Compliance Advisory

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PBGC issues guidance on bankruptcy-related plan terminations

On June 14, 2011, the Pension Benefit Guaranty Corporation (PBGC) issued final regulations for determining the plan termination date when an underfunded single-employer plan terminates while its contributing sponsor is in bankruptcy. Under these rules, the date the bankruptcy petition was filed ("bankruptcy filing date") is treated as the plan termination date for purposes of determining benefits.

Background

When a plan terminates, a termination date is established. When an underfunded plan terminates, the PBGC is typically appointed trustee of the plan and becomes responsible for paying benefits. If an underfunded plan terminates in a distress or involuntary termination, the termination date is a date agreed upon by the plan administrator and PBGC or, if they do not agree, a date established by a United States district court.

The termination date is important because it is the date as of which a plan sponsor values benefits and plan assets. It is also the date as of which a plan sponsor's liability to the PBGC for the plan's unfunded benefit liabilities is determined. Many single-employer plans that terminate in distress or involuntary terminations do so while the plan sponsor is in bankruptcy. Many plan sponsors fail to make minimum funding contributions to their plans during bankruptcy, while the plan continues to pay benefits and participants continue to accrue additional benefits. Because the termination date often comes after the sponsor has filed for bankruptcy, PBGC losses often increase substantially during the course of a bankruptcy proceeding.

Congress addressed this issue in the Pension Protection Act of 2006 (PPA). PPA provides that if a plan sponsor enters into bankruptcy or similar proceedings on or after September 16, 2006, and terminates its plan while in bankruptcy, the date the plan sponsor entered into bankruptcy proceedings will be considered the plan termination date for purposes of determining the:

- PBGC guarantees; and
- Allocation of assets to annuity benefits that were being paid or could have been paid three years before the plan termination date.

The PBGC has now published final regulations that implement these PPA provisions.

Guaranteed benefits

Before PPA was enacted, the plan termination date was used to determine:

- **PBGC guaranteed benefits.** The maximum guaranteed benefit depended on the participant's age at the later of the plan's termination date or the date he begins receiving his benefit from PBGC and on the form in which the benefit is paid;
- **The phase-in limit.** This limit provides that PBGC's guarantee of a benefit increase resulting from an amendment of an existing plan or new plan is phased in over a five-year period that is equal to the number of full years before the termination date; and
- **The PBGC "accrued-at-normal" provision.** Under this provision, the PBGC does not guarantee temporary supplemental benefits payable to a participant who retires before normal retirement age.

PPA changed the way in which the amount of guaranteed benefits is determined by substituting the **bankruptcy filing date** for the plan termination date. As a result, a plan that terminates while its contributing sponsor is in bankruptcy must

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treat the date the sponsor's bankruptcy petition is filed as if it were the plan termination date for determining a participant's guaranteed benefit. This change has several consequences:

- A participant's guaranteed benefit cannot be greater than the amount of benefit determined as of the bankruptcy filing date, even though the plan continues to operate after the bankruptcy filing date and participants continue to accrue benefits.
- Only benefits that were nonforfeitable as of the bankruptcy filing date are guaranteed.
- The PBGC guarantee limits are determined as of the bankruptcy filing date. *For example, if the plan sponsor's bankruptcy filing date is in 2008 and the plan's termination date is in 2010, the maximum guaranteeable benefit for all plan participants will be based on the 2008 limit. In addition, a participant's maximum guaranteeable benefit will be based on his age and form of benefit as of the later of the bankruptcy filing date or the date he begins to receive benefits.*

The regulations confirm that the bankruptcy filing date is the date on which:

- A petition commencing a case under the United States Bankruptcy Code is filed; or
- Any similar filing is made commencing a case under any similar Federal law or law of a State or political subdivision.

In addition, if a bankruptcy petition is filed under one chapter of the United States Bankruptcy code and the case is converted to a case under a different chapter, the date of the original petition is the bankruptcy filing date. *For example: If a Chapter 11 reorganization case is converted to a Chapter 7 liquidation case, the date of the Chapter 11 petition is the bankruptcy filing date*

The final rules also include a provision that applies in situations where a death occurs before plan termination, which affects the form of benefit being paid. In these situations, the guarantee limit is applied based on the form of benefit being paid (or that was payable) and the person who was receiving or was entitled to receive the benefit as of the plan termination date and not the bankruptcy date. *For example, if as of the bankruptcy date, a participant was receiving a joint and survivor annuity benefit but by the plan termination date, the participant had died and his spouse is receiving a survivor annuity, PBGC will determine the maximum guaranteed benefit for the surviving spouse based on the spouse's age as of the bankruptcy date but based on the straight-life annuity form being paid to the spouse at the termination date and not the joint-and-survivor benefit form that was being paid as of the bankruptcy filing date.* The provision will generally:

- Increase guaranteed benefits for the affected individuals; and
- Reduce the complexity and difficulty of computing benefits since often when a plan terminates, plan records do not reflect the full history of a benefit.

Allocation of benefits

ERISA specifies how a plan's assets must be allocated among various classes of guaranteed and nonguaranteed benefits. There are six classes of priority benefits. Priority category 3 is the portion of a participant's benefit that was in pay status as of the beginning of the three-year period ending on the plan termination date or that would have been in pay status at the beginning of such three-year period if the participant had retired before the beginning of the three-year period and had begun receiving benefits. However, the benefits in this category are limited to the lowest annuity benefit payable under the plan provisions at any time during the five-year period ending on the termination date. Benefits in priority category 3, which may or may not be guaranteed, come ahead of guaranteed benefits in priority category 4.

After each participant's benefits have been assigned to the applicable priority category, then all participants' benefits are valued, and the terminated plan's assets are valued. The plan assets are then "poured through" the priority categories, beginning with priority category 1. If the assets are sufficient to pay all benefits in priority category 1, they then pour into category 2, and so on until either all benefits in all categories have been covered or until the assets are insufficient to pay all benefits within a category.

PPA made an important change to priority category 3. The final regulations clarify that the three-year period and five-year periods are the periods before the bankruptcy filing date, rather than before the termination date. The final rules also provide that priority category 3 benefits are limited to the lowest annuity benefit payable under the plan at any time during the pre-termination period.

Additional guidance

Reduction of benefits

In a distress termination, the plan administrator is required, beginning on the proposed termination date, to reduce benefits in pay status to estimated levels under the law. The final regulations provide that for any bankruptcy termination, those estimated benefits are based on the bankruptcy filing date.

Continuation of payments

PBGC will not guarantee a benefit that was not vested as of the bankruptcy filing date even if that benefit became vested by the termination date. This includes a subsidized early retirement benefit or disability benefit to which a participant became entitled between the bankruptcy filing date and the termination date.

Participants who became entitled to subsidized early retirement benefits or other benefits after the bankruptcy filing date but before the actual date plan assets are distributed may have retired and begun receiving benefits. Under the final regulations, such participants will continue to remain in pay status. If they were not already receiving a benefit, they may go into pay status. However, the amount of their benefit would be reduced to reflect that the subsidy or other benefit is not guaranteed.

Sufficiency for guaranteed benefits

In a distress termination, the plan's enrolled actuary must certify whether the plan is sufficient for guaranteed benefits as of the proposed termination date and the proposed distribution date. The actuary must take into account nonguaranteed benefits. The final regulations provide that in a bankruptcy termination, the plan actuary and PBGC must determine sufficiency for guaranteed benefits. This determination must be based on whether, as of the termination date and the distribution date, the plan has sufficient assets to pay benefits that are guaranteed as of the bankruptcy filing date and benefits that are in priority category 3 as of three years before the bankruptcy filing date, based on plan provisions as of five years before the bankruptcy filing date.

Effective date and next steps

These regulations are effective July 14, 2011, and apply to plan terminations occurring during a bankruptcy proceeding that was initiated on or after September 16, 2006. Plan sponsors should carefully read the guidance discussed in this publication. If they have any questions, they should discuss them with the plan's enrolled actuary.

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