ERISA Advisory

Congress Revises PBGC's Controversial Substantial Cessation Liability (§4062(e)) Rules

January 7, 2015

The Multiemployer Pension Reform Act of 2014 (MPRA'14), discussed in a previous ERISA Advisory, was the most prominent pension-related legislation included in Congress's end-of-year spending bill (the CRomnibus), but it wasn't the only one. The lawmakers also took the opportunity to reform an obscure bit of the law that has generated disproportionate turmoil in recent years, the "substantial cessation" rules of section 4062(e) of ERISA.

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Background

Although it has been part of ERISA from the beginning, section 4062(e) underwent years of benign neglect. According to the statute, whenever a sponsor of an underfunded defined benefit pension plan insured by the Pension Benefit Guaranty Corporation (PBGC) ceased operations at a facility, and plan participation was reduced by 20% or more as a consequence, the PBGC could impose partial employer liability, just as if the plan had terminated, in proportion to the ensuing reduction in the plan's base of active participants. The PBGC would, however, have to return the liability payment (without interest) if the plan did not actually terminate within five years. As an alternative, the sponsor could post a bond for five years equal to 150% of the liability, or it could make some other arrangement acceptable to the PBGC.

For a long time, the PBGC saw no benefit in enforcing this provision. Only a tiny proportion of "substantial cessations of operations" presaged an underfunded plan termination within five years. The chaff-to-wheat ratio was thus too high to make winnowing it a profitable use of limited resources. It is true that in 1995, a PBGC official announced that: "The rumor is circulating that we're enforcing Section 4062(e), and the rumor is true." But there was little concrete evidence to back up that statement.

It was not until 2006 that the PBGC published its first set of regulations under section 4062(e), dealing with how to calculate substantial cessation liability, and began to take vigorous action in the area – so vigorous, in fact, that by 2012 the section had gained a place in the Chamber of Commerce's list of "most troubling federal rules and regulations." Drawing particular criticism were proposed regulations issued in 2010, which defined "substantial cessation of operations" so broadly that one might be deemed to take place at a facility where work was continuing or where there had been only a temporary interruption.

Publicly available information indicates that the PBGC has pursued over 300 section 4062(e) cases since 2006 and has so far reached settlements in about a quarter of them. In almost all cases, the employer agreed to accelerate funding of its plans, often rather modestly, without making any payments to the PBGC or posting a bond.

In July 2014, faced with rising criticism, the PBGC suspended almost all of its 4062(e) enforcement activities pending further review. The CRomnibus has now preempted self-examination by revamping the section from top to bottom. "Section 4062(e) events" should now become much rarer, but if and when they occur, the PBGC's practice of demanding accelerated funding has been systematized and made available to any employer that elects it.

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The New 4062(e)

In its new incarnation, section 4062(e) is essentially an accelerated funding requirement that may come into effect when a plan sponsor's US work force decreases by more than 15% as the result of the cessation of operations at a facility. Here are the highlights of the new rules:

1. *What plans are affected?* Section 4062(e) applies only to PBGC-insured plans that, as of the valuation date of the plan year preceding a cessation of operations, had 100 or more participants with accrued benefits and whose ratio of assets (at market value) to funding target (as determined for PBGC premium purposes) was less than 90%. For all but some small plans, the valuation date is mandatorily the first day of the plan year. If a plant shuts down in December 2015, whether section 4062(e) may affect a calendar year pension plan ordinarily will depend on its participant count and funded status as of January 1, 2014.

2. *What is a "substantial cessation of operations"?* A "substantial cessation" has two elements: First, the employer's operations at a facility must cease permanently. Usually, whether this has happened will be obvious, but the new Act neither approves nor condemns the non-intuitive definitions of "facility" and "operations" that were set forth in the PBGC's proposed regulations. It does, on the other hand, squarely foreclose the PBGC's position that a temporary cessation – resulting, for instance, from a natural disaster or a strike – could give rise to substantial cessation liability.

Second, the cessation must result in the separation from employment of more than 15% of all employees in the employer's controlled group who are "eligible to participate in an employee pension benefit plan (as defined in section 3(2) [of ERISA]) established and maintained by the employer." Unlike its predecessor, the new section 4062(e) doesn't look at reductions in plan participation individually. Section 3(2) includes retirement plans of all types – not just pension plans, but also profit sharing plans, 401(k) plans and ESOPs. For most companies, then, the group of employees "eligible to participate in an employee pension benefit plan" is very nearly synonymous with the full-time US workforce.

Example: National Pugilistics Co. has 2,000 employees in its controlled group, all of whom are eligible to participate in 401(k) plans. It thus has 2,000 "eligible employees." Its pension plan covers all 250 employees at a single factory. It closes the factory and discharges everyone who works there. Under prior law, it would have had a "substantial cessation of operations," because the facility closure resulted in the separation of more than 20% of the pension plan participants. Under the new law, section 4062(e) doesn't come into play, because the separated employees are less than 15% of the total number of "eligible employees."

3. *How is the "workforce reduction" computed?* In determining whether the 15% threshold has been reached, the denominator is "eligible employees" (those "eligible to participate in an employee pension benefit plan") as the date on which the employer began dismissing workers in connection with the closing of a facility. That date may, of course, be hard to identify in some instances. For example, a natural disaster might force a plant closure and the layoff of the personnel who work there, but it might be months or years before the employer reached a firm decision to shutter the facility permanently. In the great majority of cases, though, the testing date should not be controversial.

The starting point for the numerator is "the number of eligible employees at a facility who are separated from employment by reason of the permanent cessation of operations of the employer at the facility." That figure is then modified by subtracting separated employees who are replaced within "a reasonable period of time," so long as the replacements are US citizens or permanent residents and work at a facility located in the United States (a touch of protectionism there). Hence, relocating a facility or converting it

to different operations after a closure is less likely to result in a “substantial cessation” than under the PBGC’s interpretation of prior law. Also, contrary to the PBGC’s previous interpretation, workers at other facilities who lose their jobs as an indirect result of closing a facility are not counted in the numerator.

Example: World Wide Wicket Corporation manufactures wickets at its plant in Rahmburg, Illinois. The plant employs 1,000 workers. The controlled group has a total of 4,000 “eligible employees,” all of whom participate in the Wicket Pension Plan. The company closes the Rahmburg plant and shifts manufacturing to a new facility in Scottsdale, Wisconsin. One hundred of the Rahmburg workers accept jobs in Scottsdale, and 700 new employees are hired there. Hence, a net of only 200 eligible employees are deemed to have separated from employment as a result of the cessation of operations at Rahmburg. Since that is less than 15% of World Wide Wicket’s 4,000 eligible employees, there are no section 4062(e) consequences.

4. *How are sales of operations treated?* The PBGC’s proposed regulations viewed “the not uncommon situation where one employer sells the assets used in an operation to another employer that continues or resumes the operation” as possibly within the purview of section 4062(e). Under the new law, it is still possible for a sale of operations to constitute a substantial cessation, but the risk is much reduced.

The new rule is that, when a party outside the employer’s controlled group acquires a facility, employees who continue to work there are not considered to have been separated from employment, unless they participate in a PBGC-insured plan *and* their interest in the plan is *not* transferred to a defined benefit plan maintained by the acquirer.

Example: Suppose that, in the preceding example, World Wide Wicket has sold the Rahmburg plant to an unrelated buyer, which then continued to operate it. The employees who remained with the acquirer would not count as separated from employment, provided that WWW spun off their attributable assets and liabilities from its pension plan into a plan maintained by the acquirer. If it did not do that, a substantial cessation would occur, as the separated employees exceed 15% of the company’s eligible employees.

Employees separated as a result of the sale of the facility are not counted if, within a reasonable period of time, they are replaced by US citizens or residents. For those separated employees who participated in a PBGC-insured plan, the same plan-to-plan transfer requirement applies as for employees who continue to work at the facility. The statute does not say that the replacements must be employed at the same facility, leaving unclear what happens if the acquirer moves a substantial part of the work elsewhere.

The rationale for mandating transfers between plans is unclear, and the requirement adds a new complication to transactions, as many buyers have little desire to take over responsibility for pension benefits, particularly not for former employees who never worked for them.

5. *How is the employer’s liability calculated?* Following the lead of the PBGC’s 2006 regulations, the liability arising from a substantial cessation equals the plan’s unfunded vested benefits, as determined for PBGC premium payment purposes, as of the valuation date of the plan year preceding the cessation of operations, multiplied by the number of active employees with accrued benefits who separated from service as a result of the cessation (adjusted for replacements) and divided by the total number of active employees with accrued benefits under the plan. Note that this calculation, unlike the workforce reduction, is on a plan-by-plan basis.

Example: Acme Dynamos, Inc. shuts down its factory in Coyoteville, Arizona, on April 30, 2015, laying off 200 of its 1,000 employees. None of the factory’s operations are transferred elsewhere. All 1,000 Acme

employees are eligible to participate in an ERISA-covered retirement plan of some sort. Two of those plans are PBGC-insured defined benefit plans, one a frozen plan covering 100 current and 500 former employees, the other an ongoing plan covering 500 current and 100 former employees. Of the current employees participating in the frozen plan, 90 worked at the closed factory. The ongoing plan had only five participants at the factory.

As of the valuation date of the plan year preceding the closing (January 1, 2014), both plans were funded at less than the 90% level, and each had $2,000,000 in unfunded vested benefits. The substantial cessation liability for the frozen plan therefore is –

$2,000,000 × 90 ÷ 100 = $1,800,000

For the ongoing plan, the liability is –

$2,000,000 × 5 ÷ 500 = $20,000

6. *How can the employer satisfy its liability?* The new law does not change or eliminate any of the settlement methods – escrow payments to the PBGC, posting a bond, or a mutually acceptable alternative – that were previously available. All that it does is add a statutory version of what has been the most common alternative arrangement, funding acceleration.

An employer faced with section 4062(e) liability may elect to make additional contributions over a seven-year period, beginning with the year in which the substantial cessation occurs. Each annual installment is one-seventh of the total liability, with two provisos:

- When the plan's funded level reaches 90%, the additional contribution obligation comes to an end.
- For any particular year, the additional contributions are cut back if, when added to the minimum required contribution, they total more than 25% of the excess of the plan's unfunded vested benefits over the market value of its assets.

The additional contributions are deductible but, unlike most other contributions beyond the minimum, do not generate a prefunding balance (an amount that may, under some circumstances, be used to reduce the minimum required contribution).

The due date for the first additional contribution installment is one year after the employer notifies the PBGC of the substantial cessation (or the PBGC determines that one has occurred, if the employer fails to submit a notification), but not later than the normal due date for minimum required contributions (8½ months after the end of the plan year). Subsequent installments are due on the anniversary of the initial due date. Any failure to remit installments on time accelerates the entire obligation.

Under the PBGC's regulations, which on this point are not altered by the new law, notification of the substantial cessation is due within 60 days after the later of the cessation of operations or the requisite decline in participation. After the notification (or PBGC determination), the employer has 30 days to notify the PBGC of its election to make additional contributions. It must thereafter advise the PBGC of the amount contributed each year (or of the cessation of the obligation to contribute) within 10 days after each installment due date.

Example: Continuing the preceding example, Acme notifies the PBGC of the substantial cessation on June 29, 2015, 60 days after the plant closure. It then has another 30 days, until July 29, 2015, to elect to make additional contributions to satisfy its liability. The annual installment for the frozen plan is one-seventh of $1.8 million ($257,143). For the ongoing plan, it is a negligible one-seventh of $20,000.

The first installments, for the 2015 plan year, are due one year after the notification to the PBGC, that is, by June 29, 2016 – earlier than the deadline for minimum required contributions, which is August 15, 2015. (If the factory had closed later and the notification of the substantial cessation had been given after September 15, 2014, the deadline for the first installment of additional contributions would be September 15, 2015.)

In each of the following six years, that year's installment will be due on June 29th after the close of the plan year, unless and until the plan reaches the 90% funding level. For instance, if the valuation as of January 1, 2018, showed that the frozen plan was 90% or more funded (on a PBGC premium basis), the additional contribution requirements for 2018 and all later years would cease (even if the funded level later declined).

Effective Dates

The new section 4062(e) applies to cessations of operations on or after the date of enactment, December 18, 2014. Employers that previously had substantial cessations under the old law, but have not yet arranged with the PBGC to satisfy their 4062(e) liability, are allowed to elect the new additional contribution option. The due date for the election is 30 days after the PBGC issues a final post-enactment administrative determination that a substantial cessation has occurred. Apparently, employers need do nothing until the PBGC takes action, even if the existence of a substantial cessation has previously been acknowledged. Cautious plan sponsors may, however, wish to take the initiative and submit election notifications by January 17, 2015, the 30th day after enactment.

The PBGC is prohibited from undertaking any enforcement action inconsistent with the new law, regardless of the date of the cessation of operations, except pursuant to settlement agreements that were in place on June 1, 2014. Unfortunately, the statutory language is not entirely clear, leaving the effect of this prohibition in doubt.