May 20, 2009

SPECIFIC DEFINED BENEFIT PLAN FUNDING PROPOSALS

First Relief Proposal: Amortization of 2008 Losses.

In general. Under the Pension Protection Act of 2006 ("PPA"), 2008 asset losses must be amortized over seven years. The problem is that these losses are so large that seven-year amortization creates unmanageable funding obligations. Employers need time to recover before they can begin making up for these losses. On the other hand, if no contributions are made, the funding shortfall will only grow larger.

Accordingly, we propose that for two years, employers shall be required to pay interest on their plans' 2008 losses to prevent the plans' shortfall from growing, but seven-year amortization of those losses would not commence until the expiration of those two years. So, all 2008 losses would be fully funded, but only two years later than would otherwise be the case.

Technical clarifications of amortization proposal. Generally, the reference to "2008 losses" in this proposal would be a reference to the 2009 and 2010 "shortfall amortization bases" under Code section 430(c)(3) and ERISA section 303(c)(3). The 2009 shortfall amortization base is the amount that would, under current law, be amortized over seven years starting in 2009. Generally, 2008 losses would show up in the 2009 shortfall amortization base. However, because of the guidance issued by the IRS on March 31, 2009 (regarding the use of the full yield curve for any applicable month), for many companies, the 2008 losses will show up in the 2010 shortfall amortization base. Such base would, under current law, be amortized over seven years starting in 2010.

Second Relief Proposal: Expanding the Asset Smoothing Corridor.

Under the 2008 Act, the value of a plan's assets may be smoothed, i.e., unexpected gains or losses can be recognized over 24 months. But the 2008 Act preserved the PPA rule requiring the smoothed value of assets to be within 10% of the

fair market value of assets ("10% corridor"). Since 2008 losses were typically far greater than 10%, application of the 10% corridor will require companies to immediately recognize most of the 2008 losses, leaving companies with an unmanageable obligation.

An example illustrates this issue. Assume that a plan had $90 of assets and $100 of liabilities as of January 1, 2008; as of January 1, 2009, its assets have fallen to $65 and its liabilities remain at $100, leaving the plan 65% funded. If the 10% corridor is retained, this plan will be 71.5% funded, creating an amortization obligation that is far greater than the 2008 obligation. If the corridor is increased to 20%, the funded ratio is 78%, which still creates an amortization obligation that is very materially larger than the 2008 obligation. It is only if the corridor increases to 30% that the plan becomes 84.5% funded and the 2009 funding obligation becomes somewhat comparable to the 2008 obligation.

It should be emphasized that this plan does not even present anything close to a worst case scenario. For example, if this plan were 92% funded as of January 1, 2008, the application of the 10% corridor could result in a total funding obligation that is far more than double the 2008 obligation — perhaps triple or more, depending on the level of current benefits provided.

Under the proposal, the corridor is increased to 30% for 2009, 20% for 2010, and then back to 10% thereafter.

Third Relief Proposal: Protection of Employees and Employers.

Under the proposal, the corridor is increased to 30% for 2009, 20% for 2010, and then back to 10% thereafter. Under PPA, employees can lose certain benefits and rights if their plan falls below 60% or 80% funded and thus becomes subject to certain "benefit restrictions." For example, if a plan falls below 80% funded, participants who have been promised the option of receiving their benefits in the form of a lump sum distribution are not permitted to receive more than half of their benefit in a lump sum. This is unfair to the employees since they may have made plans based on the benefits promised by their plan.

Similarly, employers can be very adversely affected by falling below certain funding thresholds. Specifically, if a plan falls below 80% funded for a year, the employer may not use prefunding balances or funding standard carryover balances to satisfy its minimum required contribution obligation for the following year. This can impose a very material new cash flow burden on employers that, like employees, were victimized by the 2008 market downturn.

Accordingly, under the proposal, for 2009 and 2010, all benefit restrictions would apply based on a plan's funded status for 2008. Employees who have seen their 401(k)

plan benefits and other savings plummet should not be denied promised benefits or any other pension rights by reason of the market collapse. Similarly, a plan's funded status for 2008 shall be deemed to remain in effect for 2009 and 2010 for purposes of determining whether the plan sponsor may use its prefunding balance or funding standard carryover balance in the next year. Like employees, companies should not be hit with large unexpected cash demands during this difficult time.

Application of the Above Proposals to Certain Fiscal Year Plans.

With respect to all of the above proposals, in the case of plans with plan years beginning after October 31, but before January 1, and for plans with end-of-year valuation dates, the rules would apply to plan years beginning in 2008 and 2009 rather than in 2009 and 2010. So, for example, if a plan's plan year began on November 1, 2008, the plan sponsor would only pay interest for that year and the next year, and would begin seven-year amortization for the plan year beginning November 1, 2010. This reflects the fact that plans with a valuation date in late 2008 will have incurred substantial losses as of such date.

Of course, in the case of plans with beginning-of-the-year valuation dates and with plan years beginning on or after January 1 but before November 1, the above proposals would apply to plan years beginning in 2009 and 2010.

Additional Critical Issues.

Interest Rate Elections. Under the proposal, companies would be permitted to make new interest rate elections for plan years beginning in 2010. In order to make it through 2009, many companies feel compelled to elect the spot yield curve for 2009. Without such an election, contributions for 2009 would be unaffordable for such companies. However, those same companies may not be able to make business plans on an ongoing basis if they must contend with the unpredictability of the spot yield curve. So for business reasons, it is critical that companies be permitted to elect the smoothed segment rates for 2010 and thereafter. In fact, based on discussions with several large companies, it appears that a significant percentage of plan sponsors may be so concerned about the possibility of being locked into using the spot yield curve that they are considering not electing it for 2009, despite the great short-term advantages of doing so.

In short, there is a great need for companies using the spot yield curve for 2009 to be able to elect to use the segment rates for 2010. In addition, permitting such elections is appropriate. Companies should not be bound by elections made before the current proposed regulations are finalized. Certainly, the final regulations will be different from the proposed regulations, which means that companies should be entitled to reevaluate their mode of compliance.

Effective Date of Regulations. Under the proposal, the funding regulations would not be effective until plan years beginning after December 31, 2009. In addition, prior to such effective date, compliance with a reasonable interpretation of the statute will be treated as compliance with the law. The IRS has already stated that the regulations will not be effective for plan years beginning before they are issued; the IRS has also applied the reasonable interpretation standard to periods prior to the effective date of the regulations. If final funding regulations are issued soon and are effective for plan years beginning after they are issued, plans with plan years beginning July 1, 2009 or October 1, 2009, for example, could lose the right to use a reasonable interpretation of the law very soon. Such plans would then have only one year of "reasonable interpretation", instead of the two years given calendar year plans.

Also, if the funding regulations are effective for some plan years starting in 2009, but not other years beginning in 2009, new administrative challenges and possibilities for errors could be created. It would be simpler to follow a uniform rule for all plan years beginning in the same calendar year. This would also provide many plan sponsors with more time to adjust to the final regulations, especially with respect to the very difficult benefit restriction issues.

Accordingly, under the proposal, the funding regulations would not be effective until plan years beginning after December 31, 2009, with the reasonable interpretation rule applying until then.

Clarification of Target Normal Cost. In the technical corrections portion of the 2008 Act, the definition of target normal cost was amended to include "plan-related expenses". The inclusion of plan administrative expenses in normal cost was supported by prior practice. However, there are indications that Treasury may well interpret this language to include plan investment expenses in normal cost. The law has never required plan investment expenses to be included in normal cost, so the interpretation of a technical correction to make a major policy change would not be appropriate. And the burden would be very material. For example, for large plans for 2007, the plan investment expenses averaged 44 basis points; the average for smaller plans is materially higher. The law should be clarified by changing the term used to "plan-related administrative expenses". (Of course, companies that would like to contribute an amount equal to investment-related expenses on a current basis could do so.)

Correction of Effective Date for Collectively Bargained Pension Plans. The general effective date of the benefit restrictions was plan years beginning after December 31, 2007. Appropriately, there is a delayed effective date for collectively bargained plans. Generally, under that delayed effective date, the benefit restrictions apply to plan years beginning on or after the earlier of (a) the expiration of the applicable collective bargaining agreement as long as it was ratified before January 1,

2008 (without regard to extensions agreed to after the date of enactment of the PPA), or (b) January 1, 2010.

The collective bargaining delay with respect to the PPA benefit restrictions does not work correctly. Collective bargaining agreements can be three to four years in length, so that agreements adopted in 2007 can expire sometime in 2010 or 2011. Under the current rule, the benefit restrictions will apply to all plans beginning no later than the first plan year beginning on or after January 1, 2010. This means that the benefit restrictions will apply to some plans before their current collective bargaining agreement has expired. This will result in significant disruption and is an inappropriate intrusion into carefully negotiated collective bargaining agreements. Accordingly, under the proposal, the reference to the January 1, 2010 date would be modified to refer to January 1, 2012. This would permit most existing collective bargaining arrangements to run their course before the benefit restrictions apply. In addition, by retaining the outer limit of January 1, 2012, the proposal would ensure that the benefit restrictions are not unduly delayed.

Ensuring Transition Relief Applies to All Plans. The 2008 Act generally amended the PPA transition rule to provide that for purposes of determining a plan sponsor's funding shortfall, the plan's funding target is 94% of liabilities for 2009, 96% for 2010, and 100% thereafter. For example, if a plan is 91% funded for 2009, its funding shortfall is 3%, rather than 9% as under the pre-2008 Act law. However, certain plans were left out of this provision—new plans and plans that were subject to the deficit reduction contribution ("DRC") regime in 2007. For such plans, the funding shortfall in the above example would be 9%. DRC plans, which were less well-funded, are probably the ones most in need of help during this market downturn. The law should be amended to measure the funding targets for all plans by reference to the phased-in targets of 94% for 2009 and 96% for 2010.