CHEIRON CLIENT ADVISORY

Winter 2008 Vol. 5 No. 1

ENDANGERED AND CRITICAL PLANS
Sorting Through the Options

Introduction

By March 2008, several multiemployer pension plans will have received official certifications from their actuary that they are in endangered or critical status. That certification will trigger a detailed and complex set of requirements under the special funding rules for multiemployer pension plans added by the Pension Protection Act of 2006 ("PPA"). Endangered plans will be required to construct a Funding Improvement Plan that will generally enable the plan to reduce its underfunding by one-third over the next ten years. Critical plans will be required to devise a Rehabilitation Plan that will enable the plan to emerge from critical status sometime before the end of the 10-year rehabilitation period. A plan emerges from critical status if the plan actuary forecasts that it will not have a funding deficiency for the next ten years.

For most of these plans, the plan actuary will have advised the Trustees of the expected status of the plan well in advance of the certification. Many Boards of Trustees and bargaining parties will have already begun developing and sorting through their options.

This Advisory discusses the options that confront the parties and illustrates the impact of various choices using illustrative cases drawn from real life. Of course, the precise effect of each option will depend upon the conditions of each plan. As you will see, in some cases, the only option that will be effective in meeting the special funding requirements will be either an immediate, substantial increase in contribution rates or a sustained series of increases over several years.

Roles, Timing & Coordination

The Trustees are charged with notifying the participants, beneficiaries, bargaining parties, PBGC and DOL within 30 days after receiving the actuary's certification that the plan is endangered or critical. The Trustees then must develop and adopt funding improvement or rehabilitation plans within 240 days of the certification, i.e., November 25, 2008 for calendar year plans, and present the plans to the bargaining parties within 30 days after adoption. At a minimum the Trustees must adopt the default schedules specified in the law. If 180 days after the expiration of a collective bargaining agreement in effect on the date the plan entered endangered or critical status, and after having received the default Funding Improvement Plan ("FIP") or Rehabilitation Plan ("RP") from the fund, the bargaining parties still have not agreed on a plan, the default schedule goes into effect.

The ten-year correction period generally begins with the plan year following the Trustees' adoption of an FIP or RP. However, if collective bargaining agreements covering 75% of active participants on the due date for the actuarial certification expire later than that date, the correction period will begin the plan year after expiration, but not beyond the 2011 plan year. As a result, depending on when the collective bargaining agreements expire, the 10-year correction period for a calendar year plan may begin as early as January 1, 2009 or as late as January 1, 2011. The following chart shows the due dates for each of the actions.

Event	Due Date*
Actuarial certification	90 days
Notices to DOL, PBGC, participants and beneficiaries, employers, and unions	120 days
Trustees adopt FIP or RP	330 days
Provide one or more schedules under RP or FIP to Bargainers	360 days
FIP or RP takes effect**	3rd plan year after certification
Funding ratio target or emergence from critical status achieved**	13th plan year after certification

* Days from 1st day of plan year.

** Assumes collective bargaining agreements covering 75% of active members do not expire before then.

Cheiron Observation – The starting date of the ten-year correction period does not change the due date for the Trustees to adopt an FIP or RP. Thus, if the bargaining parties desire to agree on a plan, negotiations will need to start as early as possible.

One other date looms as important. If PPA is not extended, the special funding rules expire for plan years beginning after December 31, 2014. However, if the plan is within a correction period, the rules continue to apply.

Restrictions on Trustees' Actions

Once a plan has been certified as endangered or critical, the Trustees are prohibited from accepting a collective bargaining agreement that provides for a reduction in the level of contributions; a suspension of the obligation to make contributions for any period of service (e.g., 3 months for new hires); or any exclusion of younger workers or new hires.

Cheiron Observation–It is a matter of interpretation how this restriction applies to newly organized employers.

Prior to the adoption of an FIP or RP by the bargaining parties, the Trustees may not increase benefits, and thereafter, benefit increases may be adopted only if the actuary certifies that the increase is paid for out of contributions not needed to meet the funding target. Also, a critical plan is prohibited from paying benefits greater than the monthly amount payable under a single-life annuity (plus social security supplements) and may not purchase annuities from an insurance company.

Endangered Plans
Funding Improvement Plan

The PPA requires the Trustees to present two options to the bargaining parties, but gives them the authority to present additional options. The required two options are:

1. An option that reduces accruals and only provides for contribution increases if freezing accruals will not allow the fund to achieve its target (the default schedule);

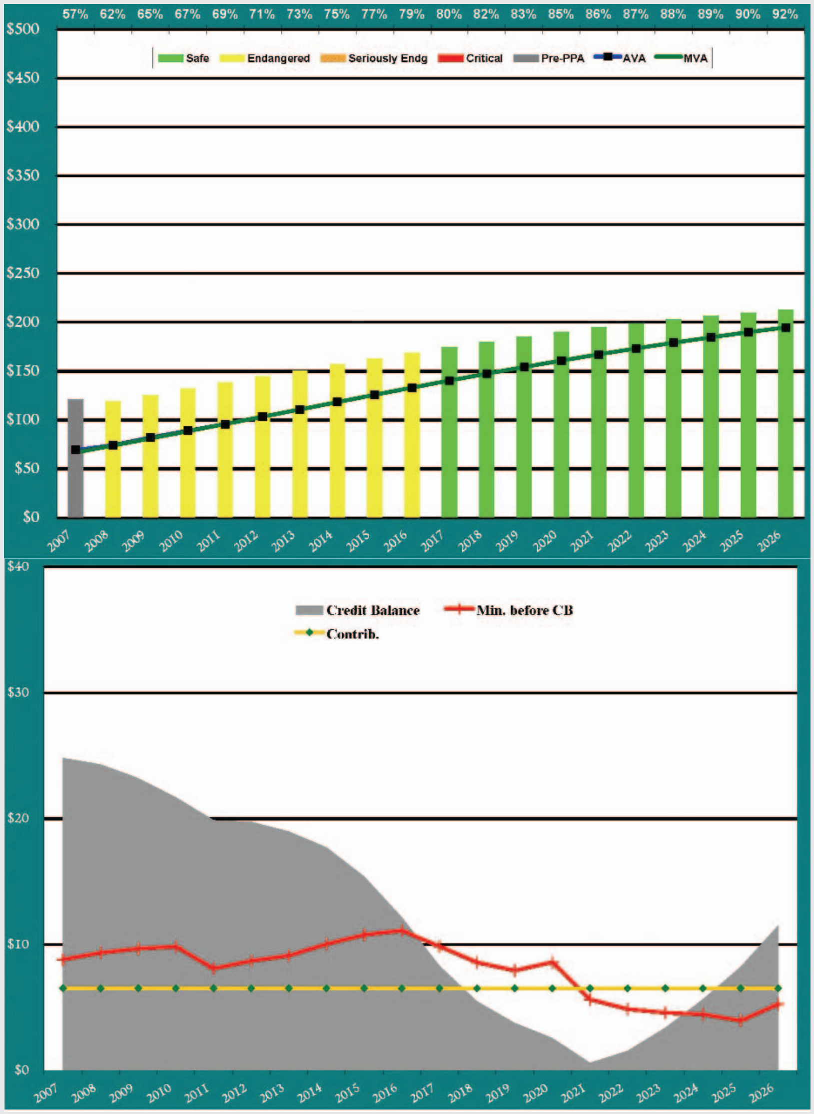
2. An option that provides only for increases in contributions and does not reduce future accruals.

An additional requirement for each option is that the actuary projects that the plan will not have a funding deficiency within the 10-year correction period.

Example:
Pension Plan A is projected to be endangered in 2008, and if nothing is done it will become critical in 2013. The following graph shows the current outlook for the plan:

Pension Plan A Before Funding Improvement Plan

Pension Plan A Funding Improvement Plan Option 1



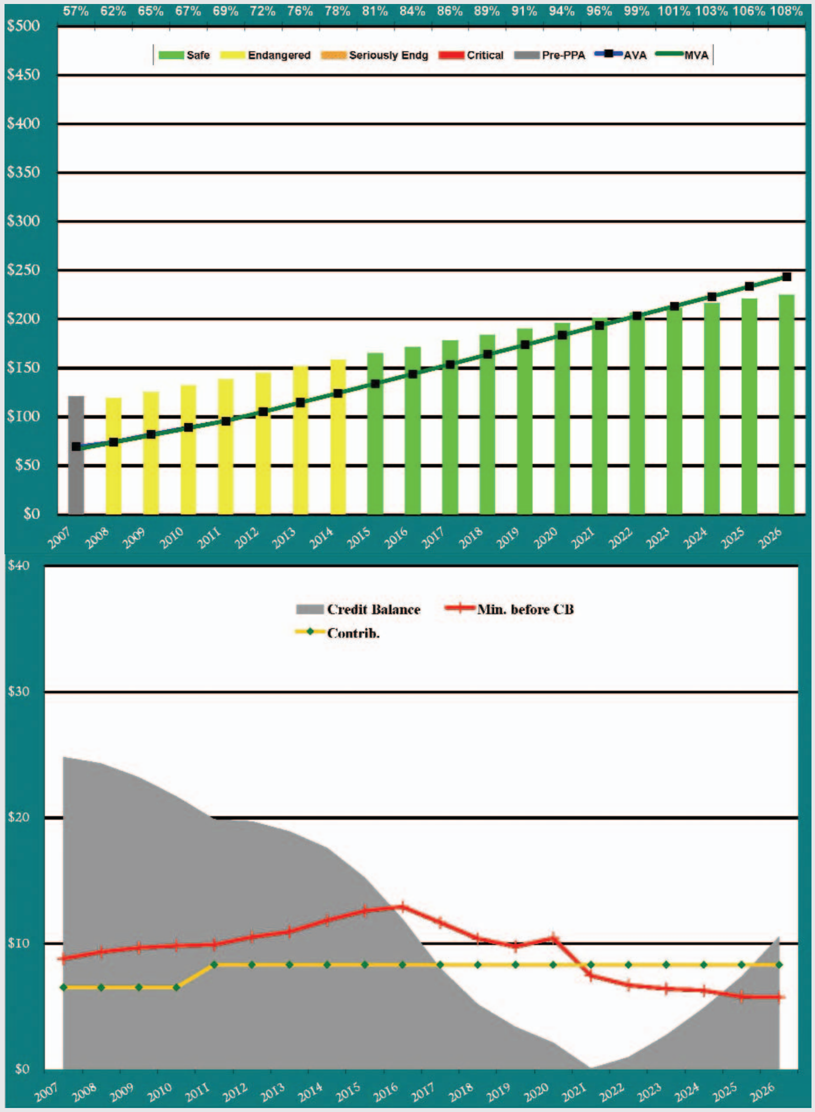
The Trustees examined three options, each of which would allow the plan to meet its funding improvement target. As required by PPA, Option 1 would reduce future accruals by 25% and keep contributions at the same level.

Option 2 would increase contributions by 27.5% and maintain the current level of accruals. The difficulty with both options is that they are projected to be close to a funding deficiency in the year after the plan met its funding target. Unfavorable experience would result in either the plan not meeting its funding target, or having a funding deficiency in the year after the plan meets its funding target. The Trustees wanted to avoid these possible results and stabilize the funding so the actuary developed Option 3, which would increase contributions by 50% beginning with the 2011 plan year.

Even though the Trustees decided to recommend Option 3, PPA would seem to allow the bargaining parties to adopt any of the options. This raises the issue of what happens when a plan is maintained under many different collective bargaining agreements. It is quite possible that some agreements will include different options. Depending on the demographics of the bargaining units, the result may not be the same as if all collective bargaining agreements adopted the same option. In addition, this could add administrative complexity to operating the plan.

As a result, when the Trustees review the progress being made by the plan in subsequent years and update the FIP, they may need to recommend changes. PPA recognizes the need for stability in the collective bargaining process and so

Pension Plan A Funding Improvement Plan Option 2



provides that a schedule adopted by the parties shall remain in effect for the duration of the collective bargaining agreement. Thus, in their annual review the Trustees will need to take into account that contribution increases will not be effective until the then current collective bargaining agreements expire.

Cheiron Observation – If the plan develops an accumulated funding deficiency, the regular excise tax will apply. In addition, if an employer fails to make the contributions required under the FIP, the employer will be subject to an excise tax equal to the difference between the contributions it makes and the contributions required under the FIP.

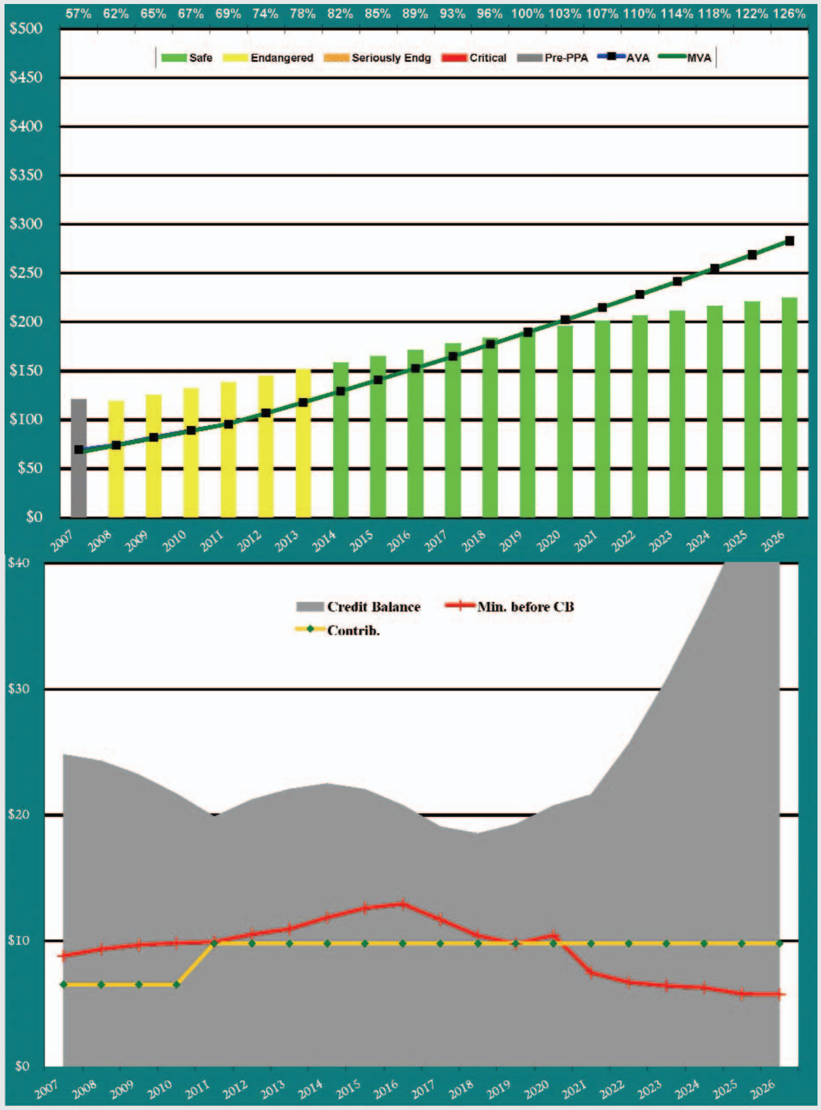
There is another important consideration. If a plan that is endangered emerges from that status at any time prior to the end of the ten-year correction period, the FIP is cancelled and no further actions are required.

Critical Plans

For critical plans, the only RP the Trustees must present to the parties is one that eliminates all adjustable benefits and reduces accruals to 1% of contributions (or the actuarial equivalent for non-contribution based plans). If those measures are not sufficient to allow the plan to emerge from critical status, then the default schedule must include increased contributions to the extent necessary to allow emergence from critical status.

Adjustable benefits generally include all early retirement, subsidized, and optional forms of benefits for non-retirees, and any benefits for retirees that have been increased in the

Pension Plan A Funding Improvement Plan Option 3



5 years preceding the first critical plan year.

The Trustees are free to adopt other RPs and present them to the bargaining parties. As a practical matter, the Trustees will probably work closely with labor and management to come up with a mutually acceptable RP.

The effect of the critical default schedule is to first reduce accruals and benefits as allowed. Thus, non-retirees may, if necessary for the plan to emerge from critical status, have their benefits limited to the normal retirement benefit.

Cheiron Observation – Even with the added ability to eliminate adjustable benefits, some plans will find it impossible to devise an RP without substantial contribution increases. PPA imposes an excise tax on employers that fail to make the contributions required under the RP. How would this provision apply to an employer that continues to bargain after a default schedule requiring increases in contributions goes into effect?

PPA imposes an excise tax on critical plans if the plan fails to achieve three annual benchmarks or to emerge from critical status within the 10-year rehabilitation period.

Escape Clause – This brings into play an important, but as yet unsettled provision of the law we will call the escape clause. If the Trustees determine that after exhaustion of **all reasonable measures**, it is not reasonable to expect the plan to emerge from critical status within 10 years, the RP may consist of reasonable measures to emerge from critical status at a future date, or if that is not reasonably possible, measures designed to forestall insolvency. The escape clause is critically important because under PPA's funding rules because an employer that agrees to a rehabilitation plan cannot be required to contribute any additional monies, nor will it be subject to any excise tax in the event of an accumulated funding deficiency. The objective of the escape clause seems to be to prevent withdrawals and increase contributions to the maximum extent possible, which will provide a better outcome for participants and beneficiaries than would a mass withdrawal. Of course, the employers will remain subject to withdrawal liability.

Cheiron Observation –Because the condition for invoking the escape clause is subject to a broad range of interpretation ("exhaustion of all reasonable measures"), it is uncertain what standards the Trustees should use in deciding whether to invoke it. Also, it is not yet known whether the IRS or DOL has authority to review its invocation, and how they will react to plans that use the escape clause. One of the reasons to use the escape clause is to assure employers that do not withdraw will not be at risk for funding deficiencies. Employers may feel that they need something in the way of agency guidance before they accept that the Trustees' invocation of the escape clause will protect them.

The following two examples illustrate how the rules might work for two very different critical plans. Plan B may well be able to adopt an RP that will allow it to emerge from critical status. The contribution increases required for Plan C are not achievable in bargaining, which brings up the possible use of the escape clause to prevent a mass withdrawal.

Plan B

This is a fiscal year plan that begins on December 1, so that the effective date of the new PPA rules for Plan B is December 1, 2008.

The plan will be critical, beginning in 2008 as shown in the Chart 1. The collective bargaining agreements expire during the summer. If the parties reach agreement on new collective bargaining agreements before December 1, 2008, it will delay the beginning of the rehabilitation period until the plan year beginning December 1, 2011.

Chart 1

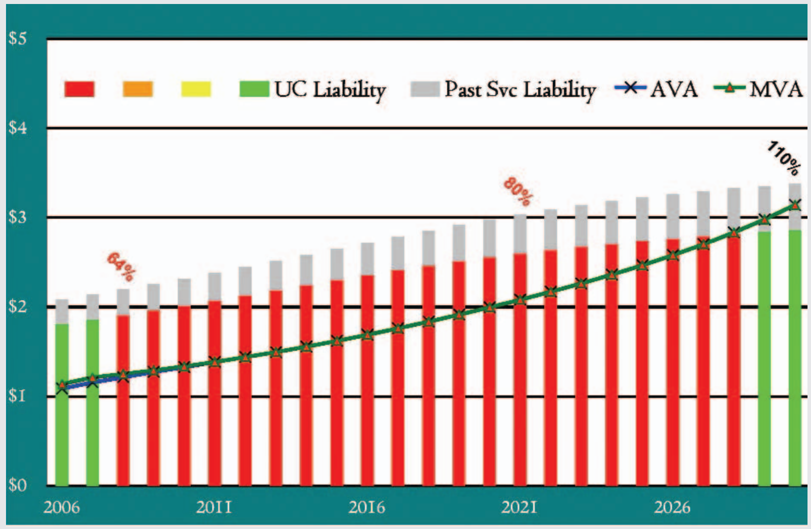


Chart 2 Projected Credit Balance Without Extension

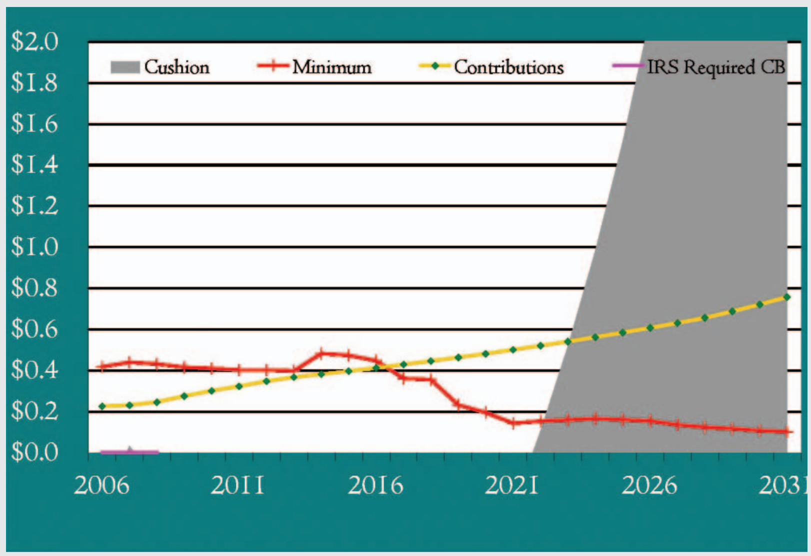
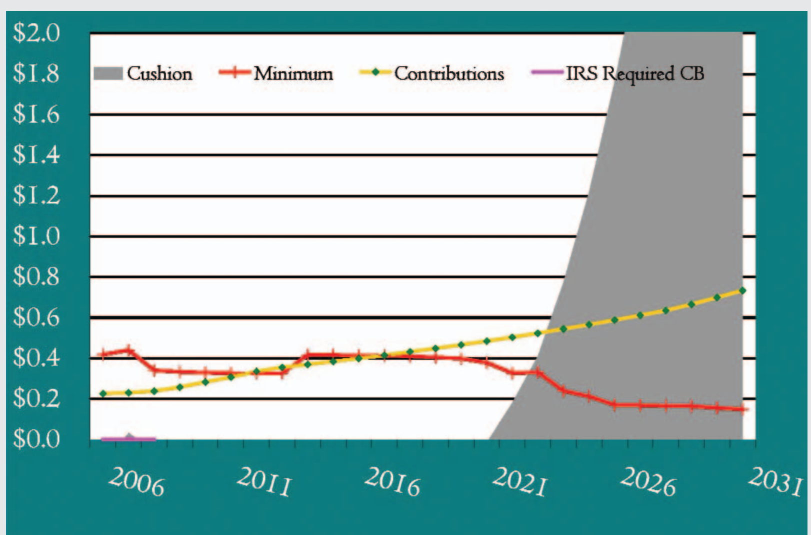


Chart 3 Projected Credit Balance With Extension



The major bargaining parties have agreed in principle to an initial 12% increase in contributions, grading down to 5% per year after several years. That amount is projected to bring the plan to a fully funded position in about 19 years.

Since the correction period begins in 2011, the actuary must be able to project no minimum funding deficiency for ten years by the end of the 2020 year. As shown in Chart 2, the likely increase in contributions by itself will not be sufficient to project no deficiency until the beginning of the 2022 plan year.

If the plan elects the automatic 5-year extension of the amortization period, it will emerge from critical status and be able to reduce the contribution increase to 11% per year for four years (Chart 3).

Cheiron Observation –The result of using the extension to emerge from critical status is that the plan will be back in critical status the next year because the actuary cannot take the extension into account in determining whether the plan is in critical status. The Trustees can then adopt the same RP using the extension to emerge from critical status in the following year. This process would seem to continue indefinitely, which is an absurd result, and will require clarification either by an IRS interpretation or most likely a statutory change.

This example illustrates two important points:

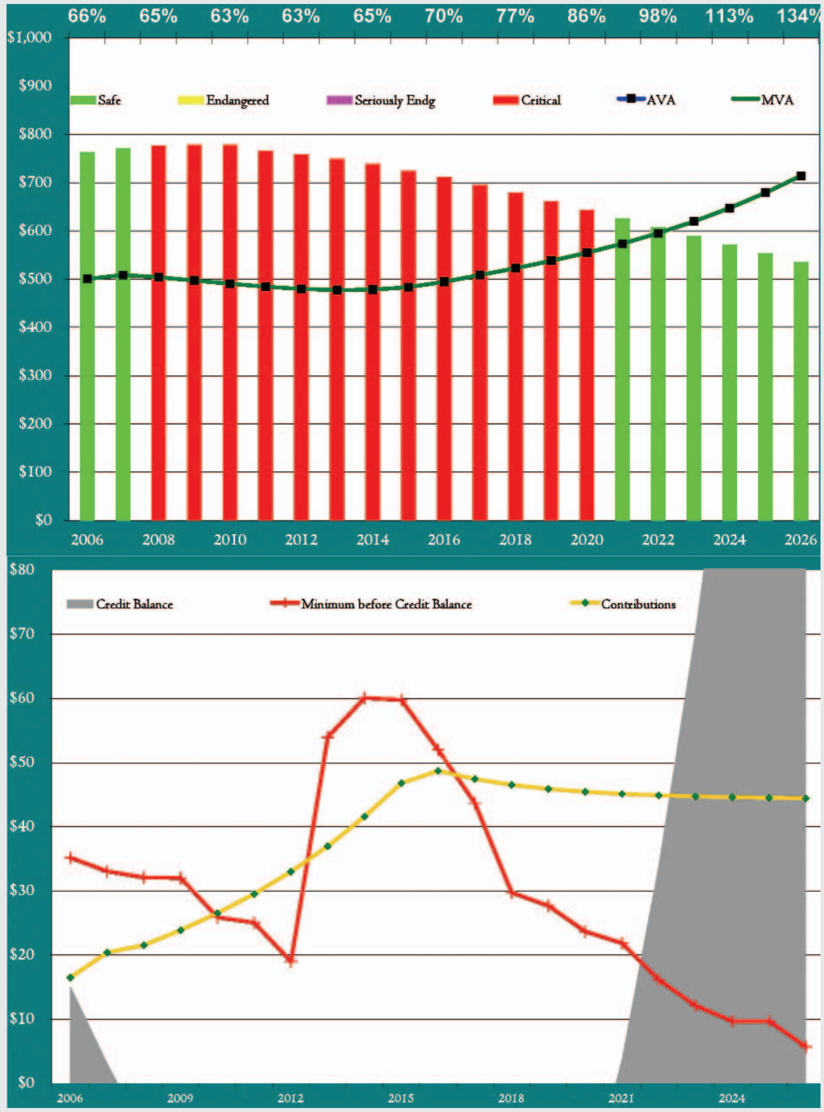
1. By negotiating new collective bargaining agreements before the end of the plan year, the parties are able to put off the beginning of the correction period; and

2. By increasing contributions in the new collective bargaining agreements, the parties have taken action to improve the plan's funding, which will make it possible to obtain the 5-year automatic extension.

Plan C

This plan is projected to become insolvent and is in critical status. The current collective bargaining agreements expire before the due date for the actuarial certification. If the parties negotiate new agreements before March 30, 2008, it will delay the start of the correction

Chart 4 Default Option



period until 2011. This means that the actuary will need to project no minimum funding deficiency for the 10-year period beginning with the 2021 plan year.

The default option would require that all early retirement and optional forms of benefits payable at normal retirement be eliminated and that the employers increase their contributions by 17.5% per year through 2015. If this option is adopted beginning with the 2008 plan year, the plan will just be able to emerge from critical status by the end of the 10-year correction period beginning in 2011, as shown in Chart 4.

The default option is unacceptable to both the union and the employers because the benefit cuts are too severe and the employers believe that the required contribution increase of 17.5% per year through 2015 will make them uncompetitive in their markets.

Because the parties could not reach agreement on the default option, the Trustees examined other options that would be acceptable, none of which would enable the plan to escape critical status. In this case, the Trustees might determine that after exhaustion of all reasonable measures, the plan could not emerge from critical status. After examining many options, projections show that with a contribution increase of 20% in 2008, and 8% per year thereafter, the plan would not become insolvent and its funded status would eventually begin to improve (Chart 5).

Unfortunately, it is extremely unlikely that the DOL or IRS will issue guidance on the standards for using the escape clause. Therefore, the Trustees should rely on plan counsel to provide standards for use of the clause until issuance of official guidance.

Conclusion

Trustees of endangered and critical plans will soon be faced with devising options to allow their plans to meet the new PPA funding standards. In many cases, the statutorily prescribed options will not be acceptable to both parties. This will force the Trustees to work with the bargaining parties to develop a mutually acceptable option.

For endangered plans, although the options must lead eventually to the required improvement in the funding percentage, the real target is to get out of endangered status, which will terminate the remainder of the FIP.

Plans in critical status face different challenges depending on the overall funded status of the plan. A plan that is not projected to become insolvent, but is in critical status because it faces a funding deficiency within 4 years may be able to emerge from critical status with relatively little pain. But a plan that is poorly funded and projected to become insolvent may not be able to emerge from critical status without unaffordable increases in contribution rates. For those plans, use of the escape clause as an alternative to forcing a mass withdrawal may be beneficial to employers, employees, and the PBGC if the plan can show that it will avoid insolvency.

Because of the law's complexity and the many interpretative issues, Trustees need to be cautious in winding their way through the law's many minefields. Fund counsel and actuaries will need to be heavily involved in the development and assessment of options available to an endangered or critical plan.

Even if a plan is safe, it might be worthwhile to project the future status of the plan and perform additional stress testing so that the bargaining parties and Trustees can head off potential problems in the future.

Chart 5 Use Escape Clause

Cheiron is a full-service actuarial consulting firm assisting corporations, public employers and Taft-Hartley sponsors to manage their benefit plans proactively to achieve strategic objectives and safeguard the interests of plan participants and beneficiaries.