to the full cost of securing all of the plan's accrued benefits through purchasing annuities, and (2) the Pension Protection Fund (a statutory body) assessing whether it will assume the plan. If the Pension Protection Fund assumes the plan, it will also assume the plan's right to attempt to recover the debt from the insolvent employer. Additionally, the UK Pensions Regulator may have the power to compel other affiliates (including subsidiaries) to support the pension plan, even if these entities are located outside the UK.

Strategies to Avoid Pension Plan Issues in the Current Market

Owners of businesses and those who lend to them may want to consider how to protect their pension plans from incurring increasingly large funding obligation liabilities in the current volatile market. In particular, the new funding rules described above require annualized payments, which may fluctuate significantly in the current economic climate. If a plan is fully funded, one option is to place pension assets into fixed income or other investment products to match liabilities. The potential downside is that, if the pension plan is not fully funded at the time this approach is adopted, then this approach may require contributing substantial amounts of money. Lenders will also want to make sure that they have a security interest in the pension obligor's assets in order to be senior to the pension liabilities with respect to the collateral or are at least *pasi passu* with the pension liabilities by obtaining guarantees of subsidiaries so that the lender will not be structurally junior with respect to the subsidiaries' assets. The recent pension funding changes will also require more regular funding of pension amounts, and companies and acquirers will need to make sure they will have sufficient liquidity to make any payments. Lenders may want to include amounts payable to pension plans as a cash obligation for purposes of determining covenant levels and calculations of cash flow for determining compliance with financial covenants. Buyers of businesses should obviously take into account the cost of pension liabilities and the timing and amounts of annual contributions (as well as the risk that such amounts may change) in determining the amount they are willing to pay for a business.

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If you have any questions regarding this client memorandum, please contact your regular Fried Frank attorney or the attorneys listed below.

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