DEFINED BENEFIT PLANS
IN CORPORATE TRANSACTIONS

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Defined benefit plans have taken on greater significance in corporate acquisitions, mergers and dispositions since the passage of the Employee Retirement Income Security Act of 1974 ("ERISA")[1] and the issuance of accounting disclosure requirements by the Financial Accounting Standards Board (FASB).[2] The issues fall generally into two categories: (1) due diligence to determine the types of benefit plans and their attendant assets and liabilities and (2) dividing responsibility for those liabilities and assets between the buyer and seller. This paper discusses the major issues that are likely to arise in both these areas when negotiating the purchase or sale of a business with a defined benefit plan.

Defined benefit liabilities are valued in different ways for different purposes and, despite improved financial disclosures, can still be the source of major off-balance-sheet liabilities or assets. Dropping interest rates have created underfunding in plans that have been fully funded for more than a decade. Uncertainty about future funding, as a result of temporary fixes of the minimum funding rules and volatility under the existing rules, has discouraged buyers from assuming these plans.

There are three general approaches to dealing with these benefits: retention of the plan by the seller, transfer of the plan to the buyer or transfer of only a portion of the plan to the buyer. Either the buyer or the seller may merge the plan with another plan or may terminate the plan if it is fully funded. A lawyer dealing with these issues needs to understand the legal, financial and practical aspects of each of these alternatives, since defined benefit plans can be a significant negotiation point in a corporate transaction.

Understanding Defined Benefit Liabilities.

Defined benefit plans are pension plans in which benefits are determined under a formula set forth in the plan document. The formula will usually involve factors such as the age and service of the employee when he retires and, in many cases, the salary of the employee. Defined benefit plans are funded on a group basis, using actuarial assumptions about long-term interest rates, mortality, turnover, retirement age and other factors that influence how much money will be needed to pay the promised benefits.

While there are minimum funding standards under Code and ERISA,[3] there is no guarantee that the plan will have sufficient assets to cover accrued liabilities. Under ERISA, an employer is given an extended period to fund past service liabilities created either when the plan is established

or as a result of subsequent amendments.[4] Gains and losses are also funded over a number of years. While an employer is not required take advantage of the extended period to fund past service liabilities,[5] most employers do. In addition, it is not possible to fund certain contingent event benefits, such as plant shutdown benefits or job elimination benefits, in advance.[6] Many employers have implemented early retirement window benefits[7] in recent years to facilitate downsizing and that has created unfunded pension liabilities. All of these factors can lead to unfunded benefit obligations even though the employer is meeting all required minimum funding payments.

Defined benefit plans can also have surplus assets, *i.e.* assets exceed liabilities. The minimum funding rules generally require that employers fund for projected benefits in plans that base benefits on future salary (called "final average pay plans"). These plans often have more assets than are needed to pay for benefits accrued to date (although under current economic conditions, such plans are becoming less common). The financial accounting rules require that liabilities (called "benefit obligation" in the financial statement footnotes) be measured on the basis of the "projected benefit obligation" ("PBO"), which also takes into account future salary increases.

The issue for both underfunded and overfunded plans is what assumptions are used to determine the liabilities. There are at least three purposes for which these liabilities are normally determined: funding, financial accounting, and termination liability. Each of these involves a different set of assumptions and methods:

- **Funding assumptions** reflect long term projections of economic factors and do not necessarily represent current conditions. For example, most pension plans are funded using a 7-9% interest rate assumption, reflecting long term expectations for the return on the trust's assets. These liabilities are generally funded on a projected basis. Underfunded plans are required to make an additional "deficit reduction contribution" that is based on current liabilities determined using an interest rate based on an average of 30-year Treasury rates and a specified mortality table. Because Treasury has stopped issuing the 30-year bond, the interest rate on the outstanding bonds has fallen below the rate used by PBGC to calculate termination liability.

- **Financial accounting** requires that the interest rate be adjusted to reflect current rates at which the liabilities could be "settled." The Securities and Exchange Commission (SEC) has indicated that this rate should not be higher than the yield on a portfolio of double-A or higher-rated bonds whose cash flows matches the predicted schedule of benefit payments. Since this rate will change with bond yields, there can be substantial changes in the value of the liabilities. This can result in considerable volatility in the annual expense calculation. For example, at the end of 1997, most employers were using an interest rate in the range of 6.5-7.25%; by the end of the following year, rates were about 50 basis points lower. Since lower interest rates translate into higher pension liabilities, the value of the liabilities for most companies increased even before taking into account the additional benefits earned in 1998. Rates reversed direction again for 1999, lowering employers' pension liabilities.

- **Termination liability**, the basis for PBGC's claim when an underfunded plan terminates, is determined under assumptions set by the PBGC. Unlike the funding and financial accounting rules, termination liability is based only on benefits accrued to the date of a plan termination, without any liability for future salary increases. PBGC rates are generally lower than the financial accounting assumption and may be higher or lower than funding assumptions depending on whether current interest rates are higher or lower than the historic returns generally used to set the funding assumption. Other PBGC assumptions, such as those related to mortality and expected retirement age, can also have a significant effect on the funded status of a defined benefit pension plan.

- **Prudent investor rate**, applied by bankruptcy courts to value PBGC's claims in bankruptcy, is the rate that a reasonably prudent investor would receive from investing the funds.[8] This is generally a higher rate than any of the other rates and therefore results in a lower value of the liabilities.

Given the difference between the ongoing cost to maintain a plan and the termination liability, almost all underfunded plans terminate in bankruptcy or other dissolution of the sponsoring employer(s). The bankruptcies of Copperweld Steel Company (CSC) and USAirways provide good examples of the differences that interest rates can make in valuing the liabilities and how difficult it is to judge those liabilities from a company's financial statements. Three of the Copperweld plans were terminated. The following chart compares Copperweld's unfunded pension liabilities on three bases: as reported by Copperweld on its financials at the end of the year before the termination, as claimed by PBGC, and as determined by the bankruptcy court using a prudent investor rate:

	Unfunded liabilities	**Interest rate**
CSC financials	$16.5 million	8.75%
PBGC claim	$49.7 million	6.4 % for the first 20 years and 5.75% thereafter
Prudent investor rate	$ 1.8 million	10%

The parties stipulated that the "prudent investor rate" would be 10 percent; PBGC's actual 5-year average investment returns have consistently exceeded this rate and therefore a higher rate might reasonably be used. The unfunded pension liability shown on Copperweld's audited financial statement was for only two underfunded plans. One of the three plans terminated by PBGC was overfunded on an accounting basis. Had its net assets been included, the amount of unfunded liabilities would have been reduced even further.

In the USAirways bankruptcy, only one plan was terminated so it is easy to make a direct comparison. USAirways presented evidence on a variety of possible interest rates, combined with a different mortality table that was more stringent than the one PBGC uses as well as a different assumed early retirement age (60 for USAirways versus 55 under the PBGC assumptions). The following chart shows the differences in the liabilities and the assumptions on which they were based:

	Liabilities	Interest Rate	Mortality Table
USAirways financials			
PBGC claim	$3.6 million	5.1% for the first 20 years and 5.25% thereafter	83 GAM set back 6 years for females
Funding rate	$2.1 million	8%	94 GAM
Upper range of prudent investor rates	$1.8 million	9.1%	94 GAM
Lower range of prudent investor rates	$2.4	7.1%	94 GAM
Lower range with PBGC assumptions	$2.8	7.1%	83 GAM set back 6 years for females

PBGC's rates are based on a survey of insurance companies, who are asked to quote on specific annuities. From these quotes, PBGC derives the interest rate that would be used if the insurance companies were using PBGC's mortality table (since the insurance companies generally use different mortality assumptions). A study by the American Academy of Actuaries ("AAA") in 2000 indicated that PBGC assumptions overvalue the liabilities by 3-4% compared to actual annuity purchases.[9] This may be because negotiation of actual annuities usually results in more favorable results than the initial quotes would suggest. The difference in large cases can be significantly greater than the reflected by the AAA study, since the mean value of the annuities in the study was only $5 million. For example, for annuities on a plan with liabilities in the $300-400 million range, the ultimate quotations after several rounds of bidding were more than 10 percent lower than the PBGC's assumptions.

Note that PBGC has proposed a change in its mortality table.[1] When adopted in final regulations, the new mortality table should result in a corresponding increase in the PBGC's interest rate, so that there may be little or no change in the total termination liability.

Controlled Group Liability

Minimum funding requirements, PBGC premiums and termination liabilities on are joint and several liabilities of the plan's contributing sponsor and each member of its controlled group.[10] The "controlled group" is determined under section 414 of the Internal Revenue Code.[11] Thus, a buyer acquiring a business with an underfunded plan cannot insulate the rest of the controlled group by acquiring the business through a separate subsidiary.

There are two different definitions of controlled groups that are used for different purposes in ERISA and the Internal Revenue Code. One definition includes only corporations or trades or businesses under common control within the meaning of section 414(b) or (c) of the Internal Revenue Code. This includes parent-subsidiary control groups and brother-sister controlled groups. Parent-subsidiary controlled groups are groups in which a parent company directly or indirectly owns 80 percent of at least one or more subsidiary. Brother-sister controlled groups exist if the

[1] 70 Fed. Reg. 12429 (March 14, 2005).

same five or few shareholders who are individuals, trusts or estates own 80 percent of more of two or more companies ("controlling interest") and, taking account the lowest ownership percentage in each company, the same shareholders own more than 50 percent each company ("effective control"). There are complex attribution rules in making these determinations[12] and understanding them can be critical to avoid inadvertently creating a controlled group that could become liable for missed minimum funding contributions, PBGC termination liability and PBGC premiums.

In addition, for qualified plan purposes (including minimum funding) and for PBGC premiums, the controlled group also includes affiliated service groups and other related employers under section 414(m) and (o) of the Internal Revenue Code. Affiliated service groups are generally limited to organizations providing professional services that have some common ownership and companies that provide management services, whether there is any common ownership or not.[13] Section 414(o) of the Code provides broad authority to the IRS to define other categories of organizations that should be treated as under common control "as may be necessary to prevent avoidance" of the a variety of Code requirements governing employee benefit plans. There are currently no regulations under either of these sections although the IRS in the past has attempted to promulgate rules designed to curb perceived abuses of the nondiscrimination rules for qualified plans, but inadvertently drew otherwise unrelated groups into the controlled group, thus potentially subjecting them to some, but not all, of the PBGC claims.

Accordingly, the PBGC may claim the entire amount from each of them and collect all or part from any of them, although PBGC's total recoveries cannot exceed the amount of the statutory obligation. The 30 percent of net worth tax status claim is filed in each member's bankruptcy case (but not granted) and could be demanded from each member that is not a bankruptcy debtor. Each, in turn, may have rights against the other members for contribution to the amount paid to PBGC.

Foreign controlled group members present a different problem for the PBGC. Although they generally will not be included in a U.S. bankruptcy proceeding, PBGC is not able to make a direct claim against them in U.S. courts unless they meet the minimum contacts test that permits the U.S. courts to assert jurisdiction over them.[14]

Dividing Defined Benefit Assets and Liabilities

If employees of the business being purchased have participated in a larger plan maintained by the seller, the parties will have to negotiate the division of the assets and liabilities. In some cases, the buyer may assume only the benefits of employees who transfer to the buyer at the time of the sale. In other cases, the buyer will assume responsibility for retirees, beneficiaries and inactive participants. How the assets and liabilities are divided can make a significant difference in both accounting costs and funding requirements for the buyer and the seller after the transaction. If the parties are unable to agree on a division of the plan, the seller may keep the plan with the buyer setting up its own plan.

Assets must be divided in accordance with the requirements of section 414(l) of the Code and the corresponding provision of ERISA, section 208. Those rules require that each participant must have a benefit immediately after the transaction, if the plan were to terminate, that is no less than the benefit the participant would have received if the plan had terminated immediately before

the transfer. The regulations generally provide that the plan participants' benefits and the funding of those benefits must be the same after the transfer as it would have been before the transfer, assuming in each case that the plan had terminated.[15] PBGC's assumptions are a safe harbor in measuring pension plan liabilities under the section 414(l) regulations [16] but other reasonable assumptions may be used.

The regulations require that assets be allocated in accordance with the priorities established for terminated plans.[17] This means that assets will be allocated in the following order:

- first, to benefits attributable to employee contributions[18]
- then to benefits of retired employees and those eligible to retire three years prior to the date of the transfer, under the terms of the plan in effect five years prior to the transfer[19]
- then to the benefits that would be guaranteed by PBGC[20]
- then to the remaining nonforfeitable benefits[21] and
- finally, to any nonforfeitable benefits in the plan.[22]

Once assets equal to the liabilities have been allocated to each plan, the parties are free to negotiate over the division of surplus assets.[23] In a *de minimis* spinoff, one in which the transferred assets are less than 3 percent of the assets of the plan from which the spinoff is occurring, liabilities and assets can be transferred without regard to the allocation priorities as long as the assets and liabilities transferred are equal.[24]

Since the interest rate used to calculate the value of participants' benefits will change with market conditions, establishing the date of the spinoff is critical to ensure compliance with these rules. There are no rules specifying the date of a spinoff. However, the regulations identify the following factors to determine the date:

- the date as of which employees cease to participate in one plan and begin to participate in the other plan;
- the date as of which the assets and liabilities to be transferred are calculated;
- the date as of which interest or earning are credited to the amount to be transferred.[25]

The closing date is usually specified in the sales agreement as the spinoff date although another date can be chosen.[26]

PBGC's Early Warning Program

Companies with large amounts of underfunded pension liabilities are likely to hear from the PBGC long before bankruptcy, particularly if the company has below investment-grade bond ratings. PBGC has established an Early Warning Program that focuses on transactions that, in PBGC's opinion, may pose an increased risk of long-run loss to PBGC. PBGC issued Technical Update 2001-3 in July 2000 to explain when the PBGC is likely to intervene in a transaction and the types of pension protections PBGC is likely to seek. The Technical Update indicates that PBGC will focus only on transactions involving financially-troubled companies and transactions involving companies with pension plans that are underfunded on a current liability basis, although in the past

they have also intervened in transactions involving plans that were fully funded on a current liability basis but underfunded on a termination basis. In prior years, PBGC had taken a more expansive view of when it would intervene.

PBGC's intervention in corporate transaction has in the past come as a surprise to corporate executives, often coming after the transaction has already been structured. In these cases, PBGC's intervention can threaten to delay or derail the transaction and, because it is unexpected, can limit options that might otherwise be available if the problem had been identified at an earlier stage in the transaction. PBGC's intervention may be particularly surprising when the company's financial statement shows that the plan's assets exceed its liabilities and the plan is at the "full funding limit," the point at which minimum funding contributions are no longer required or may even be penalized with an excise tax.

The difference in assumptions used in the various measures of liability discussed above may cause a plan that is *overfunded* for both funding and financial accounting purposes to be substantially *underfunded* in the PBGC's view. The PBGC values are rarely calculated for ongoing plans (except by the PBGC and those in negotiation with the PBGC). The problem is exacerbated by the rise and fall of interest rates, since pension liabilities are very sensitive to interest rates. Often the only available actuarial valuation is months old. Any actuarial valuation of the plan must be reviewed not only to determine whether economic conditions have changed (e.g., whether interest rates have risen or fallen) but also whether plan conditions have changed. For example, have there been benefit increases, significant layoffs or future benefits negotiated in collective bargaining but not yet reflected in the plan documents?

PBGC focuses transactions that may substantially weaken the financial support for a pension plan or PBGC's potential recovery in a future bankruptcy. Examples of transactions that will attract PBGC's attention include:

- Breakup of a controlled group (for example, a sale or a spin-off of a subsidiary);
- Corporate transaction in which significantly underfunded pension plans (or portions of plans) are transferred to a new controlled group that has a below-investment grade bond rating;
- Leveraged buyout;
- Major divestiture by an employer who retains significantly underfunded pension liabilities;
- Payment of extraordinary dividends (e.g., a dividend, stock redemption or other payment within the controlled group that exceeds the adjusted net income of the company making the distribution, either for the prior year or for the four preceding years); or
- Substitution of secured debt for previously unsecured debt.

Thus, many of the transactions involved in a pre-bankruptcy workout will result in PBGC intervention.

Technical Update 2001-3 encouraged companies and their advisors to contact PBGC's Corporate Finance and Negotiations Department (now known as the Corporate Finance and

Restructuring Group as a result of a recent PBGC reorganization) in advance of a transaction. PBGC'S Corporate Finance Group is a small group of financial analysts and actuaries who monitor the companies with the largest underfunded plans. Analysts in PBGC'S Corporate Finance Group act much like Wall Street analysts, following particular companies and particular industries, particularly industries that have previously resulted in large claims such as the auto, steel and airline industries. They monitor financial publications, company press releases and on-line financial information. They also talk to analysts and others who follow their industries.

Depending on the nature of the transaction, there are four possible legal grounds that PBGC may assert when it intervenes in a transaction:

- the plan has not met minimum funding requirements.
- the "possible long-run loss of the [PBGC] may reasonably be expected to increase unreasonably if the plan is not terminated."
- a cessation of operations at a facility that results in a 20 percent reduction in active participants under the plan.
- the threat that PBGC will bring a subsequent evasion action if the plan is terminated within 5 years after the transaction (see below).

In the first two cases, PBGC may move to terminate the plan(s) and pursue the employer and each member of its controlled group for termination liability.

If there is a cessation of operations at a facility that results in a 20 percent reduction in active participants under the plan, PBGC may require the employer to make a payment into the plan or, at the employer's election, post a bond or escrow equal to 150 percent of the liability attributable to the closed facility for five years.[27] This provision has been little used in the past because the statutory measure of liability was calculated by reference to rules for calculating the liability of a substantial employer terminating participation in a multiple-employer plan, which imposed liability based on the employer's proportionate share of contributions to the plan. This made little sense in a single-employer plan since there generally is only one employer. PBGC has recently proposed regulations, however, to determine the liability attributable to the closed facility by multiplying the plan's termination liability by the percentage of the participants who ceased to be active employees as a result of the facility closing.[28] Once the regulations are finalized, PBGC is likely to more aggressively pursue facility closings. One of the unanswered questions, not addressed by the proposed regulation, is whether and when a sale of a facility would constitute a facility closing. PBGC General Counsel Opinions have previously interpreted section 4062(e) not to apply to asset sales.[29]

If PBGC identifies a long-run loss case, PBGC will attempt to negotiate with the parties to obtain protection for itself and the plan without terminating the plan. Protections that PBGC has accepted in the past include:

- a guaranty from a strong company that's leaving the controlled group;
- additional contributions to the plan, with restrictions on how the resulting credit balance may be used; or

- security to protect the plan against future missed contributions or termination liability.

Typically the guaranty or security stays in place for a set period of five years or, if later, until the plan sponsor meets certain performance benchmarks. These are usually tied to the risk that threatened to increase the long run loss. For example, when American Cyanamid was spinning off Cytec in 1993, the guaranty was tied to the resolution of environmental problems that were the reason for the increased risk. In other cases, release of the guaranty or security may be tied to achieving investment grade status or financial benchmarks customized to the specific company or industry.

PBGC's bargaining position is strongest when termination prior to a transaction will result in a full recovery for the plan, protecting both PBGC and the participants and the potential recovery after the transaction is significantly lower. When termination will bring a loss to PBGC, PBGC may accept less favorable terms rather than terminating the plan. Therefore, a careful analysis of the plan liabilities, PBGC guarantees and the potential recovery if PBGC terminated the plan (both in bankruptcy and outside) must be made before negotiating with the PBGC.

Evasion Transactions

If a principal purpose of any transaction is to evade liability and the transaction becomes effective within 5 years before termination, any person involved in the transaction (and that person's controlled group on the termination date) can be held liable as if that person were a contributing employer under section 4069 of ERISA.[30] Benefit increases after the transaction are excluded.

There has been very little litigation under this provision. In a case governed by ERISA as in effect prior to the enactment of section 4069, International Harvester had been found liable for its highly-leveraged sale of the Wisconsin Steel Company.[31] In that case, the buyer failed and the transferred plan terminated so quickly that the plan's assets had not yet been transferred from the International Harvester master trust.

In contrast, the only case decided under section 4069 involved the termination of a plan more than 5 years after the initial business sale that gave rise to the claim. In *PBGC v. White Consolidated Industries*,[32] the Third Circuit held that a sale transaction did not become effective—and therefore the five-year period with respect to a former plan sponsor did not begin—until the former sponsor ceased making substantial contributions to fund the plan. In a subsequent decision, White Consolidated was found to have engaged in an evasion transaction by transferring underfunded plans in a highly-leveraged buyout in which assumption of the pension liabilities was the sole consideration for the business.[33] In settlement, White Consolidated agreed to resume sponsorship of the terminated plans, to increase benefits by five percent, to merge the restored plans with an overfunded plan it maintained and to purchase annuities to provide the benefits.[34]

PBGC has brought very few evasion actions. The issue more often comes up in the context of a buyer who is not taking the plan but wants comfort that PBGC will not subsequently assert liability for the underfunded plan(s) left behind. That was the basis for PBGC's agreement with General Motors (GM) that allowed GM to spinoff its subsidiary, EDS, to the shareholders. In that

transaction, GM agreed to contribute more than $10 billion in cash and stock to its underfunded plan to obtain the release.

PBGC Bankruptcy Claims

If a company with a defined benefit plan files for bankruptcy, PBGC typically makes several claims. With the exception of claims related to premiums and certain ongoing funding obligations, the claims are filed as a result of, or contingent on, the termination of the plan and/or PBGC's appointment as statutory trustee. If the sponsor reorganizes in such a way that the plan does not terminate, the termination contingency does not arise and PBGC typically withdraws the contingent claims.

Employer Contributions. Claims for unpaid employer contributions are filed in bankruptcy cases as claims of the pension plan, not the PBGC. PBGC will file contingent claims, since they will usually become the plan trustee if the plan terminates during the bankruptcy. Claims for unpaid employer contributions may fall into any of five categories, which are, in order of priority:

- Secured claims. Failure to make required contributions in excess of $1 million gives rise to a lien on all controlled group property in favor of the plan, which is enforceable by the PBGC. If this lien is perfected prior to the filing of the bankruptcy petition, the PBGC will have a secured claim to the extent of the value of assets subject to the lien in each controlled group member's bankruptcy case. The lien is treated as a statutory tax lien.[35]

  The plan may also have a secured claim for the unamortized amount of any funding waivers if the sponsor has posted collateral as security and a security interest had been perfected.[36] Although the IRS grants funding waivers, PBGC negotiates the collateral and enforces the lien. A plan sponsor may also grant PBGC a security interest in connection with a negotiated agreement under the Early Warning Program, usually to permit a corporate transaction that in PBGC's view would pose an increased risk of increased risk of loss to the PBGC. These liens are consensual rather than statutory.

- Administrative Priority Claim. PBGC files an administrative priority claim[37] for the amount of unpaid minimum funding accruing from the date the debtor filed its petition under bankruptcy law through the date of pension plan termination as a ordinary and necessary business expense of the estate. The amount is determined by applying a ratio of days ongoing to days in the plan year to the minimum funding.[38] Of course, any amount allowed as a secured claim would not be claimed again as administrative.[39]

  Virtually every court that has considered the question has limited the administrative priority claim to the value of the benefits accrued during the pendency of the bankruptcy case as measured by the plan's normal cost.

  PBGC will also claim administrative priority for unpaid minimum funding contributions in excess of $1 million. PBGC claims that administrative priority is available without need for a showing that the debt constitutes a benefit to the estate or necessary business expense of the estate. The amount of contributions missed gives rise to the tax lien discussed above

and is "treated as taxes due and owing the United States."[40] This priority was rejected by the 10th Circuit in *In re CF&I Fabricators of Utah, Inc.* and by the 6th Circuit in *In re CSC Industries*.41

- Employee Plan Priority Claim. A fourth priority claim[42] is filed for the unpaid minimum funding accruing during the 180 day period ending on the date the bankruptcy petition was filed (or the date the debtor's business ceased, if earlier).[43] This claim is limited to a maximum of $4,650 times the number of employee/participants during that period, minus the aggregate amount paid those employee/participants on account of third priority wage claims. Any amounts accruing during the 180 day period in excess of the limitation become part of the unsecured claim below. Any funding waivers allowed as a secured claim would not be claimed again here.

- Tax Priority Claim. To the extent the missed contribution above $1 million arose pre-petition but is not allowable as a secured claim, PBGC claims that amount as a priority pre-petition tax.[44] This priority was rejected in *CF&I Fabricators of Utah, Inc.* and *In re CSC Industries.* [45]

- General Unsecured Claim. All unpaid minimum funding amounts not permitted under the secured or priority categories above are filed as an unsecured claim. Again, all funding waivers may be treated as revoked in the computation of the amount if the waiver contains language that nullifies the waiver on plan termination.

Employer Liability to PBGC. The PBGC files a priority claim for the amount of the unfunded benefit liabilities (or 30 percent of the combined net worth of the contributing sponsor and all trades or businesses under common control with the sponsor, if that amount is less than the underfunding). In bankruptcy and insolvency cases, PBGC asserts that this claim is to be "treated as a tax due and owing to the United States" as provided by section 4068 of ERISA, so it is filed as a tax priority claim. If the plan is terminated during the administration of the bankruptcy, it is filed as an administrative tax claim. In the event that any part of the claim is determined to have arisen pre-petition, that part is claimed in the alternative as a seventh priority pre-petition tax. If the plan is terminated prior to the bankruptcy case, it is filed as a pre-petition tax claim.[46] This priority has been consistently rejected under the Bankruptcy Code.[47]

PBGC's employer liability claim is for 100 percent of the unfunded benefit liabilities under the plan. Generally, benefit liabilities will include all fixed and contingent benefits provided under a plan at the date of plan termination date from the value of benefit liabilities under the plan as of that date.[48] Prior to 1986, PBGC's *claim* was limited to the amount of unfunded guaranteed benefits or 30 percent of net worth, whichever was less. Now 30 percent of net worth is only relevant as a limit on the PBGC tax lien and priority claims.[49]

PBGC determines the actuarial present value of the benefit liabilities pursuant to the assumptions prescribed by PBGC in its valuation regulation.[50] The interest rate assumption in PBGC's valuation regulation can have a substantial effect on the amount of PBGC's claims and therefore it is challenged in virtually every bankruptcy.[51] The Sixth and Tenth Circuits have both held that the bankruptcy court may value the liability using a "prudent investor rate," the rate that a

reasonably prudent investor would receive from investing the funds.[52] Bankruptcy courts have authority under the Bankruptcy Code to determine the amount of claims in bankruptcy proceedings.[53] Moreover, the Bankruptcy Code requires that same-class creditors be treated equally.[54] Since PBGC's claim is for the stream of future payments it will have to make to pension plan participants, these courts have concluded that the bankruptcy court may determine the present value of this stream of payments under this authority and must apply an interest rate that treats PBGC and similarly-situated creditors the same. The prudent investor rate applied by the bankruptcy courts has been higher than the PBGC rates. The effect of the higher interest rate has been to lower or even eliminate PBGC's claim, as illustrated by the CSC example above. The prudent investor approach was recently rejected by bankruptcy court in the *USAirways* case, in which the court held that the liabilities should be valued using PBGC assumptions. [55]

The prudent investor challenge to the PBGC's employer liability claim arises because of the interplay between the Bankruptcy Code and ERISA. Controlled group members that are not in bankruptcy may have difficulty asserting these claims. Therefore, when PBGC claims are likely, all members of the controlled group normally file for bankruptcy if possible. Some businesses, such as banks and insurance companies, may not be able to file for bankruptcy, however.[56]

Premium Claims. Premiums payable to the PBGC are the joint and several liability of the plan's contributing sponsor and members of the sponsor's controlled group. However, these premiums are also obligations of the plan itself and generally may be paid from plan assets. PBGC claims administrative priority to the extent that the premium relates to the post-petition period.

Contractual Claims. Occasionally, the PBGC of the terminated plan may have rights under a contract that will give rise to an additional claim. Situations in which such contractual claims may arise include:

- settlement agreements to which the PBGC is a party,
- commitments to make a plan sufficient in a standard termination filed with the PBGC,
- notes held by a plan, and
- sales agreements providing for continuing funding responsibility on the part of a seller.

As noted above, the claim will be filed as a secured claim if collateral was pledged as part of the contract.

Employee Contributions. From time to time, the PBGC encounters a case in which employee contributions were withheld by an employer but not paid over to the plan. A claim that these amounts are impressed with a trust is filed on behalf of the plan, stating that the Debtor's estate had no title to the amounts, and that they must be paid in full to the rightful custodian, the pension plan. Employee contributions in defined benefit plans are relatively rare, however, and this issue rarely comes up.

Notices to Participants

204(h) Notice of Significant Reductions. If the seller retains the plan but the participants are transferred to the buyer, the plan administrator may have to give participants notice under section 204(h) of ERISA. Section 204(h) requires advance notice if an amendment is adopted that significantly reduces the rate of future accruals, early-retirement benefits or retirement type subsidies. Whether notice will be required in connection with a merger or acquisition transaction turns on whether an amendment is required.[57] For example, in an asset sale, employees will automatically cease to be participants at the time of the sale if they transfer to the buyer and therefore no notice is required that they will cease accruing benefits in the seller's plan. Similarly, in a stock sale of a subsidiary, no notice is required if the plan already provides that participants cease to accrue benefits in the plan if the company they work for is no longer a member of the parent's controlled group.

The notice must be "written in a manner calculated to be understood by the average plan participant and to apprise [potentially affected participants] of the significance of the notice."[58] A summary of the amendment is sufficient. Sufficient information must be given allow affected individuals "to understand the effect of the amendment."[59]Individual benefit calculations are not required. However, the notice must give sufficient information to allow the participant to understand the impact of the amendment. If notice is being given because accruals are ceasing entirely, mathematical examples are not required because the magnitude of the reduction is obvious from a description of the amendment. If benefit formulas are being changed and a description does not make the magnitude of the reduction obvious, illustrative examples must be given that bound the range of reductions.[60]

The notice must be given to each affected participant and alternate payee, as well as any collective bargaining representative whose members future benefit accruals are reduced by the change.[61] Notice need not be given to individuals whose benefits are not affected by the amendment, such as employees who remain with the seller. Delivery by first class mail or by hand is acceptable; posting is not acceptable.[62] The regulations provide a safe harbor for notice given electronically.[63]

The 204(h) notice is normally required at least 45 days before the effective date of amendment.[64] However, if the notice is connection with a business transaction, the time period is reduced to 15 days. [65] In addition, if the notice is required in connection with a plan transfer or merger as part of a business transaction, the notice may be delayed until 30 days *after* the transfer or merger but only if the effect of the amendment is to reduce early retirement benefits or retirement-type subsidies, not the rate of future benefit accrual.[66]

The rules described above are generally those for amendments effective after September 2, 2003. Prior to that date, a reasonable good faith interpretation of the requirements is permitted.

Failure to provide the notice results in an excise tax of $100 per day per participant.[67] In addition, the amendment may be invalidated until the plan administrator "egregiously" fails to provide the required notices.[68]

SPDs. The buyer who provides a defined benefit plan after the transaction will be required to provide a summary plan description or summary of material modification describing benefits in the buyer's plan. This may simply be an existing SPD if the transferred employees are becoming participants in a plan that the buyer already maintains. If the buyer establishes a new plan, for example a clone of the seller's plan, new SPDs will have to be provided.

Notice to IRS of Plan Merger, Consolidation, Spinoff or Transfer

IRS Form 5310-A must be filed in connection with a plan merger or transfer of a single-employer defined benefit plan. The Form 5310-A does not have to be filed for a *de minimis* transfers (i.e., those involving less than three percent of the transferring plans assets). An actuarial statement of valuation showing compliance with section 414(l) must be attached to the Form 5310-A. The statement must identify the type of transaction (e.g., merger, spinoff, or transfer) and provide information verifying compliance with the requirements of section 414(l) of the Code.

The form must be filed 30 days before the merger or transfer. Often the actuarial statement cannot be provided until sometime after the merger or transfer date, primarily because of data issues. Notice is therefore often given 30 days before the transfer of assets, rather than before the effective date of the merger or transfers itself. A precautionary filing in advance of the effective date, without the statement, is often filed in advance of the effective date.

Failure to timely file the Form 5310-A results in a $25 per day penalty but does not invalidate the merger or transfer.

Reportable Event Filings

PBGC does not rely on the formal filings of reportable events since notices of reportable events are generally given 30 days after the event, usually too late for PBGC to take action. The large companies PBGC monitors are almost all publicly-traded companies that are required under the securities laws to notify the public of financially significant transactions. As a result, PBGC can find out about these transactions from news releases and reports from financial analysts that follow these companies.

Privately-held corporations — primarily those that do not file with the Securities and Exchange Commission — with pension underfunding of more than $50 million, have to give PBGC notice 30 days in advance for the reportable events added by the RPA and the regulations. Waivers and extensions for advance filers are much more limited than the waivers and extensions described below for after-the-fact filers.[69]

Information provided in connection with a reportable event is exempt from the Freedom of Information Act (FOIA) and disclosure (other than to Congress) is prohibited.[70] The prohibition on disclosure is identical to the Hart-Scott-Rodino pre-notification statute, so companies now feel more comfortable coming to PBGC and providing information in advance. Identifying materials provided in advance of the formal reportable event as protected by this FOIA exception is wise.

The reportable events commonly encountered in corporate transactions are:

- **Change in corporate sponsor or controlled group.** A transaction that results "in one or more persons ceasing to be members of the plan's controlled group" is reportable.[71] Most typical here is a sale of a subsidiary in a stock sale or the transfer of a pension plan in connection with a sale of assets. A sale of assets, if it does not involve a transfer of a plan, is not a reportable event and, by itself, is unlikely to increase PBGC's risk of loss. PBGC is likely to be concerned if the new controlled group is below investment grade. Notice is waived for transactions involving less than 10 percent of the controlled group, for foreign members of the group other than the parent, for public companies whose plans are all at least 80 percent funded and for plans that that do not pay the variable rate PBGC premium or have less than $1 million in unfunded vested benefits.[72] Note that the 30-day time to report begins with the signing of a legally-binding agreement, if earlier than the actual closing.[73] The 30-day period is extended for plans that would have met the waiver tests in the prior year, for transactions involving foreign parents, and publicly traded companies.[74]

- **Liquidation of a contributing sponsor or controlled group member.** In addition to complete liquidations, PBGC is interested whenever a valuable controlled group member, typically one with little debt, is being liquidated into a parent company with significant debt.[75] Even though the overall financial health of the controlled group may be unchanged, PBGC will be concerned if its ability to collect employer liability on plan termination is reduced. PBGC has a separate claim against each member of the controlled group. If the parent company has more debts than assets but its subsidiary has significant net worth, PBGC's claims can be recovered up to the amount of the subsidiary's net worth. Once the subsidiary's assets are liquidated into the parent, PBGC's claims will compete with the claims of the parent's other creditors for those assets. Waivers and extensions are generally the same as for change of plan sponsor, above.[76]

- **Extraordinary distribution or stock redemption.** In the statute "extraordinary dividend" was defined by reference to section 1059(c) of the Internal Revenue Code. Both PBGC and the Negotiated Rulemaking Committee concluded that definition was unworkable. Therefore, the final reportable events regulation substitutes a new definition that compares the size of the distribution (whether it is a dividend, stock redemption or other payment within the controlled group) to adjusted net income of the company making the distribution, either for the prior year or for the four preceding years. If the distribution exceeds any of these measures of adjusted net income, then it is reportable.[77] For noncash distributions, the reporting threshold is 10 percent of the company's total net assets.[78] Waivers and extensions are somewhat broader than for change of plan sponsor, above, except that the *de minimis* threshold is set at 5 percent of the controlled group rather than 10 percent.[79]

- **Plan spinoff or transfer under section 414(l) of the Internal Revenue Code.** Under PBGC's reportable events regulation, after-the fact filers only have to report non-de minimis plan spinoffs and transfers that do not meet the safe harbor.[80] If the assets and liabilities are divided in using the PBGC assumptions or if both plans after the transfer

are fully-funded using the PBGC assumptions, no reporting is required. (Notice by advance reporters is waived if both plans are overfunded or if one of the plans has fewer than 500 participants and PBGC assumptions are used). PBGC examines plan spinoff transactions to determine whether such transactions are, in its view, creating underfunded plans where none previously existed. PBGC took action in one case to prevent the transfer by notifying the bank trustee that the transaction as originally structured violated ERISA and asked the trustee not to transfer the assets. The parties quickly restructured the transfer to come within the safe harbor and PBGC promptly notified the trustee that there was no problem with the restructured transaction. When PBGC has examined a transfer and concluded that it complies with section 414(l), PBGC has been willing to issue no-action letters. In Technical Update 2000-3, however, PBGC stated that it would no longer review transactions for compliance with section 414(l) and therefore presumably will also be unwilling to issue no-action letters.

- **Reduction in active participants.** A reportable event occurs when the number of active participants under a plan is reduced to less than 80 percent of the number of active participants at the beginning of the plan year or to less than 75 percent of the number of active participants at the beginning of the previous plan year.[81] As discussed above, PBGC may treat a 20 percent participant reduction as a result of cessation of operations at a facility as a withdrawal and require the employer to make a payment into the plan or post a bond or escrow. Reporting is waived for small plans (under 100 participants), for plans that are not required to pay the variable rate PBGC premium and for plans with less than $1 million in unfunded vested benefits.[82] Unless the reduction in active participants results from the cessation of operations at a single facility, the period for reporting such cessations is extended.[83]

- **Loan default by the contributing sponsor or a controlled group member.** Loan defaults are reportable if the loan balance is $10 million or more.[84] If the loan default results from a failure to make required payments when due, the default is reportable 30 days after the due date (10 days for advance reporters) unless the payment has been made by that time. Defaults for other than nonpayment are limited to situations in which the lender accelerates the loan or issues a notice of default on account of failure to maintain cash-reserve levels, unusual or catastrophic events, or a persisting failure by the debtor to attain agreed-upon financial performance targets. No notice is required for post-event filers if the default is cured or waived by the lender within 30 days (or the end of the cure period, if later).[85]

- **Bankruptcy or similar settlement involving a contributing sponsor or controlled group member.** This reportable event, which had been limited to the contributing sponsor in the earlier reportable events regulation, has now been extended to include bankruptcies or workouts involving controlled group members.[86] Reporting is waived for foreign entities.

PBGC has issued two one-page forms (Form 10 for Post-Event Notice and Form 10-Advance for Advance Notice) that can be used for reportable events. Plans are not required to use these forms, but fewer documents need to be submitted if the form is used. The notice can be filed by fax or

electronic mail. PBGC has posted an electronic version of the form that can be downloaded and filled out, then returned by e- mail.[87] This may be useful if the client (or the corporate attorney) has delayed in informing the benefits attorney of a transaction that must be reported.

Collective Bargaining Agreements.

Collective bargaining agreements covering employees of the businesses to be acquired should always be examined. There are a number of special health issues that can arise under collective bargaining agreements, some of which are not reflected on the seller's financial statement:

Negotiated Benefit Increases. Collective bargaining agreements will indicate whether the employer has agreed to pension or other benefit increases that are not reflected in the plan documents or the balance sheet. If so, then the buyer should evaluate the plans' unfunded liabilities taking into account the agreed to benefit increases. If the collective bargaining agreement is nearing re-negotiation, the buyer should understand the historical bargaining pattern and factor likely increases from the next round of bargaining.

Withdrawal Liability from Multiemployer Pension Plans. The collective bargaining agreement will also indicate whether the employer is contributing to a multiemployer pension plan on behalf of the covered employees. Multiemployer plans, also known as Taft-Hartley plans, are collectively bargained plans to which more than one employer is obligated to contribute. Multiemployer pension plans are typically defined benefit plans even though the collective bargaining agreement may call only for a specific contribution to be made by employers for each employee. If an employer ceases to make contributions or otherwise withdraws from the plan, the employer and its controlled group will be required to continue to fund a share of the plan's unfunded liabilities.[88]

Therefore, if the seller is obligated to contribute to a multiemployer plan, the buyer will have to determine:

- whether the multiemployer pension plan is well-funded or poorly funded and
- whether to structure the acquisition as a stock acquisition or an asset acquisition.

If the deal is structured as a stock acquisition, the employer that is contributing to the plan (i.e., the corporation) does not change and there is no withdrawal that can trigger withdrawal liability to the plan. However, the buyer will succeed to the entire contribution history of the seller, which may result in a large withdrawal liability if the buyer should have a partial or complete withdrawal in the future.

If the acquisition is structured as an asset sale, the sale will constitute a complete withdrawal triggering withdrawal liability if the seller makes no other contributions to the multiemployer pension plan.[89] Similarly, if the seller makes contributions to the multiemployer plan on behalf of the employees of another business but such contributions represent less than 30% of the total contributions which the employer previously made to the plan, the sale could cause a

partial withdrawal from the multiemployer plan which can result in partial withdrawal liability.[90] The partial withdrawal may also result in withdrawal liability for the seller.

In a sale of assets, it is possible to avoid the imposition of withdrawal liability on the seller by complying with the sale of assets rules of ERISA section 4204. Under these provisions, the buyer must agree to continue to make contributions to the plan for substantially the same number of base units as the seller and to post a bond or deposit funds in escrow in case it ceases to contribute to the plan or withdraws during the subsequent five years.[91] The seller must agree to be secondarily liable for the withdrawal liability it would have had in the event the buyer withdraws during the subsequent five years and fails to make buyer's withdrawal liability payments.[92] Compliance with these provisions has a dramatic effect on the potential withdrawal liabilities of the buyer and seller. First the seller's possible exposure is changed to a secondary liability that will only be triggered in limited circumstances. Second, the buyer does not pick up the full contribution history of the seller. The buyer picks up only the last five years of the seller's contribution history.[93] In many instances, the last five years contribution history will not result in any potential withdrawal liability for the buyer.[94] The net effect of complying with the sale of asset rules can be to totally expunge the possible withdrawal liability that the seller might have had.

There are circumstances in which the sale of assets will not constitute a withdrawal:

- **Construction employer.** If the seller is a construction employer in a construction industry plan, the sale will not constitute a withdrawal as long as the seller ceases to perform the same type of work in the jurisdiction of the collective bargaining agreement .[95]

- **Entertainment employer.** There is a similar rule for employers in the entertainment industry who contribute to an entertainment industry plan, although they must cease doing similar work in the jurisdiction of the plan (which in some cases have national jurisdiction).[96]

- **No withdrawal.** If the acquisition is structured as a sale of assets and the seller continues to contribute to the multiemployer plan for the employees of another business where the continuing contributions exceed 30% of the seller's historic contribution level, the sale is neither a complete withdrawal nor a partial withdrawal. In this situation, it is not necessary to comply with the sale of asset rules – seller will not incur any withdrawal liability because of the sale. If the buyer and seller do not comply with the sale of asset rules of ERISA § 4204, the buyer does not inherit any of the seller's contribution history – it starts as a brand-new employer under the plan. This will also allow the buyer to take withdraw without any liability if the buyer withdraws within the first six years and the plan has adopted the "free look" rule in ERISA section 4210.

If the seller is selling substantially all of its assets outside of bankruptcy, its withdrawal liability may be limited to a percentage of its liquidation or dissolution value[97] Similarly, if an insolvent seller is undergoing liquidation, the liability may be reduced,[98] although the reduction generally benefits the seller's other creditors rather than the seller.

Successor Liability Clause. Whether or not the sale is a stock or an asset transaction, there may be successor liability imposed under labor law. Buyers should be aware of such claim because, for example, successor liability may be expanding as a means of collecting money owed to multiemployer pension plans.

Because the obligation for unpaid contributions and withdrawal liability falls on the contributing employer, it ordinarily does not pass to an unrelated buyer in an arms-length assets transaction. With respect to unpaid pension plan contributions, however, an employer may be liable for its predecessor's unpaid contributions if there is sufficient continuity between the two companies and the successor had notice of the prior liability.[99]

The collective bargaining agreement should be reviewed to determine if there is a "successor employer" clause. However, liability may be imposed on a buyer even where there is no contractual obligation. For example, under the National Labor Relations Act, which guarantees employees the right to union representation and proscribes discriminatory treatment for engaging in protected activities, a successor employer who

- substantially assumes a predecessor's assets,
- continues the predecessor's operations without interruption or substantial change, and
- has notice of a pending unfair labor practice charge at the time of acquisition

may be required to remedy the predecessor's unfair labor practice. This has been the law since at least 1973, when the Supreme Court decided *Golden State Bottling v. N.L.R.B.*[100] More recently, however, the National Labor Relations Board has taken the position that, to avoid liability, the successor must also prove that it lacked knowledge of its predecessor's unfair labor practice.[101]

Future Benefit Increases. Collective bargaining agreements usually last for a number of years. The agreement may call for scheduled benefit increases in future years. Also, if the contract is expiring, the buyer may be faced with demands for increased benefits in the upcoming bargaining, particularly if benefits are below the industry norm. Liability for both scheduled increases and potential future negotiations should be factored into the buyer's valuation of the business.

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Qualification Defects

In most corporate transactions the business being acquired will have one or more pension, profit sharing or stock bonus plans which are intended to be qualified plans under Code §401(a). Significant tax and financial results depend on the continued qualification of such plans. If a plan which has been presumed to be a qualified plan should be determined not to be qualified, it would have a significant adverse tax and financial impact on the business being acquired – the employer would lose its tax deductions for contributions which are not immediately vested, the trust would be subject to income taxes on its investment income, and the employees would be subject to tax on the vested benefits under the plan even though they had not yet received the benefits.

Tax qualified status of a retirement plan can be lost in any one of three ways:

- the form of the document may not comply with the extensive qualification requirements of the Code;
- the plan may not be administered in accordance with the qualification provisions of Code or the provisions of the plan document; or
- the plan may become discriminatory in favor of highly compensated employees either with respect to coverage, contributions or benefits.

In connection with a corporate transaction, the buyer should be very careful to verify that the retirement plans that will be adopted or assumed by buyer as a part of the transaction meet the qualification requirements. This should be done through document review, representations and warranties, and covenants.

It is not unusual during a corporate transaction for the parties to discover one or more defects relating to the qualification of the retirement plans of the business being acquired. Once defects are uncovered, the buyer and seller must decide what to do about the defects or the plans. If the defect has occurred only during the prior two plan years, the parties may be able to correct the defect without involving the IRS.[105] Solutions for defects of a longer duration or egregious violations may range from submitting an application to the IRS under its Voluntary Compliance Resolution ("VCR") or Walk-in Closing Agreement Programs.[106] In rare cases, the buyer and seller

may revise the transaction so that buyer does not adopt or assume the plan. More often, through negotiation, the liability is assigned to one party or the other in the sales contract.

Fiduciary Issues in Transactions

Settlor v. Fiduciary Decisions. ERISA permits an officer, employee, agent or other representative of the plan sponsor to serve as a plan fiduciary.[107] Where an individual serves in a dual capacity, ERISA's fiduciary requirements apply only to functions that are fiduciary in nature. Thus, the critical issue as to whether a person wearing "two hats" has an obligation to participants affected by a corporate transaction requires a determination of whether the plan-related activities are an exercise of the right to terminate or amend a plan – so called "settlor actions"; or, whether the individual is exercising any authority to manage the plan or plan assets or to administer the plan. The Supreme Court affirmed the long-standing principle that a sponsor's decision to establish, amend or terminate a benefit plan is not a fiduciary act subject to Title I of ERISA in three recent holdings.

In *Curtis-Wright Corp. v. Schoonejongen*, the Court stated that "employers or other plan sponsors are generally free under ERISA for any reason at any time to adopt, modify or terminate their welfare plans."[108] The Court squarely adopted the settlor-function doctrine, in the pension plan context, in *Lockheed Corp. v. Spink*.[109] There, the plaintiffs alleged that Lockheed breached its fiduciary duties under ERISA when it adopted and implemented an amendment to its plan which provided enhanced early retirement benefits to employees conditioned on the employee's release of employment-related claims. The Court recently made it clear, in *Hughes v. Jacobson*[110] that fiduciary responsibility does not attach to settlor decisions even involving the use of surplus assets in contributory plans, where the employees would have a right to a portion of the surplus in a plan termination, so long as the plan is on-going.

The DOL has long taken the position that actions taken to implement settlor decisions may involve fiduciary decisions. For example, the DOL takes the view that the plan administrator has a fiduciary obligation to insure that the division of plan assets between a buyer's and a seller's plan complies with the requirements of section 414(l) of the Code and section 208 of ERISA.

Paying Expenses from the Plan. The DOL has issued guidance on how these principles are applied to determine whether plan expenses associated with a transaction can be paid by a plan. In 2001, the DOL issued Advisory Opinion 2001-01A on payment of expenses with plan assets and posted on its website six hypotheticals applying the principles set forth in the advisory opinion to different fact situations.[111] Advisory Opinion 2001-01A "clarified" Advisory Opinion 97-03A, which had been issued to a representative of the California Insurance Commissioner. In Advisory Opinion 97-03A, the Department of Labor had taken the position that "a portion of the expenses attendant to [amending a plan to maintain its tax-qualified status and obtaining an IRS determination letter] may constitute reasonable expenses of the plan." However, the Department went on to note:

> Where, as here, there are benefits to be derived by both the plan sponsor (or the estate of the plan sponsor) and the plan, and where one party appears to be acting in both a settlor capacity on behalf of the plan sponsor (or the estate of the plan sponsor), and in a fiduciary

capacity on behalf of the plan's participants and beneficiaries, it would generally be necessary, in order to avoid violations of ERISA sections 406(b)(1) and 406(b)(2), to have an independent fiduciary determine how to allocate the expenses attributable to those benefits.

The Department concluded, however, that the California Insurance Commissioner did not have to engage an independent fiduciary because the state agency did not benefit from the tax-qualified status of the plan. This pronouncement, however, led the Kansas City office of the DOL to require allocation between the plan and the employer of the cost of maintaining tax-exempt status "based on [the] benefit to [the] plan sponsor." The Kansas City office also required allocation of nondiscrimination testing.

In Advisory Opinion 2001-01A, the national office rejected this interpretation:

> In Advisory Opinion 97-03A, the Department expressed the view that the tax-qualified status of a plan confers benefits upon both the plan sponsor and the plan and, therefore, in the case of a plan that is intended to be tax-qualified and that otherwise permits expenses to be paid from plan assets, a portion of the expenses attendant to tax-qualification activities may be reasonable plan expenses. This view has been construed to require an apportionment of all tax qualification- related expenses between the plan and plan sponsor. The Department does not agree with this reading of the opinion. The opinion recognizes that, in the context of tax-qualification activities, fiduciaries must consider . . . whether the activities are settlor in nature for purposes of determining whether the expenses attendant thereto may be reasonable expenses of the plan. However, in making this determination, the Department does not believe that a fiduciary must take into account the benefit a plan's tax-qualified status confers on the employer. Any such benefit, in the opinion of the Department, should be viewed as an integral component of the incidental benefits that flow to plan sponsors generally by virtue of offering a plan.

The hypotheticals went further and made it clear that the expense of obtaining a determination letter, after the settlor has amended the plan, is a permissible expense of the plan. The hypotheticals also clarified when plans could pay expenses incident to corporate merger and acquisition transactions and other settlor activities.

In analyzing expenses related to the transfer of defined benefit plan assets in connection with the sale of a business segment, the DOL concluded that the following were all expenses related to the settlor activities and therefore could *not* be paid by the plan:

- a plan design study in connection with the transaction,
- amending the plan to provide for the spinoff or
- bargaining with the union concerning the asset transfer.

The Department indicated that "Activities (such as union negotiations, benefit studies, actuarial analyses) that take place in advance of, or in preparation for, a plan change will almost always constitute settlor activities." In contrast, the cost of computing the assets necessary to implement the transfer "would be a permissible plan expense if the expense is attendant to implementing [the employer's] decision to spin-off certain participants, rather than for assisting [the employer] in

formulating the spin-off." Recomputing the amount to be transferred would be a permissible plan expense if "the delay in the closing date was through no fault of the sponsor and the plan was duly amended to accomplish the merger at the new closing date." While the wording of this example implies that recalculation of the amount to be transferred might not be a reasonable plan expense if the delay was caused by the plan sponsor, it is difficult to see why that would be the case since the plan fiduciaries would still have an obligation to ensure that the amount transferred satisfied section 414(l) of the Code and section 208 of ERISA.

Fiduciary Breach Claims in Bankruptcy. When successor fiduciaries discover that a fiduciary violation has taken place, they may pursue a claim for damages.[112] With the increase in corporate bankruptcies and the wave of shareholder and ERISA suits involving accounting scandal allegations, it is more likely that the some fiduciary claims will be brought against individual fiduciaries who themselves have filed for bankruptcy. Some fiduciary claim has been found to be "non-dischargeable" in an individual fiduciary's bankruptcy.[113] In order to be exempt from discharge under section 523(a)(4) of the Bankruptcy Code, the claim must arise from "fraud or defalcation while acting in a fiduciary capacity, embezzlement or larceny." [114] To the extent that such a claim goes unpaid in the bankruptcy, it is not forgiven by the bankruptcy discharge and may be pursued after the bankruptcy case is over.

The Ninth Circuit has concluded that an ERISA fiduciary was a fiduciary for purposes of section 523(a)(4).[115] However, the court held that a breach of fiduciary duty under ERISA was not sufficient to constitute "defalcation while acting in a fiduciary capacity." The decision indicates that there were no allegations of "accounting failure or misappropriation."

Conclusion

Some of the most interesting negotiations in corporate transactions involve defined benefit plans. The outcome will impact both the buyer and the seller's financial statements and therefore are among the few benefits issues of interest to the business people negotiating the transaction. Successful resolution can impact the profitability of both buyer and seller in the years following the transaction. Therefore, an understanding of the legal and accounting issues involved in the treatment of employee benefits in corporate transactions is essential.

ENDNOTES

[1] PL 93-406 (1974).

[2] Fiancial Accounting Statements 87 and 88 ("FAS 87 and 88") govern defined benefit pension plans. FAS 87 deals with the on-going cost of defined benefit plans and 88 deals with settlements and curtailments for pension plans. Financial Accounting Statement 106 ("FAS 106") provides the accounting treatment for post-retirement benefits that cause these liabilities to be disclosed by employers and factored into the employer's earnings. These standards were subsequently modified by Financial Accounting Standard 132 ("FAS 132"). References to FAS 87, 88 and 106 in this article are to the modified versions.

[3] Internal Revenue Code ("IRC") §412 and ERISA §302.

[4] Originally, ERISA §302(b)(2)(B)(ii) and IRC §412(b)(2)(B)(ii) provided that past service liabilities could be funded over a 30 year period for single-employer plans. Subsequent legislation has added ERISA §302(d) and Code §412(l) which provide for a deficit reduction contribution which requires that sponsors of severely underfunded plans make additional deficit reduction contributions.

[5] IRC §404(a)(1)(D) allows an employer which has more than 100 employees who participate in defined benefit pension plans to make a contribution to such plans up to the amount of their unfunded current liabilities as defined in IRC §412(l) and to deduct the full amount of the contribution. Employers with fewer than 100 employees who participate in defined benefit pension plans cannot fund past service liabilities faster than over a 10 year period without incurring adverse tax consequences.

[6] *See* ERISA §302(d)(7)(B)(i) and IRC §412(l)(7)(B)(i).

[7] An early retirement window benefit involves an enhancement to the regular early retirement benefit provided by the pension plan for any employee who retires early during a specified period of time – the "window period."

[8] *In re CSC Industries*, 232 F.3d 505 (6th Cir. 2000); *PBGC v. CF&I Fabricators of Utah, Inc*., 150 F.3d 1293 (10th Cir.1998), *cert. denied*, 119 S. Ct. 2020 (1999). The bankruptcy court in CF&I had upheld use of PBGC valuation assumptions in determining the amount of the unfunded benefit liabilities claim but was reversed on appeal.

[9] PBGC Plan Termination Cost Study (American Acadamy of Actuaries – Conference of Consulting Actuaries 2000).

[10] ERISA §§ 302(c)(11)(B) (minimum funding), 4007(e)(2) (premiums), and 4062 (termination liability); IRC § 412(c)(11)(B) (minimum funding).

[11] ERISA § 4001(b)(1).

[12] *See* Treas. Reg. § 1.414(c)-4.

[13] Code § 414(m)(2) and (5).

[14] *PBGC v. Satralloy, Inc.*, No. C-2-90-0630 (S.D. Ohio July 16, 1992).

[15] Treas. Reg. §1.414(l)-1(n)-(o).

[16] Treas. Reg. §1.414(l)-1(b)(5)(ii).

[17] See ERISA § 4044.

[18] See ERISA § 4044(a)(1)-(2).

[19] See ERISA § 4044(a)(3).

[20] See ERISA § 4044(a)(4).

[21] See ERISA § 4044(a)(5).

[22] See ERISA § 4044(a)(6).

[23] *IBEW v. AT&T*, 159 F.3d 1376 (D.C. Cir. 1998). This is true only if assets and liabilities are being divided between plans maintained by different controlled groups. For plans being divided within the same controlled group, section 414(l)(2) specifies the formula for dividing the surplus.

[24] Treas. Reg. § 1.414(l)-1(n)(2).

[25] Treas. Reg. § 1.414(l)-1(b)(11).

[26] *See* e.g., *Flanigan v. General Electric Co.*, Civil Action No. 3:93 CV 516 (JBA) (D. Conn. March 29, 2000) (plan assets and liabilities determined as of the last day of the plan year ending before the transaction).

[27] ERISA §§ 4062(e), 4063(b)(3); 29 U.S.C. §§ 1362(e), 1363(b)(3).

[28] 70 Fed. Reg. 9258 (Feb. 25, 2005).

[29] In PBGC Opinion Letter 75-92 (July 30, 1975*)*, PBGC raised the possibility that section 4082(e) might apply to a sale of assets without deciding the issue. PBGC subsequently considered the issue and concluded that section 4062e) would not apply to an asset sale, at least when the buyer assumed the plan. *See* PBGC Opinion Letter 77-147 (May 24, 1977), 78-29 (Dec.12, 1978) and 82-28 (Oct. 22,1982).

[30] ERISA § 4069, 29 U.S.C. § 1369.

[31] *In re Consol. Lit. Concerning International Harvester's Disposition of Wisconsin Steel,* 681 F. Supp. 512 (N.D. Ill. 1988).

[32] 988 F.2d 1192 (3d Cir. 1993), *cert. denied*, 62 U.S.L.W. 3477 (U.S. Jan. 11, 1994) (No. 93-661).

[33] *PBGC v. White Consolidated Industries Inc*., 215 F.3d 407 (3d Cir. 2000).

[34] "White Consolidated Agrees to Resume Sponsorship of Pension Plans; Retirees Promised Full Benefits," PBGC Press Release (July 6, 2000).

[35] IRC § 412(n)(4)(C), 29 U.S.C. §1082(f)(4)(C); 11 U.S.C. §§ 545, 547(c)(6).

[36] ERISA § 306, 29 U.S.C. § 1085a; ITC § 412(f)(3).

[37] 11 U.S.C. §§ 503(B)(1)(A), 507(a)(1).

[38] IRS Revenue Ruling 79-237.

[39] *Columbia Packing Co. v. PBGC*, 81 B.R. 205 (D. Mass. 1988).

[40] U.S.C. §§ 503(b)(1)(B), 507(a)(1): ERISA § 302(f)(4)(C), 29 U.S.C. § 1082(f)(4)(C); and IRC § 412(n)(4)(C).

[41] 150 F.3d 1293, 1298 at note 4 (10th Cir. 1998) and 2000 FED App. 0393P (6th Cir.).

[42] 11 U.S.C. § 507(a)(4).

[43] *Columbia Packing Co. v. PBGC*, 81 Bankr. 205 (D. Mass. 1988); *In re Saco Local Development Corp.*, 23 Bankr. 644 (Bankr. D. Me. 1982), *aff'd* 711 F.2d 441 (1st Cir. 1983); *In re P.C. White Truck Line Inc.*, 22 Bankr. 540 (M.D. Ala. 1982).

[44] 11 U.S.C. § 507(a)(7); ERISA § 302 (f)(4)(C), 29 U.S.C § 1082(f)(4)(C); and IRC § 412 (n)(4)(C).

[45] *See* note. 15, *supra*.

[46] I*n re Washington Group,* No. C-86-665-G (M.D.N.C. Mar. 9, 1987), modified, No. C-86-665-G (M.D.N.C. Mar. 29, 1987), *aff'g in part. rev'g in part*, Nos. B-77-695, B-77-697 through 702 (Bankr. M.D.N.C. June 16, 1986); *see also, In re Bollinger Corp*., No. 76-282 (Bankr. W.D. Pa Jan. 30, 1981). Note that both of these cases were under the Bankruptcy Act, rather than the current Bankruptcy Code.

[47] *See In re Tenn-Ero Corp.*, 14 B.R. 884 (Bankr. D. Mass. 1981), *aff'd sub nom*, *PBGC v. Ouimet Corp.*, 32 B.R. 65 (D. Mass. 1982); *In re Divco Philadelphia Sales Corp.*, 64 B.R. 232 (Bankr. E.D. Pa. 1986); *In re CSC Industries, Inc.*, 232 F.3d 505 (6th Cir. 2000).

[48] ERISA § 4001(a)(18), 29 U.S.C. § 1301(a)(18).

[49] ERISA § 4062(a), 29 U.S.C. § 1362(a).

[50] 29 C.F.R. Part 4044.

[51] IRS Rev. Rul. 79-237.

[52] *In re CSC Industries*, 232 F.3d 505 (6th Cir. 2000); *PBGC v. CF&I Fabricators of Utah, Inc*., 150 F.3d 1293 (10th Cir.1998), *cert. denied*, 119 S. Ct. 2020 (1999). The bankruptcy court in CF&I had upheld use of PBGC valuation assumptions in determining the amount of the unfounded benefit liabilities claim but was reversed on appeal.

[53] 11 U.S.C. §§ 502(b) and 1123(a)(4).

[54] 11 U.S.C. § 1123(a)(4).

[55] *In re US Airways Group, Inc.*, Case No. 02-83984-SSM, slip op. (Bankry. E.D. Va. Dec. 29, 2003) ("*US Airways II*"). The court's decision approving the termination of the plan is reported at 296 B.R. 734, 743 (E.D. Va. 2003) ("*US Airways I*").

[56] *See* 11 USC § 109 (b)(1)-(3), (d).

[57] Treas. Reg. § 54.4980F-1, Q&A-16. This regulation was published in final form at 68 Fed. Reg. 17277 (April 9, 2003).

[58] Treas. Reg. § 54.4980F-1, Q&A-11(a)(2).

[59] Treas. Reg. § 54.4980F-1, Q&A-11(a)(1).

[60] Treas. Reg. § 54.4980F-1, Q&A-11(a)(4)(ii).

[61] ERISA § 204(h)(1).

[62] Treas. Reg. § 54.4980F-1, Q&A-13(a).

[63] See Treas. Reg. § 54.4980F-1, Q&A-13(c).

[64] Treas. Reg. § 54.4980F-1, Q&A-9(a). A prior version of section 204(h) required that notice be given at least 15 days before the effective date but only *after* adoption of the amendment. The requirement that the amendment be adopted before the notice is given has been eliminated. See 68 Fed. Reg. 17279. Additional time may be required if a participant is given a choice between benefit formulas. See Treas. Reg. § 54.4980F-1, Q&A-12.

[65] Treas. Reg. § 54.4980F-1, Q&A-9(d)(1).

[66] Treas. Reg. § 54.4980F-1, Q&A-9(d)(2).

[67] I.R.C. § 4980F.

[68] ERISA 204(h).

[69] *See* 29 CFR § 4043.62-.68.

[70] ERISA § 4043(f).

[71] 29 CFR § 4043.29.

[72] 29 CFR § 4043.29(c).

[73] 29 CFR § 4043.29(a).

[74] *See* 29 CFR § 4043.29(d).

[75] 29 CFR § 4043.30(a).

[76] 29 CFR § 4043.30(c)-(d).

[77] 29 CFR § 4043.31(a)(1).

[78] 29 CFR § 4043.31(a)(2).

[79] 29 CFR § 4043.30(c)-(d).

[80] 29 CFR § 4043.32(a), (c).

[81] 29 CFR § 4043.23(a).

[82] *See* 29 CFR § 4043.23(c).

[83] 29 CFR § 4043.23(d)(2)-(3).

[84] 29 CFR § 4043.34(a).

[85] 29 CFR § 4043.34(c)(1).

[86] 29 CFR § 4043.35(a).

[87] The electronic version of the form can be found at www.pbgc.gov/repevenf.htp.

[88] ERISA Sec. 4201 et. seq.

[89] ERISA §4203; 29 U.S.C.A. §1383 (1985).

[90] ERISA §4205-4206; 29 U.S.C.A. §1385-86 (1985).

[91] ERISA §4204(a)(1); 29 U.S.C.A. §1384(a)(1) (1985).

[92] ERISA §4204(a)(1)(C); 29 U.S.C.A. §1384(a)(1)(C) (1985).

[93] ERISA §4204(b)(1); 29 U.S.C.A. §1384(b)(1)(1985).

[94] Under MEPPAA, a multiemployer plan can allocate unfunded vested pension liabilities in a number of different ways. Under some of the methods, unfunded vested benefits are attributed to certain periods during which they were created. They are then allocated proportionately among the employers based upon their contributions during such period. If no unfunded vested benefits were created during the last five years then under certain methods, the buyer will not have any allocable share of the unfunded liabilities and will consequently not have withdrawal liability based on such five years. See ERISA §4211.

[95] ERISA §4203(b)(1); 29 U.S.C.A. §1383(b)(1)(1985).

[96] ERISA §4203(c)(1); 29 U.S.C.A. §1383(c)(1)(1985).

[97] ERISA §4225(a) 29 U.S.C.A. §1405(a)(1985).

[98] ERISA §4225(b) 29 U.S.C.A. §1405(b)(1985).

[99] Upholsterers'Int'l Union Pension Fund v. Artistic Furniture, 920 F.2d 1323 (7th Cir. 1990). See Hawaii Carpenters Trust Fund v. Waiola Carpenter Shop, 823 F.2d 289 (9th Cir. 1987); Northwest Administrator's Inc. v. Con Inverson Trucking, 749 F.2d 1338, 1340 (9th Cir. 1984); Moriarity v. Svec, 994 F. Supp. 963, 968 (N.D.Ill. 1998).

[100] 414 U.S. 168 (1973).

[101] See M&J Supply Co., 300 N.L.R.B. 45 (1990); Peters v. NLRB, -- F.3d --, 1998 WL 458390 (6th Cir. 1998).

[102] Upholsterers'Int'l Union Pension Fund v. Artistic Furniture, 920 F.2d 1323 (7th Cir. 1990). See Hawaii Carpenters Trust Fund v. Waiola Carpenter Shop, 823 F.2d 289 (9th Cir. 1987); Northwest Administrator's Inc. v. Con Inverson Trucking, 749 F.2d 1338, 1340 (9th Cir. 1984); Moriarity v. Svec, 994 F. Supp. 963, 968 (N.D.Ill. 1998).

[103] 414 U.S. 168 (1973)

[104] See M&J Supply Co., 300 N.L.R.B. 45 (1990); Peters v. NLRB, -- F.3d --, 1998 WL 458390 (6th Cir. 1998).

[105] See Rev. Proc.2000-16, Part IV, for a description of the Administrative Policy regarding Self-Correction (APRSC).

[106] See Rev. Proc.2000-16, Part V, for a description of the VCR and the voluntary Closing Agreement Program ("Walk-in CAP"). For a more complete description of all of the IRS voluntary compliance and closing agreement programs, see Hennessy, Kramer and Meagher , "Finding and Curing Plan Defects," ABA National Institute on Curing What Ails You (September 25, 1998).

[107] ERISA § 408(c)(3).

[108] 514 U.S. 73, __; 115 S. Ct. 1223, 1228 (1995).

[109] 517 U.S. 882; 116 S. Ct. 1783 (1996).

[110] 525 U.S. 432 (Jan. 25, 1999).

[111] Advisory Opinion 2001-01A (Dec. 18, 2001) is available on the PWBA website at http://www.dol.gov/ebsa/programs/ori/advisory2001/2001-01A.htm; the hypotheticals are at http://www.efast.dol.gov/ebsa/programs/ori/advisory2001/setq&are.htm.

[112] *See* ERISA §§ 404-406, 502 29 U.S. C. §§ 1104-6, 1132.

[113] *See, e.g., In re Daniels*, Case No. 92-13051-JNF, Adv. P. No. 93-1332 (Bankr. D. Mass. April 25, 1994) ("a fiduciary's failure to account constitutes a defalcation").

[114] *See* 11 U.S.C. § 523(a)(4).

[115] *Blyler v. Hemmeter*, No. 99-55777, DC No. CV-98-03640-CBM (9th Cir. Mar. 26, 2001).