AMERICAN BENEFITS
COUNCIL

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PENSION FUNDING RELIEF IN THE DRAFT HIRE ACT

The American Benefits Council (the "Council") applauds Senators Max Baucus and Chuck Grassley for their leadership in including pension funding relief in the draft HIRE Act released on February 11.

Need for immediate relief.

Pension funding relief is a jobs issue. A February 2010 Mercer study of over 800 companies found that required cash contributions to pension plans will be more than 400% higher in 2010 than in 2009. A May 2009 Aon Consulting survey indicated that 68% of employers will have to cut other expenses, including jobs, in order to make required pension contributions.

Jobs have been lost and are being lost today because of the funding issue. In order to have the cash available to make enormous additional contributions in the next two years, cost-cutting measures are being adopted today. Many have already occurred. Every day that we wait for funding relief, more jobs are lost.

Favorable market conditions are extremely unlikely to solve the problem. A February 2010 study by Towers Watson found that even if equities rise by 20% in 2010 and projected interest rates increase by 100 basis points (which would very significantly decrease the value of pension liabilities), total 2011 funding obligations would still be approximately triple the level of 2009 funding obligations.

Pension funding relief does not cost the government any money; in fact, pension funding relief raises $6 billion. For these reasons, we urge Congress to adopt pension funding relief as soon as possible. Also, as discussed below, it is critical that the "cash flow rule" in the draft HIRE Act be modified to make the funding relief usable and thus to avoid widespread layoffs.

Draft HIRE Act.

The draft HIRE Act is a major step forward in the enactment of pension funding relief. In particular, we applaud the following features of the draft bill:

- Employers' flexibility to use the relief when most needed during the 2008-2011 period. Because of employers' varied situations, the years for which they need relief varies markedly.
- The availability of the 2 and 7 rule and the 15-year amortization rule to all plans, active or inactive.
- The availability of comparable relief to plans subject to the pre-Pension Protection Act ("PPA") funding rules. In some situations, the pre-PPA rules required greater contributions than the PPA rules, making relief from those rules essential.
- The extension of the benefit accrual lookback rule, so that plans that were at least 60% funded for the 2008 plan year would not be required to freeze accruals for the 2009 or 2010 plan years.

Also, in the spirit of the constructive dialogue that has occurred between Congress and the retirement plan community, we offer the following recommendations regarding the pension funding provisions in the draft HIRE Act. As noted, in order for funding relief to be usable and for widespread layoffs to be prevented, it is critical that the cash flow rule be modified in the ways discussed below.

Cash Flow Rule.

The vast majority of our comments relate to what we refer to as the "cash flow rule". Very generally, under the cash flow rule, with respect to a year, employers are required to make contributions to a plan (in addition to any other required contributions) equal to the sum of (1) the aggregate amount of taxable compensation in excess of $1 million, and (2) the "extraordinary dividends and redemptions" for the year. Extraordinary dividends are dividends required to be reported to the PBGC (without regard to any waivers in effect). Extraordinary redemptions are redemptions of at least 10% of a company's stock in a 12-month period. The cash flow rule applies for 15 years (if the employer elects the 15-year amortization rule) or nine years (if the employer elects the 2 and 7 rule).

We cannot support the cash flow rule. The nation's top priority is economic recovery, so that Americans can get back to work. Pension funding relief is an essential part of achieving economic recovery, so restrictive conditions on that relief are counterproductive, especially conditions that last extremely long periods, such as nine or 15 years. In addition, it is not appropriate to effectively deny companies the ability to use critical tools in the recovery effort, such as incentive compensation or equity compensation, as the cash flow rule does.

On the other hand, we understand the current political dynamics that could prompt consideration of the cash flow rule. So although we do not support the rule, we offer suggested modifications of the rule.

The "worse than present law" aspect of the rule should be eliminated. An example illustrates this issue. Assume that a plan's shortfall amortization base for 2010 is $70 million. Assume, for simplicity of presentation, that interest rates are at zero. (If we used actual interest rates, the "worse than present law" problem is even worse than illustrated below.) Under present law, the employer would be required to contribute $10 million per year for seven years, starting in 2010 and ending in 2016. Under the 2 and 7 rule, the employer would owe nothing for 2010 and 2011 (because we are assuming for simplicity that interest rates are at zero), and then $10 million per year for seven years, starting in 2012 and ending in 2018.

Assume further that in 2011 the cash flow rule would trigger an $80 million additional payment (before application of the cap) due to an extraordinary redemption and excess compensation generated solely by stock appreciation. In that case, under the bill, the employer must make the entire $70 million contribution in 2011. In other words, by electing the relief, the employer is forced to pay off the entire shortfall amortization base by the second year, instead of having seven years to pay it off, as under current law.

This "worse than present law" aspect of the cash flow is severely punitive and may well have been inadvertent. There is no reason to apply rules far harsher than present law. If unchanged, a large number of companies that need relief will feel compelled to forego it and do layoffs instead.

The solution is straightforward. The increase in shortfall amortization installments caused by the cash flow rule should be limited by the total amount of current and past contributions that would have been required but for the relief, plus interest. So in the example above, the shortfall amortization installments for 2011 would increase to $20 million in 2011 and would be $10 million per year in 2012 through 2016.

The cash flow rule applies for much too long a period. Even if the "worse than present law" aspect of the bill is fixed, the cash flow rule could still cause enormous spikes in contribution levels. For example, amortization payments could easily more than triple in a year by reason of the cash flow rule. This type of spike is completely inconsistent with business planning, thus forcing employers to avoid the application of the cash flow rule.

Avoiding the application of the cash flow rule means companies would need to commit for the next nine or 15 years not to use valuable practices to grow their business. Companies cannot do this. Company leaders would be imprudent to the point of negligence if they agreed for the next nine or 15 years, for example, not to (1) use equity or incentive pay, (2) do material stock repurchases, or (3) provide substantial dividends. To commit in 2010 with respect to actions in 2020 and beyond is unthinkable from a

business perspective. Not only would such a commitment be extremely imprudent from a business perspective, it could have a very adverse effect on a company's ability to enter into mergers and other business transactions for the next nine or 15 years. In short, if these periods are unchanged, most (if not substantially all) major companies will forego the relief and may be forced to lay off employees in order to make their pension payments.

The 9-year period applicable to the 2 and 7 rule should be shortened to two years. The 2 and 7 rule provides two years of relief; then the regular amortization schedule begins. It is true that one can argue that in a theoretical sense the relief lasts nine years. But that argument results in relief that is generally unusable by large companies. Our objective is to keep Americans employed. Regardless of the legitimate theoretical arguments on both sides, the decision needs to be made based on the jobs issue; the 9-year rule will cost many jobs.

Correspondingly, the 15-year period should be shortened to two years. The 15-year amortization rule is presented as relief that is "equivalent" to the 2 and 7 rule: less relief early in the period, more relief later. Some companies have expressed a strong preference for the 2 and 7 rule, others a strong preference for the 15-year rule. Why should two "balanced" options be subject to different conditions? Again, we recognize the legitimate theoretical argument that the cash flow rule should last as long as the relief. But the simple answer to that is that that argument will cost jobs across the country by preventing employers from electing relief.

If any period longer than two years is used, a mechanism is needed to avoid the contribution spikes, so that the cash flow rule cannot increase funding obligations by more than a specified percentage, such as 10%.

The cash flow rule should not be triggered by events totally outside the control of the employer. Assume, for example, that an employer granted a large number of stock options in 2007. Assume further that the stock options will vest in 2012 and assume that the value of the stock increases dramatically by 2012 due to excellent performance by the company.

This wonderful success story, based entirely on actions taken before the introduction of the draft HIRE Act, would undoubtedly trigger massive payments under the cash flow rule, perhaps undermining the company's ability to continue its excellent performance and retain employees. Moreover, this result is not attributable to any decision made after February 4, 2010 to pay excessive compensation that could have gone to the plan.

This illustrates a key point. Every company with stock options outstanding or with any other binding commitment to pay incentives or equity-based compensation will be forced to evaluate whether the relief will be of any value or whether it will

provide the potential for unexpected cash requirement down the line. If the chances are that existing commitments may well render the relief worthless or perhaps more costly than no relief at all, then the company must move forward with layoffs. No one wants this result.

The solution is to exempt compensation paid pursuant to binding commitments in effect as of February 4, 2010. Any other rule would have an unfair retroactive effect and unintentionally render the relief ineffective for many companies across the country.

The excess compensation rule should not apply to all employees. The application of the excess compensation rule to all employees would have some counterproductive effects. For example, employees who work on the basis of commissions or similar incentive arrangements could generate "excess employee compensation" solely by reason of successfully implementing the company's recovery program. This is not executive compensation; it is money for non-executives who are helping revive a company. It would be very unfortunate for the cash flow rule to undermine the engine that drives business success.

The group of employers to whom the excess compensation rule applies should be narrowed to apply only to the top officers who are in a position to have significant input into their own compensation.

Transition relief is needed in the case of mergers and acquisitions. Assume that an employer elects the relief and becomes subject to the cash flow rule. Assume further that while the cash flow rule applies, the employer merges with another company that did not elect the relief. Compensation paid or payable by such other company could immediately cause the cash flow rule to be triggered. That is not fair or appropriate. In the case of business transactions, a transition period is needed—similar to existing transition periods for business transactions—whereby for a period of time, actions by the "other" company with respect to itself or its employees cannot trigger the cash flow rule.

Clean-up changes to the extraordinary redemption rule. There are two important changes to the extraordinary redemption rule that appear to be more in the nature of clean-up changes. First, the current definition has an enormous cliff when the redemption hits 10%, moving from zero to the full 10% amount. Only the excess over 10% should be treated as extraordinary.

Second, the bill does not specify how the 10% threshold is calculated when the stock value increases or decreases. For example, assume that a company's outstanding stock has a value of $100 million when a $9 million stock repurchase program is executed. Within 12 months, the stock value falls 20%, so $9 million is more than 10% of the value of all the shares (including the redeemed shares). The decrease in the value of the stock should not cause the redemption to fail the 10% test. The 10% test should

be applied based on the value of the stock as of the day that the order to redeem the stock is first issued.

Extraordinary dividends. Purely as a technical matter, the extraordinary dividend rule does not work and needs to be revised. The statutory definition of an "extraordinary dividend" only applies to corporate shareholders receiving a dividend and is based on the corporation's basis in the stock. This simply has no application to the determination of whether a corporation paying a dividend is paying an extraordinary dividend.

The PBGC seemed to recognize this in its reportable event regulations. The PBGC developed a workable definition of "extraordinary dividend" in its regulations, then "waived" all other reporting required under the statute. The problem is that the draft HIRE Act disregards all "waivers" in applying the extraordinary distribution rule, so the bill would require use of the unworkable statutory rule. The solution is to apply the extraordinary dividend rule taking into account the applicable waivers under the PBGC regulations.

One other clean-up change is needed with respect to the extraordinary dividend rule. Technically, a dividend paid, for example, by a subsidiary to a parent company can be an extraordinary dividend under the PBGC regulations. Although it may be appropriate to report such a transaction to the PBGC, it should not trigger the cash flow rule. Moving money within a controlled group does not indicate any corporate ability to make additional pension contributions. Thus, dividends with a controlled group should not trigger the cash flow rule.

Other Funding Issues.

The draft HIRE Act addresses the core funding challenges. But there are other funding issues that need immediate attention and should be included in the HIRE Act.

Clarification that target normal cost does not include investment expenses. 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 in 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".

Exclusion of social security level-income options from the definition of prohibited payments. In general, under current law, if a defined benefit plan is under 60% funded for a plan year, no benefits may be paid in the form of a "prohibited payment" (as defined below). If a plan is at least 60% funded but less than 80% funded, at most, only half of any benefit may be paid in the form of a prohibited payment.

For purposes of the above rule, a prohibited payment is generally defined as any payment in excess of the monthly amount paid under a single life annuity, plus any "social security supplement" (generally, a supplemental monthly benefit provided to early retirees to provide a bridge to the date that Social Security benefits begin). The prohibited payment benefit restriction was targeted at lump sum distributions and similar payments. It has, however, been interpreted in regulations to include other forms of payment, including social security level-income options. Social security level-income options are economically the equivalent of social security supplements; the only difference is that plans can be amended to eliminate earned social security supplements, but earned social security level-income options are protected from elimination.

The proposal would exclude social security level-income options from the definition of "prohibited payment", just as social security supplements are currently excluded. There is no reason to treat economically identical payment streams differently.

Delay in the application of the benefit accrual and shutdown benefit restrictions to collectively bargained plans. The effective date of the benefit accrual and shutdown benefit restrictions with respect to collectively bargained plans should be delayed until plan years beginning after December 31, 2011. This delay is important for two reasons. First, where the collective bargaining agreement makes the benefits contingent on the restrictions not applying, members of collective bargaining units would be denied important benefits that they have bargained for, which is unfair, especially during these difficult economic times. Second, where the benefits are not so contingent, employers that have entered into these agreements would be forced to fund extraordinary amounts (or waive similarly large amounts of credit balance) to honor agreements entered into when no one could imagine funded statuses falling so low. The burden on such employers could be overwhelming.

Credit balance lookback rule. Under this proposal, for purposes of applying the rule denying an employer the ability to use credit balances with respect to a plan if the plan was less than 80% funded in the preceding year, the employer may deem the plan's funded status for the 2007 or 2008 year to be in effect for the succeeding two years. This is a critical issue for many companies, including a national charity. Without this relief, employers that had pre-funded their plans and made business plans based on using that pre-funding to offset future funding obligations will suddenly have large, unexpected funding obligations. Such unexpected divisions of cash can trigger layoffs, business contractions, and, in the case of charities, a cutback in critical services.