

## Restructuring pension liabilities in the US and UK

BY [TINAMARIE FEIL](#)

Treatment of pension liabilities in the face of employers' insolvency has long been a subject of great interest and even controversy. As insurer of the US' private defined benefit pensions for more than thirty years, the Pension Benefit Guaranty Corporation (PBGC) takes an active role in corporate bankruptcy proceedings on behalf of workers whose pension plans are not fully funded. The PBGC was created in 1974 after a series of US corporate failures led to the closure of corporate pension plans. In the UK, the mandatory Pension Protection Fund (PPF), modeled on the PBGC, was launched just three years ago in April 2005 and pays compensation to members of certain defined benefit pension schemes whose employers become insolvent and where there are insufficient assets in the scheme to pay PPF levels of compensation.

Both insurers are unfunded by their respec-

tive governments. The PPF collects a pension protection levy from eligible pension schemes, but also generates income from recoveries of money, and other assets from insolvent employers of schemes that it takes on: the assets of schemes transferred to the PPF and returns on its own investments. The PBGC is financed by insurance premiums set by Congress and paid by sponsors of defined benefit plans, investment income, assets from pension plans trusted by PBGC, and recoveries from the companies formerly responsible for the plans.

Both have recently asserted positive results of their continuing efforts with insolvent employers. In February this year, Charles E F Millard, director of the PBGC, praised autoparts supplier Dana Corporation for emerging from US Chapter 11 bankruptcy protection retaining its retirement plans, in what the PBGC called the "latest in a series of transactions in which the PBGC has worked with companies to help them retain sponsorship of their retirement plans." Mr Millard also declared "the transition continues a trend in which companies have emerged from bankruptcy with their pension plans intact without the need for PBGC to assume control." In spring 2007, Dana successfully restructured its UK businesses through a company voluntary arrangement (CVA). Dana's UK operations were healthy but for the overwhelming liabilities to its pension plans.

Since the introduction of the Enterprise Act, the focus in the UK has been on saving companies and businesses. If an underlying business is sound, the company may be rescued by a CVA. Obviously, such an approach saves jobs and allows the pension scheme to enter the PPF. If the existing shareholders are seeking to retain control of the company or business going forward, and at the same time transfer the pension scheme to the PPF, the PPF will ensure that it secures a better outcome for the pension scheme than would have occurred in a normal insolvency. The PPF looks to receive cash pay-

ments into the scheme and participation in any upside by taking a stake in the emergent company or sharing in any profit made on exit by an investor. Richard Favier, senior insolvency adviser at the PPF, says this approach results in significant recoveries. So far in its three-year existence, the PPF has accumulated approximately £345m from deals and roughly £77m from normal insolvencies. In addition, the PPF has remaining equity stakes, some or all of which may prove to be of value.

Other recent successes, according to the PBGC, include Federal Mogul Corp's US pension plan intact, a \$77.5m agreement with Swedish owned Electrolux Home Products Inc., efforts to preserve Tower Automotive's pension plan when the company's assets were purchased by Cerberus Capital Management before Tower emerged from bankruptcy court protection and an agreement with Daimler Chrysler in May 2007, as part of Daimler's sale of its North American Chrysler operations, to an affiliate of Cerberus Capital, to pay \$1bn into the Chrysler plans if they ended within five years. Chrysler also agreed to make \$200m in pension contributions over the next five years beyond the legally required minimum.

Unfortunately, the past several years delivered record terminations and underfunded pension plans in the US pushing the PBGC to a deficit high of \$23bn in 2005. These factors led to the 2006 enactment of the Pension Protection Act (PPA). The PPA is intended to help restore the PBGC to solvency and improve funding of corporate defined benefit plans, while facing the risk that it might push companies into exiting the system. Major points under the PPA include: (i) stricter funding requirements, with minimum contribution levels based on a funding target of pension assets equal to 100 percent of liabilities, with the expectation the increase would represent approximately a \$200bn increase in system wide funding - with some exceptions, sponsors will ►►

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have seven years to reach this level of funding; (ii) restricting heavily underfunded plans from increasing benefits; (iii) elimination of an exception allowing underfunded plans to avoid paying a variable premium based on the amount of the underfunding; and (iv) changes to calculations of asset and liability values, which was to eliminate the opportunity to make the contribution requirements more predictable and smoother - in addition, rates would vary, to some extent, with the length of time and until payments were to be made.

Although the PBGC is still operating at a deficit, the deficit has declined to approximately \$14bn in fiscal 2007. There is some current concern over the PBGC's February announcement of a new diversified investment policy to help ensure it can meet its long term obligations to the US's retirees. Under this new policy, the PBGC will allocate 45 percent of its assets to a diversified set of fixed income investments, 45 percent to diversified equity investments and 10 percent to alternative investment classes. Last year, just 28 percent of its investments were in equities. According to one commentator, Zvi Bodie, professor of finance and economics, Boston University School of Management, the PBGC already has huge exposure to equities through

guaranteeing company pension plans. Bodie contends poor equity performance, reflecting a weak economy, will increase the number of bust companies passing their pensions to the PBGC. With typical equity weightings in US pension plans; deficits and each PBGC loss will also be bigger.

Meanwhile, the PPF has raised the threshold at which pension schemes pay no risk based levy to 140 percent of their funding. The PPF has justified the change on the basis that even well funded schemes could pose a long term risk. Companies are concerned whether they can afford to provide more funding. The situation is likely to be exacerbated by credit tightening, while stock market volatility may also mean that the pension scheme deficit is larger than anticipated.

Those who can't pay say they may be forced into formal insolvency as a result, with the pension scheme liability then transferring to the PPF. For those who won't pay, the Pensions Regulator (PR) may require the sponsoring employer and/or associated companies to contribute to the underfunded pension scheme, pursuant to Section 43 of the Pensions Act 2004. Under Section 43, the PR can issue a financial support direction (FSD) on an associated or connected party, (as defined in Sec-

tion 435 of the Insolvency Act 1986), if a) the employer is insufficiently funded, or, b) is a service company, where they consider it to be reasonable to do so. Subsidiaries in a group and their parent may be considered associates of each other.

The first ever FSD, which sought to oblige Sea Containers Ltd to put in place additional financial support for pension funds, was handed down by the Determinations Panel of the PR on 3 July 2007, but was appealed against. Sea Containers Ltd has been a debtor under Chapter 11 in the US since 15 October 2006. According to a press release of 6th February 2008, Sea Containers has reached a settlement with pension Trustees and withdrawn its appeal against the FSD. Sea Containers, alongside the Trustees, will be seeking approval from the Pensions Regulator for the proposed settlement. The proposed settlement is also subject to US Bankruptcy Court approval and may be objected to by other creditors of the estate.

It appears that treatment of pension liabilities in the face of employers' insolvency will continue to be subject of great interest, and even controversy. ■

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