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Pension Protection Act of 2006
New Funding and Related Requirements for Defined Benefit Plans

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On Thursday, August 17, 2006, President Bush signed into law the Pension Protection Act of 2006 (PPA). The PPA—widely reported as the most comprehensive reform of pension law since ERISA—covered numerous areas of pension and employee benefit law, but the centerpiece of the PPA, and among the most controversial and far-reaching of its provisions, are a host of new rules imposing stricter funding and related requirements for single-employer defined benefit pension plans and their sponsoring employers.

As more fully described below, the PPA generally requires defined benefit plans to be fully funded on an ongoing basis—with less than fully funded plans being required to "catch up" to full funding in seven years—and it requires the use of actuarial and asset value assumptions that more precisely reflect a plan's actual liabilities and investment experience. These more conservative assumptions will likely have the effect of materially increasing the cost of funding defined benefit plan liabilities over the next 10 years, and, in combination with other changes (such as more onerous rules regarding PBGC variable premiums and PBGC and participant reporting), the PPA may well accelerate the recent trend by employers of freezing (and eventually terminating) their traditional defined benefit pension plans and shifting to enhanced defined contribution designs instead.

Annual Required Contributions

***Background**:* Pre-PPA law generally allowed defined benefit plan sponsors to contribute the amount required to fund current-year liabilities, as well as an additional amount required to amortize, over a period of 30 years, certain past service liabilities. Plans that were not at least 90% funded (deficit reduction plans) were subject to more onerous requirements.

***New Rules**:* Effective for plan years beginning in 2008, the annual minimum funding contribution required for all plans will be the sum of (i) the plan's current-year liabilities (i.e., the plan's "normal cost" for benefits expected to accrue in that year) and (ii) the amount required to amortize, over a period of seven years, the shortfall between plan assets and 100% of accrued liabilities for the current and six prior plan years. The calculation of plan liabilities is made using certain actuarial assumptions and asset valuation rules described in subsequent portions of this LawFlash.

In determining the above-described accrued liability shortfall, any "credit balances" a plan has

generally must be subtracted from plan assets. Credit balances include both amounts that were contributed under pre-PPA law in excess of the annual required minimum contribution (funding standard carryover balances), as well as amounts contributed under the PPA's new minimum funding rules in excess of annual required minimum contributions (pre-funding balances). The PPA requires this reduction in order to increase the accuracy of a plan's financial disclosures. Specifically, Congress concluded that credit balances are misleading, since pre-PPA law allowed them to grow at a deemed rate of interest that often did not reflect actual investment experience, allowing sponsors to take a contribution holiday based on phantom assets. However, under a special rule in the PPA, if a plan is 100% funded when credit balances *are* taken into account (i.e., when credit balances are *not* subtracted from assets), any shortfall between assets (reduced by credit balances) and accrued liabilities is disregarded. The 100% funding requirement under this special rule will be phased in over four years—the applicable funding requirement under the special rule is 92% for 2008, 94% for 2009, and 96% for 2010.

Sponsors will be allowed to use credit balances to offset any minimum required contribution, but only if the plan is at least 80% funded (determined after subtracting out pre-funding balances but not funding standard carryover balances).

Plans that are deemed "at risk" are subject to certain additional funding requirements. A plan will fall in this category if it (i) has more than 500 participants; (ii) is less than 80% funded, based on the actuarial assumptions described below; and (iii) is less than 70% funded, based on certain "at risk" actuarial assumptions. A plan's funded status, for this purpose, is determined after reducing plan assets by any credit balances.

Action Item: Defined benefit plan sponsors should determine, well before the 2008 effective date, the extent of any shortfall between their plans' assets and accrued liabilities (based on the actuarial assumptions and asset valuation requirements described below). They may want to consider making additional contributions so that plan assets, determined when including (i.e., without subtracting out) any credit balances, are at least 92% (in 2008), 94% (in 2009), 96% (in 2010), and 100% (thereafter) of accrued liabilities. The advantage of meeting this threshold under the "special rule" is that the minimum required contribution for any plan year will be the plan's normal cost for that year, without any need to contribute toward amortizing unfunded accrued liabilities.

Actuarial Assumptions

Background: Under pre-PPA law, sponsors were allowed to calculate benefit liabilities using a discount rate chosen by the plan's actuary at its discretion (within reason) and a mortality table specified by the Treasury Department. Deficit reduction plans were required to use instead (in 2004 and 2005) a rate specified by the Treasury Department based on investment-grade corporate bonds.

New Rules: The PPA, in contrast, generally requires the use of three different interest rates based on a modified yield curve of investment-grade corporate bonds. The three different rates correspond to three different time horizons for paying out plan benefits: those benefits that are anticipated to come due within five years of the valuation date will be calculated using bond rates maturing during that period, benefits payable after five years and before 15 years of the valuation date will be based on corporate bond rates for that period, and liabilities payable thereafter will be based on bonds with that longer maturity horizon. These new discount rates will generally be phased in over three years, beginning in

2008. In addition, a new mortality table, specified by the Treasury Department, will be required that more accurately reflects plan participants' mortality.

Action Item: Sponsors should assess the funded status of their plans, as described in the above-provided discussion of the new minimum funding requirements, based on the actuarial assumptions mandated by the PPA. The assumptions mandated by the PPA may adversely affect a plan's funded status if the assumptions used under pre-PPA law reflected an unrealistic anticipated rate of return on plan assets. The interest and mortality assumptions mandated by federal pension law for plan years 2004 and 2005 will continue in effect prior to 2008, so sponsors have time to consider the effect of the new assumptions on the funding of their plans.

Plan Asset Valuation

Background: In order to minimize the effect of asset volatility, pre-PPA law allowed plan assets to be "smoothed" by averaging their fair market value over a period of no more than five years. This valuation method arguably contributed to plan underfunding by commensurately overstating the value of plan assets.

New Rule: The PPA requires that assets be smoothed over no more than two, rather than five, years.

Action Item: Sponsors should review their current investment policy and asset allocation prior to 2008, when the new plan asset rules go into effect. Investing in less volatile investment vehicles may avoid the unanticipated funding shortfalls that could result during a period of increased volatility in asset values (although this benefit will have to be balanced against the potential for reduced long-term investment returns if less volatile asset classes are used). Another strategy may be to increase the number of asset classes used for pension investment, again in order to reduce volatility.

Benefit Restrictions

Background: Pre-PPA law prohibited the sponsors of certain underfunded plans and sponsors in bankruptcy from amending their plans to increase benefits. In addition, plans with a "liquidity shortfall" could not pay benefits in a form other than a life annuity. These rules were designed to prevent a drain of assets from financially troubled plans.

New Rules: Beginning in 2008, the PPA expands these rules to cover a larger class of sponsors and to increase the types of restrictions. Specifically, the sponsor of a plan that is underfunded by certain specified percentages is limited in its ability to (i) amend the plan to increase benefits, (ii) pay benefits in a form other than a life annuity, (iii) allow additional benefits to accrue, or (iv) pay "unpredictable contingent event benefits" (e.g., benefits payable when a plant shuts down). The specified percentages range from 60% to 80%. In determining whether a plan is underfunded for these purposes, assets generally must be reduced by credit balances (i.e., by funding standard carryover balances and pre-funding balances). However, if a plan is 100% funded when assets are determined without reducing them by any credit balances, the benefit restrictions do not apply. This 100% threshold is phased in prior to 2011 at a rate of 92% in 2008, 94% in 2009, 96% in 2010, and 100% thereafter.

Action Item: Sponsors should review the status of their plans to determine whether they are adequately funded to avoid the above-described benefit restrictions. Plan assets should be reduced by credit

balances in making this determination, unless the plan is 100% funded (or 92%–96% funded in years prior to 2011, as described above) when such balances are not subtracted from assets. Alternatively, the PPA allows sponsors to permanently forfeit credit balances if doing so would allow them to avoid application of the benefit restrictions.

Variable PBGC Premiums

Background: Pre-PPA law requires certain employers that sponsor defined benefit pension plans to pay both a $30 per-participant flat PBGC insurance premium and a variable premium based on the amount of "unfunded vested benefits" in the plan (using a special mandated interest rate); the premium is $9 per $1,000 of unfunded vested benefits. Plan sponsors that made contributions to the plan up to the "full funding limit" in the preceding plan year (or were prohibited under that limit from making deductible contributions) were exempt from the variable premium requirement.

New Rules: The PPA will require, beginning in 2008, the variable premium to be based on the funding shortfall for the plan determined under the new minimum funding rules (including the at-risk rules where applicable). The "full funding limit" exception will no longer apply.

Action Item: Plan sponsors will want to consider the potential financial impact of the revised variable premium requirement in planning their funding between now and 2008.

PBGC Notice Rules

Background: Pre-PPA law required that employers with an aggregate underfunding of $50 million or more provide the Pension Benefit Guaranty Corporation with certain financial and actuarial information on a confidential basis. PBGC uses this data to help it track employers that pose a threat of material potential loss to PBGC through distress termination and, where applicable, to take action to ensure that the threat is minimized.

New Rules: The PPA eliminates the $50 million underfunding threshold and instead requires that all defined benefit plans that are less than 80% funded (determined after subtracting out credit balances) file certain plan actuarial and employer financial information and information regarding termination liabilities with PBGC, starting in 2008. PBGC, in turn, must provide annual reports to Congress summarizing such information. PBGC may provide in regulations for exemptions from the reporting requirement for small plans, and it will likely do so (rather than being burdened by having to sort through financial and actuarial information from small underfunded plans that do not represent any material threat of liability to PBGC).

Action Item: Sponsors not already required to file annual reports with PBGC and that wish to stay off PBGC's "radar screen" should consider funding their plans at least sufficiently to avoid falling below the 80% funding threshold before 2008.

Participant Reporting Rules

Background: Under pre-PPA law, participants in defined benefit plans generally receive only a summary annual report (SAR), excepting certain financial information from the plan's Form 5500, once a year, two months after the 5500 is filed. The SAR does not provide information regarding the

plan's funding level. In certain deficit reduction plans, an additional participant notice must be provided at the same time addressing specifically the funded level of the plan and the level of PBGC guaranteed benefits. Multiemployer pension plans, in contrast, are all required to provide participants with an annual notice containing information regarding the plan's funding level.

New Rules: The PPA eliminates the SAR requirement and the prior special funding notice in favor of a single funding notice required to be issued for all single-employer defined benefit plans, beginning for the 2008 plan year. The notice is to be issued 120 days after the close of the plan year (for plans with less than 100 employees, the notice can be delayed until the due date of the Form 5500), and it must provide information regarding the number of plan participants, broken down among active, retired, and deferred vested; a statement of the plan's assets and liabilities (determined as under the funding rules) for the current year and three preceding years; the plan's applicable funded percentage for the current year under the minimum funding rules (if less than 100%); information regarding the plan's funding policy and asset allocation; and information regarding plan amendments or other events during the year materially affecting the plan's funding status, as well as certain additional information.

Action Item*:* Plan sponsors should consider the potential adverse affect on employee morale of a less-than-favorable report regarding the plan's funded status in determining how aggressively to fund their plan's unfunded liabilities between now and 2008.

Funding Restrictions for Nonqualified Plans

Background: Under pre-PPA law, plan sponsors may elect to fund or secure nonqualified supplemental pension benefits payable to management and highly compensated employees through either a "secular trust" (one protected from company creditors in bankruptcy) or a "rabbi trust" (one subject to creditors' claims in bankruptcy), without regard to the funded status of any qualified defined benefit plan or their financial condition (although the utility of secular trusts has been substantially limited by the enactment of Code Section 409A, and assets transferred into a secular trust on the eve of bankruptcy may be subject to recapture under bankruptcy law).

New Rules: The PPA prohibits plan sponsors from funding either a secular trust or a rabbi trust during three specified "restricted periods": (i) while any of the plan sponsor's or a controlled group member's defined benefit plans are in "at-risk" status, (ii) while the plan sponsor or any controlled group member is in bankruptcy, or (iii) during the period beginning six months before and ending six months after the distress termination of any plan sponsored by the plan sponsor or another controlled group member. Violation of this rule will result in imposition of immediate tax plus a 20% penalty on nonqualified plan participants who are (or were at termination) the plan sponsor's CEO, one of its top four other most highly compensated officers, or subject to the reporting and short-swing profit requirements under Section 16(a) of the Securities Exchange Act of 1934. This new rule is effective on the date of enactment (August 17, 2006), although the at-risk rules do not come into effect until 2008, so that portion of the rule will necessarily have delayed effect.

Action Item: The primary impact of this prohibition will be on the funding of rabbi trusts (since, as noted, secular trust funding would likely have triggered penalty taxes under Section 409A anyway); employers will need to confirm that they are not in a restricted period before funding (or adding additional funds to) any rabbi trust.

The foregoing discussion is merely intended as a summary of the highlights of the PPA with respect to its funding-related provisions. If you have any questions regarding how the PPA will affect the funding of your particular plan, please feel free to contact any of the following individuals or any Morgan Lewis Employee Benefits and Executive Compensation lawyer with whom you work.

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