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# FUNDING OF PUBLIC SECTOR PENSION PLANS: WHAT CAN BE LEARNED FROM THE PRIVATE SECTOR?

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*Public pensions can be poorly funded, and, if recent events are any guide, benefit promises may be impaired in municipal bankruptcies. Experience with private-sector pension plans suggests that responsible funding is the best protection against default risk.*

*Studebaker's default on promised pensions inspired the 1974 federal pension reform act, ERISA. The company's pension plan was substantially underfunded when the company failed, despite periodic contributions under pre-ERISA standards. The plan's assets first paid retirees' benefits, leaving 7,000 younger workers with little to nothing in retirement. ERISA addressed this default risk through funding rules and PBGC insurance.*

*ERISA's minimum funding rules have not prevented pension plan failure. To the contrary, the PBGC and plan participants have absorbed some large losses. However, the funding rules remain the primary protection against default risk.*

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I thank Amy Monahan, Professor at the University of Minnesota Law School, for the opportunity to present this concept at the American Law Institute's 2015 conference, *The Law and Public Pensions*, and Brendan Maher, Professor at the University of Connecticut Law School, for the opportunity to present at the Fifth Annual National Benefits & Social Insurance Conference in 2016. Professor Monahan's work is an important starting point for anyone who wants to understand the issues that affect public pensions. *E.g.*, Amy B. Monahan, *State Fiscal Constitutions and the Law and Politics of Public Pensions*, 2015 U. ILL. L. REV., 117 (2015); Thomas J. Fitzpatrick IV & Amy B. Monahan, *Who's Afraid of Good Governance? State Fiscal Crises, Public Pension Underfunding, and the Resistance to Governance Reform*, 66 FLA. L. REV. 1317 (2014). Natalya Shnitser, Assistant Professor at Boston College Law School, has done important empirical work in this area. Natalya Shnitser, *Funding Discipline for U.S. Public Pension Plans: An Empirical Analysis of Institutional Design*, 100 IOWA L. REV. 663 (2015).

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*Among the strengths of ERISA's funding rules are mandatory amortization of unfunded liabilities, constraints on actuarial methods and assumptions, a variety of enforcement tools, and payment restrictions for poorly funded plans. ERISA also has robust reporting and disclosure requirements, which can help promote funding discipline.*

*Congress has amended ERISA's funding rules many times since 1974, as it addresses competing social and federal revenue-raising goals. Though generally sound, some changes have been ill-timed or made for the wrong reasons.*

*This article's thesis is that the experience under ERISA, both positive and negative, has important lessons for public plans. The article first provides a brief history of legal developments up to ERISA's enactment. It then describes ERISA's minimum standards, which include vesting and benefit accrual rules, funding standards, fiduciary standards, reporting and disclosure, and benefit insurance, but which generally do not apply to public plans. It then surveys ERISA's funding rules for both single-employer and multiemployer plans, and provides a history of those rules, showing how Congress has generally tightened the rules, though it has sometimes relaxed them. Next, it surveys other controls on funding, such as reporting and disclosure, accounting rules, and actuarial standards. Finally, it sets forth conclusions that may be of use to law reformers, among them the need for funding rules, conservative actuarial assumptions, actuarial independence, enforcement tools, transparency, and a balance between funding and benefit promises.*

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## I. INTRODUCTION

In my tenure with the Pension Benefit Guaranty Corporation ("PBGC"), I have often seen pension plans fail that might have survived if funding rules had been stronger. Among them are plans in the steel and airline industries that were underfunded by billions of dollars.<sup>2</sup>

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<sup>2</sup> PBGC is the federal agency charged with insuring private-sector defined benefit pension plans. 29 U.S.C. §1302 (2012). PBGC was established by the Employee Retirement Income Security Act of 1974, 29 U.S.C. §1001-1461. In carrying out its statutory mission, PBGC devotes much of its day-to-day attention to financially troubled sponsors of underfunded plans. For an overview, see Israel Goldowitz, Garth Wilson, Erin Kim, & Kirsten Bender, *The PBGC Wins a Case Whenever the Debtor Keeps Its Pension Plan*, 16 MARQ. BENEFITS & SOC. WELFARE

Corporate sponsors of PBGC-insured defined benefit plans have struggled with a number of adverse trends. Among them globalization of manufacturing and trade, industry obsolescence, and volatility in financial markets, and pension cost increases due to improvements in life expectancy. The decline in private sector unionization and the growth in defined contribution plans have also contributed to the steady decline in private defined benefit plans. As a result, fewer workers in the defined benefit system are supporting more retirees for longer periods. That puts an increasing burden on labor costs and, in turn, the cost of goods and services. The same pay package supports retiree healthcare in many cases.<sup>3</sup>

Some of these trends affect defined benefit pension plans for state and local employees. So the private-sector experience may be useful to those considering funding rules for public plans.

Public plans cover about 15 million employees and 10 million retirees and surviving dependents. Based on reported data and plan-specific actuarial assumptions, public plans are underfunded by more than \$1 trillion. They are 73% funded on average, and plans in Illinois, Connecticut and Kentucky less than 50% funded. The unfunded liabilities represent an average taxpayer burden of about \$3,000 per capita, with Illinois, Connecticut, and Ohio at about \$7,000.<sup>4</sup>

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L. REV. 257 (2015), <http://scholarship.law.marquette.edu/cgi/viewcontent.cgi?article=1005&context=benefits>.

<sup>3</sup> For another synthesis, see Ilana Boivie, NAT'L INST. ON RET. SEC., *Who Killed the Private Sector DB Plan?* (March 2011), [http://www.nirsonline.org/storage/nirs/documents/Who%20Killed%20DBs%20final\\_-\\_who\\_killed\\_the\\_private\\_sector\\_db\\_plan.pdf](http://www.nirsonline.org/storage/nirs/documents/Who%20Killed%20DBs%20final_-_who_killed_the_private_sector_db_plan.pdf).

<sup>4</sup> Alaska leads the nation at \$11,000 per capita and Puerto Rico is close behind at \$10,000. Keith Brainard & Alex Brown, NAT'L ASSOC. OF STATE RET. ADMIN., *Public Fund Survey* ("NASRA Survey") and *id.*, APPENDIX B (Mar. 2016), <http://www.nasra.org/publicfundsurvey>; *Standard and Poor, Ratings Direct, U.S. State Pension Funding: Strong Investment Returns Could Life Funded Rations, But Longer-Term Challenges Remain* (Jun. 24, 2014), <http://www.nasra.org/Files/Topical%20Reports/Credit%20Effects/sandpstate1406.pdf>. Data are as of 2014. For accounting and funding purposes, future benefits are discounted to present value. The higher the assumed interest rate, the lower the present value. Dan M. McGill, Kyle N. Brown, John J. Haley, Sylvester J. Schieber & Mark J. Warshawsky, *Fundamentals of Private Pensions* 207-09 (9th ed. 2010). The NASRA Survey notes: "Even a small change in a plan's investment return assumption can impose a disproportionate impact on a plan's funding level and cost. For most of the Public Fund Survey's measurement period, the median investment return assumption used by public pension plans was 8.0 percent. Since 2009, a majority of plans have reduced their assumed investment return, resulting in a

In the past decade, pension obligations have been a factor in several municipal bankruptcies. Central Falls, Rhode Island, for example, negotiated a benefit reduction that in some cases exceeded 40%.<sup>5</sup> Detroit negotiated a 4.5% benefit reduction, along with other benefit concessions, to resolve litigation with bondholders and present a viable plan of adjustment of its debts.<sup>6</sup> Like many jurisdictions, Detroit had used aggressive interest rate assumptions to value benefit liabilities, masking the problem. Detroit had also depleted plan assets by paying a “13<sup>th</sup> check” during flush times and overstating the earnings transferred to commonly managed annuity accounts.<sup>7</sup> Stockton, California, sought to withdraw from the California Public Employees Retirement System (“CalPERS”), but eventually decided against it.<sup>8</sup>

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reduction to the median return assumption to 7.75 percent.” *Id.*, Figure N. “Asset smoothing,” i.e., averaging of returns, can also have a significant effect. See Mary Williams Walsh & Michael Cooper, *New York Gets Sobering Look at Its Pensions*, N.Y. TIMES (Aug. 20, 2006), <http://www.nytimes.com/2006/08/20/nyregion/20pension.html>.

<sup>5</sup> Mary Williams Walsh, *Cuts for the Already Retired*, N.Y. TIMES (Dec. 19, 2011), <http://www.nytimes.com/2011/12/20/business/pension-deal-in-rhode-island-could-set-a-trend.html>. W. Zachary Malinowski, *Chafee Signs Law Giving Retired Central Falls Police, Firefighters Pension Supplement*, PROVIDENCE J. (Aug. 27, 2014), <http://www.providencejournal.com/article/20140827/News/308279896> (noting that the state later enacted legislation to restore up to 75% of the original amounts).

<sup>6</sup> Susan Tompor, *Detroit Retirees to See Pension Cuts Starting Monday*, DETROIT FREE PRESS (Mar. 2, 2015), <http://www.freep.com/story/money/personal-finance/susan-tompor/2015/02/27/detroit-orr-pension-checks-cuts/24144513>. INTERNAL REVENUE SERV., *Internal Revenue Manual*, § 7.11.6.6.11 (Sept. 18, 2015), [https://www.irs.gov/irm/part7/irm\\_07-011-006.html](https://www.irs.gov/irm/part7/irm_07-011-006.html) (noting in the private sector, if a plan “is amended on a regular basis to provide for thirteenth checks..., the series of amendments may give rise to an expectation of such payments and be subject to protection as an accrued benefit...”).

<sup>7</sup> NATHAN BOMEY, *DETROIT RESURRECTED: TO BANKRUPTCY AND BACK* 52-57, 157-61 (W.W. Norton & Co. 2016).

<sup>8</sup> Marc Lifsher and Melody Peterson, *Judge Approves Stockton Bankruptcy Plan; Worker Pensions Safe*, L.A. TIMES (Oct. 30, 2014), <http://www.latimes.com/business/la-fi-stockton-pension-court-ruling-cuts-20141029-story.html>; *In re City of Stockton, California*, 526 B.R. 35 (Bankr. E.D. Cal. 2015) (city authorized to reject its contract with CalPERS and to avoid a statutory “termination lien” for pension underfunding under the Bankruptcy Code, which preempts contrary state law); *Id.* (noting CalPERS is apparently an “agent” rather than “cost-sharing multiple-employer plan,” with common administration of separate plans for

Outside bankruptcy, courts are generally more protective of public employees' pension benefits. For example, the Illinois Supreme Court recently held that Chicago cannot reduce cost-of-living adjustments despite requiring increased contributions and providing administrative and judicial remedies, thereby putting pensions on a sounder financial footing for a greater "net benefit." "[M]embers of the Funds already have a legally enforceable right to receive the benefits they have been promised" under the State Constitution, the Court held. "By offering a purported 'offsetting benefit' of actuarially sound funding and solvency in the Funds, the legislation merely offers participants in those funds what is already guaranteed to them—payment of the pension benefits in place when they joined the fund."<sup>9</sup>

Pension funding issues, of course, exist in a larger context of budget politics.<sup>10</sup> To avoid statutory borrowing limits, Detroit set up remote entities to finance pension debt, collateralized the debt with casino tax revenues, and tacked on default insurance and interest-rate swaps.<sup>11</sup> The Chicago "net benefit" proposal was designed to avoid a property tax increase.<sup>12</sup> New Jersey's governor declined to follow a law that required inclusion of an

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participating employers rather than a single risk pool); see Shnitser, *supra* note 1, at 688-89.

<sup>9</sup> Jones v. Mun. Employees' Annuity & Benefit Fund of Chicago, 50 N.E.3d 596, 607 (Ill. 2016) (internal quotations omitted).

<sup>10</sup> See STATE BUDGET CRISIS TASK FORCE, Full Report (2012), <http://www.statebudgetcrisis.org>. For an influential report focused on public pensions, see Donald J. Boyd & Pieter J. Kiernan, *Strengthening the Security of Public Sector Defined Benefit Plans*, THE NELSON A. ROCKEFELLER INST. OF GOV'T (St. U. of N.Y. ed., 2014), [http://www.rockinst.org/pdf/government\\_finance/2014-01-Blinken\\_Report\\_One.pdf](http://www.rockinst.org/pdf/government_finance/2014-01-Blinken_Report_One.pdf).

<sup>11</sup> The arrangement was undone in a bankruptcy settlement. Bomey, *supra* note 7, at 23-30, 92-112.

<sup>12</sup> Monica Davey and Mary Williams Walsh, *Pensions and Politics Fuel Crisis in Illinois*, N.Y. TIMES (May 25, 2015), <http://www.nytimes.com/2015/05/26/us/politics/illinois-pension-crisis.html>. Chicago continues to struggle, with a new valuation more than doubling the shortfall of its Municipal Employees' Annuity and Benefit Fund, Elizabeth Campbell, *Chicago's Pension-Fund Woes Just Became \$11.5 Billion Bigger*, BLOOMBERG (May 19, 2015), <http://www.bloomberg.com/news/articles/2016-05-19/chicago-s-pension-fund-troubles-just-became-11-5-billion-bigger>, and the legislature overriding a veto of a funding relief bill for the uniformed services plan. Elizabeth Campbell, *Illinois Lawmakers Override Veto of Chicago Pension Break*, BLOOMBERG (May 30, 2016), <http://www.bloomberg.com/news/articles/2016-05-30/illinois-senate-moves-to-override-veto-of-chicago-pension-break>.

actuarially determined “minimum required contribution” as a line item in annual appropriation acts and conferred a contract right on plan members to that contribution. The State Supreme Court agreed—“The Debt Limitation Clause of the State Constitution interdicts the creation . . . of a legally binding enforceable contract compelling multi-year financial payments in the sizable amounts” at issue.<sup>13</sup>

Cities have sold or pledged assets to fund pension costs. Detroit’s “grand bargain” included a purchase of the Detroit Institute of Art’s collection by national and local charitable foundations.<sup>14</sup> Chicago and other cities have pledged future parking meter revenues.<sup>15</sup> And Scranton, Pennsylvania, recently monetized its sewer system in part to pay down its pension shortfall.<sup>16</sup>

Pensions, in short, represent a major challenge for state and municipal finance.<sup>17</sup> The concern extends to U.S. territories. In June 2016, Congress enacted the Puerto Rico Oversight, Management, and Economic

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<sup>13</sup> *Burgos v. State of New Jersey*, 118 A.3d 270, 274-75 (N.J. 2015). Later, condemning “accounting gimmickry,” the governor vetoed a bill calling for quarterly and supplemental pension contributions. Christopher Baxter, *Christie Vetoes Quarterly N.J. Pension Payments Bill, \$300M 'Pre-payment'*, NJ.COM (Aug. 10, 2015), [http://www.nj.com/politics/index.ssf/2015/08/christie\\_vetoes\\_quarterly\\_nj\\_pension\\_payments\\_bill.html](http://www.nj.com/politics/index.ssf/2015/08/christie_vetoes_quarterly_nj_pension_payments_bill.html).

<sup>14</sup> Jordan Weissman, *Detroit Exits Bankruptcy, Thanks to Its Art Museum*, SLATE (Nov. 7, 2014), [http://www.slate.com/blogs/moneybox/2014/11/07/detroit\\_exits\\_bankruptcy\\_city\\_s\\_pensions\\_saved\\_in\\_part\\_thanks\\_to\\_detroit.html](http://www.slate.com/blogs/moneybox/2014/11/07/detroit_exits_bankruptcy_city_s_pensions_saved_in_part_thanks_to_detroit.html). Some doubt that this could be a template for other cities. Michael J. Bologna, *Would Detroit's 'Grand Bargain' Work in Chicago?*, BLOOMBERGBNA (May 6, 2016), <http://www.bna.com/detroits-grand-bargain-n57982070754/>. The bargain was upheld under the doctrine of equitable mootness—which prevents appellate courts from “unscrambling complex bankruptcy reorganizations.” *Ochadlus v City of Detroit* (In re City of Detroit), 838 F.3d 792 (6<sup>th</sup> Cir, 2016) (citations omitted).

<sup>15</sup> Donald Cohen, *Cities Need to Weigh Costs of Private Partnerships*, N.Y. TIMES, (Jul. 23, 2013), <http://dealbook.nytimes.com/2013/07/23/cities-need-to-weigh-costs-of-private-partnerships/>.

<sup>16</sup> Terrie Morgan-Besecker, *Sewer Sale Could Save Scranton Pensions*, SCRANTON TIMES-TRIB. (Dec. 10, 2015), <http://thetimes-tribune.com/news/sewer-sale-could-save-scranton-pensions-1.1981682>.

<sup>17</sup> See generally, James E. Spiotto, *How Municipalities in Financial Distress Should Deal with Unfunded Pension Obligations and Appropriate Funding of Essential Services*, 50 WILLAMETTE L. REV. 515 (2014); Alicia H. Munnell & Jean-Pierre Aubry, *Will Pensions and OPEBs Break State and Local Budgets?*, CTR. FOR RETIREMENT RES. AT B.C. (Oct. 2016), [http://crr.bc.edu/wp-content/uploads/2016/10/slp\\_51-1.pdf](http://crr.bc.edu/wp-content/uploads/2016/10/slp_51-1.pdf).

Stability Act (“PROMESA”), establishing an Oversight Board to restructure the island’s \$72 billion in debt and balance its budget. PROMESA requires an actuarial study of territorial pensions, but not a compromise of pensions as part of a restructuring plan.<sup>18</sup> Even the pension plan for Marianas Island employees briefly found shelter in bankruptcy until the case was dismissed on jurisdictional grounds.<sup>19</sup>

To be sure, many public plans are reasonably well funded, at least under stated assumptions.<sup>20</sup> In some cases, they survived a larger financial crisis. In 1976, New York State imposed a Financial Control Board with a majority of members appointed by the Governor as a condition of rescuing New York City’s finances.<sup>21</sup> The Board remains in place and retains certain

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<sup>18</sup> Puerto Rico Oversight, Management, and Economic Stability Act, S. 2328, 114th Cong. § 211 (2016) (noting PROMESA authorizes the Oversight Board to conduct an actuarial analysis of any underfunded territorial pension plan to aid “in evaluating the fiscal and economic impact of the pension cash flows... [such an analysis would include] (1) an actuarial study of the pension liabilities and funding strategy that includes a forward looking projection of payments of at least 30 years of benefit payments and funding strategy to cover such payments; (2) sources of funding to cover such payments; (3) a review of the existing benefits and their sustainability; and (4) a review of the system’s legal structure and operational arrangements, and any other studies of the pension system the Oversight Board shall deem necessary.”) Peter Roff, *A Bad Bailout for Puerto Rico*, U.S. NEWS & WORLD REP. (May 26, 2016), <http://www.usnews.com/opinion/articles/2016-05-26/house-bill-promesa-that-grants-bailout-to-puerto-rico-rips-off-bondholders> (“Puerto Rico’s general obligation bonds . . . would [] take a back seat to Puerto Rico’s almost totally underfunded \$46 billion public pension system”). Puerto Rico’s pension system is described in Nick Brown, *Puerto Rico’s Other Crisis: Impoverished Pensions*, REUTERS (Apr. 7, 2016), <http://www.reuters.com/investigates/special-report/usa-puertorico-pensions>. A recent audit indicates that Puerto Rico’s Employees’ Retirement System, with a reported \$30 billion in liabilities, will run out of money within a year. Michelle Kaske, *Puerto Rico Pension Risks Insolvency Next Year, Audit Says*, BLOOMBERG (Jun. 3, 2016), <http://www.bloomberg.com/news/articles/2016-06-02/puerto-rico-pension-plan-risks-insolvency-next-year-audit-says>.

<sup>19</sup> Caitlin Kenney, *Judge Says Pension Fund Can’t Seek Bankruptcy Protection*, NPR (Jun. 5, 2012), <http://www.npr.org/sections/money/2012/06/05/154302347/judge-says-pension-fund-cant-seek-bankruptcy-protection>.

<sup>20</sup> Brainard & Brown, *supra* note 4.

<sup>21</sup> CONG. BUDGET OFF., *The Causes of New York City’s Fiscal Crisis 1975*, 90 POL. SCI. Q. 659 (Winter 1975-76); Roger Dunstan, CAL. RES. BUREAU, CAL. STATE LIBR., *Overview of New York City’s Fiscal Crisis* (1995), <http://www.library.ca.gov/crb/95/notes/v3n1.pdf>. As part of the compromise, the City teachers’ pension fund bought bonds of the Municipal Assistance Corporation,

oversight duties.<sup>22</sup> New York City's pensions have respectable funding ratios, though hardly strong ones.<sup>23</sup> As part of the federal rescue of the District of Columbia's finances in 1997, Congress had the federal government takeover \$4.8 billion in unfunded pension liability for DC police, firefighters, teachers, and judges; froze the plans; adopted an amortization schedule; and authorized replacement plans. The new plans were required to be funded under standards borrowed from ERISA as then in effect. These plans have strong funding ratios.<sup>24</sup>

## II. OVERVIEW OF FEDERAL PENSION LAW

ERISA governs private-sector employee benefit plans.<sup>25</sup> ERISA sets minimum standards for participation, vesting, benefit accrual, funding, fiduciary conduct, and reporting and disclosure. ERISA also established PBGC to insure benefits under failed defined benefit plans.<sup>26</sup>

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which was formed to provide the City with emergency financing. Eric Jaffe, CITYLAB, *The Time the Teachers' Union Saved New York from Bankruptcy* (July 24, 2013), <http://www.citylab.com/work/2013/07/time-teachers-union-save-new-york-city-bankruptcy/6306>.

<sup>22</sup> STATE OF N.Y., FIN. CONTROL BD., MISSION STATEMENT, <http://www.fcb.state.ny.us> ("During sunset, the Control Board must review the four-year financial plan at least quarterly, and must notify the City if a plan or modification to the financial plan does not conform to the Act's standards. In addition, the Control Board must make a determination annually whether a new control period . . . should be declared").

<sup>23</sup> New York City's two largest pension plans have funding ratios of 58% and 70%. The statewide plans have ratios greater than 90 percent. NASRA, PUBLIC FUND SURVEY, APPENDIX B, *supra* note 4. The State's budget process can obscure the facts, however, and pension funding is no exception. RICHARD RAVITCH, SO MUCH TO DO: A FULL LIFE OF BUSINESS, POLITICS, AND CONFRONTING FISCAL CRISES 215-16 (2014) (contribution of promissory notes under the guise of "pension smoothing").

<sup>24</sup> Balanced Budget Act of 1997, Pub. L. No. 105-33, §§11001-11087, 111 Stat. 251, 715-31 (1997). See EDWIN C. HUSTEAD, PENSIONS IN THE PUBLIC SECTOR 354-362 (Olivia S. Mitchell and Edwin C. Husted, eds. 2001). Those plans now have 89-percent and 107-percent funding ratios. NASRA, *supra* note 4.

<sup>25</sup> 29 U.S.C. §§ 1001-1453 (2014). ERISA exempts governmental plans. 26 U.S.C. § 414(d) (2015); 29 U.S.C. §§ 1003(b)(1) (2002), 1321(b)(2) (2008).

<sup>26</sup> 29 U.S.C. §§ 1301-1453. A defined benefit plan is one that promises a benefit based on a formula, typically a percentage of final pay times years of service. 29 USC § 1002(35) (2008). Because the benefit is due regardless of the plan's funding

The House Ways and Means Committee, one of the committees of jurisdiction, saw responsible funding as the main protection for vested benefits under such plans— “Without adequate funding, a promise of a pension may be illusory and empty.” Moreover, “[t]o create a plan termination insurance program without appropriate funding standards would permit those who present the greatest risk in terms of exposure to benefit at the expense of employers who have developed conscientious funding programs.”<sup>27</sup>

#### A. HISTORY OF PENSION REGULATION

Pensions were originally a workforce management tool.<sup>28</sup> A trained workforce is a valuable asset. But pay increases as worker’s advance, and workers wear out as they age, especially in industrial jobs. So at some point, it makes sense to replace older workers. By giving older workers an incentive to retire and new hires an incentive to stay, pensions help to manage turnover.

The first pensions were for the military. Private pensions were first introduced by steel companies, railroads, and public utilities in the late 19<sup>th</sup> Century. Pensions for federal civilian employees and state and local employees are mainly a 20<sup>th</sup> Century development.<sup>29</sup>

State courts initially saw pensions as gratuities, and unenforceable.<sup>30</sup> A few courts saw a pension promise as an offer of a unilateral contract—promise for performance—to a class of persons. For example, if an employer promises anyone who works 20 years and reaches age 65 a pension of one-

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status, investment risk is on the employer. *See, e.g.*, *Hughes Aircraft Co. v. Jacobson*, 525 U.S. 432, 439-40 (1999).

<sup>27</sup> H.R. REP. NO. 93-533 at 7, 14 (1973), *reprinted in* 1974 U.S.C.C.A.N. 4639, 4645, 4652.

<sup>28</sup> LAWRENCE A. FROLIK & KATHRYN L. MOORE, *LAW OF EMPLOYEE PENSION AND WELFARE BENEFITS* 7 (3d ed. 2012) (citing MERTON C. BERNSTEIN, *THE FUTURE OF PRIVATE PENSIONS* 10 (1964)).

<sup>29</sup> ROBERT L. CLARK, LEE A. CRAIG, & JACK W. WILSON, *PENSION RESEARCH COUNCIL, A HISTORY OF PUBLIC SECTOR PENSIONS IN THE UNITED STATES* (U. Penn. Press ed. 2003), <http://www.pensionresearchcouncil.org/publications/pdf/0-8122-3714-5-1.pdf>; JEFFREY LEWIS, MYRON D. RUMELT, & IVELISSE BERIO LEBEAU, *EMPLOYEE BENEFITS LAW 1-1* (3d ed. 2012); David Gregory, *The Scope of ERISA Preemption of State Law: A Study of Effective Federalism*, 48 U. PITT. L. REV. 427, 438 (1987).

<sup>30</sup> *E.g.*, *McNevin v. Solvay Process Co.*, 32 A.D. 610 (N.Y. App. Div. 1898), *aff’d per curiam*, 60 N.E. 1115 (N.Y. 1901), cited in Gregory, *supra* note 29.

third of her final pay for life, any member of the class who meets these conditions would have a contractual right to a pension.<sup>31</sup>

A worker rights theory mainly emerged in other forums. For example, the Internal Revenue Service (“IRS”) developed a theory of vesting in plan assets when a plan terminates (or when a major downsizing can be considered a termination for affected employees).<sup>32</sup> The IRS administers the rules that allow pension plans to be tax-qualified. Employer contributions to a qualified plan are tax deductible, the plan’s earnings are not taxed, and employees are taxed only on their distributions.<sup>33</sup> No employer wants its plan to be disqualified, given the substantial tax benefits at stake.

The Labor-Management Relations Act, 1947 (“LMRA”), altered the balance of power between management and labor, and included pension provisions. Some unions had negotiated pension and health benefit plans funded by employers. Congress required that the money be held in trust, that contributions be governed by a written agreement, and that the trust be administered by equal numbers of employer and union appointees.<sup>34</sup> In light of these requirements, some courts held that if the trustees changed the eligibility rules and did so arbitrarily, they could be compelled to honor the prior rules.<sup>35</sup>

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<sup>31</sup> See *Wickstrom v. Vern E. Alden Co.*, 240 N.E. 2d 401 (Ill. App. Ct. 1968) (early retirement offer), cited in 1-3 Corbin on Contracts § 3.16 (2006). An example well-known to lawyers is *Carlill v. Carbolic Smoke Ball Company*, 1 QB 256 (1893). A vendor put an ad in a newspaper saying that anyone who bought this contraption and inhaled its vapors and still contracted the flu would be paid 100 pounds. The court held that this was an offer to a class and that any member of the class who met the conditions had accepted the offer and held an enforceable right to payment.

<sup>32</sup> Isidore Goodman, *Developing Pension and Profit-Sharing Requisites*, 13 SANTA CLARA L. REV. 1, 20-21 (1972). See *In re Gulf Pension Litig.*, 764 F. Supp. 1149 (S.D. Tex. 1991). See also Lewis, *supra* note 29, at 1-5 (Tax Code’s “exclusive benefit” rule was designed to curb deductions for amounts subject to recapture by revocation of pension trust, but also to encourage formation of trusts on which employees can rely for retirement income); 26 U.S.C. § 411(d)(3) (2014).

<sup>33</sup> 29 U.S.C. §§ 401(a), 402(a), 501(a).

<sup>34</sup> As trustees, those appointees serve as fiduciaries, not collective bargaining representatives. *NLRB v. Amax Coal Co.*, 453 U.S. 322 (1981).

<sup>35</sup> See *Danti v. Lewis*, 312 F.2d 345, 348 n.3 (D.C. Cir. 1962) (“[the] authorities are divided as to whether an applicant for a pension has a contractual interest in the Fund as a third party beneficiary to the Wage Agreement, or whether his interest is merely equitable and conditioned on meeting the eligibility requirements reasonably established by the Trustees. Since our view of the present case does not require a determination of this controversy, we express no opinion on it.”).

In 1948, the National Labor Relations Board held that pensions are among the terms and conditions of employment, and, as such, a mandatory subject of collective bargaining.<sup>36</sup> In 1958, Congress enacted the Welfare and Pension Plans Disclosure Act,<sup>37</sup> which required all employee benefit plans to file an annual report with the Department of Labor. But there was no comprehensive federal law until ERISA.

#### B. ERISA'S MINIMUM STANDARDS

ERISA's minimum standards codify an understanding that pensions are deferred compensation for services rendered.<sup>38</sup> Among its key features, ERISA:

- requires that employees be allowed to participate in a plan after a minimal length of service;
- requires that benefits vest within a reasonable period, so employees do not forfeit their rights if they go to work elsewhere, become disabled, or retire early;
- requires that a surviving spouse receive a benefit, to protect non-working spouses;
- provides that accrued benefits generally cannot be reduced;
- requires that defined benefit plans be advance funded;
- imposes minimum standards of prudence and loyalty on plan fiduciaries, and prohibits self-dealing;
- requires annual financial reporting, and plain-English disclosure of plan terms;
- provides for federal insurance of defined benefit pension plans if they terminate (single-employer plans) or become insolvent (multiemployer plans);
- authorizes the Labor Department and plan participants to enforce the minimum standards;

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<sup>36</sup> *Inland Steel Co. v. NLRB*, 170 F.2d 247 (7th Cir. 1948) (noting that a failure to bargain in good faith on the terms and condition of employment is an unfair labor practice). 29 U.S.C. § 158(a)(5); *NLRB v. Katz*, 369 U.S. 736 (1962).

<sup>37</sup> Welfare and Pensions Plans Disclosure Act, Pub. L. No. 85-836, 72 Stat. 997 (1958).

<sup>38</sup> 29 U.S.C. §§ 1001(a), 1001(b) (“...the continued well-being and security of millions of employees and their dependents are directly affected by [employee benefit] plans... [ERISA’s declared policy is to] protect interstate commerce and the interests of participants in employee benefit plans and their beneficiaries . . .”).

- broadly preempts State law as it relates to employee benefit plans; and
- opens the federal courts to benefit claims.<sup>39</sup>

Like all legislation, however, ERISA represents a compromise. In the first place, ERISA does not require an employer to have a plan. Nor did Congress want to deter employers from establishing or continuing plans by making them too expensive.<sup>40</sup> Thus, for instance, ERISA does not require immediate vesting.<sup>41</sup> Most important for our purpose, ERISA does not require that benefits be fully funded. Rather, it allows a funding shortfall to be amortized over a period of years.<sup>42</sup>

ERISA's minimum standards are found in the Labor title of the U.S. Code (Title 29) as positive law. Thus, for example, the vesting and anti-cutback rules are enforceable in court.<sup>43</sup> The minimum standards are also found in the Internal Revenue Code (Title 26), mainly as conditions of tax qualification. To enjoy favorable tax treatment, an employer must (for example) ensure that its plan meets the vesting and anti-cutback

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<sup>39</sup> 29 U.S.C. §§ 1021-25, 1052-55, 1082-85(a), 1102-11, 1114(a), 1132, 1301-1453.

<sup>40</sup> See H.R. REP. NO. 93-533 *supra* note 27, at 9 (“The Committee believes that the legislative approach of establishing minimum standards and safeguards for private pensions is not only consistent with retention of the freedom of decision-making vital to pension plans, but in furtherance of the growth and development of the private pension system.”).

<sup>41</sup> Compare 29 U.S.C. § 1053(a) (1976) (permitting employers to use ten-year “cliff” vesting under defined benefit plans; an employee was not vested at all until after ten years of participation, and then became 100% vested) with 29 U.S.C. § 1053(a) (2000) (mandating five-year cliff vesting).

<sup>42</sup> See *infra* p.16 (noting ERISA initially provided for a series of charges and credits to a “funding standard account,” each to be amortized over a period that in some cases was as long as 30 years. Under current law, there is a single “shortfall,” generally amortized over seven years.) See James Wooten, “*The Most Glorious Story of Failure in the Business*”: *The Studebaker-Packard Corporation and the Origins of ERISA*, 49 BUFF. L. REV. 683, 700-01 (2001) (noting Pension plans generally begin life with a significant unfunded past service liability, as they usually grant credit for service with the employer before it established the plan. Otherwise, at least in a unionized workplace, senior employees might prefer to forgo pensions in favor of larger paychecks.); Malcolm Gladwell, *The Risk Pool*, THE NEW YORKER (Aug. 28, 2006), <http://www.newyorker.com/magazine/2006/08/28/the-risk-pool>.

<sup>43</sup> E.g., *Cent. Laborers Pension Fund v. Heinz*, 541 U.S. 739 (2004).

requirements.<sup>44</sup> By Executive Order, President Carter allocated primary authority between the Department of Labor and the Department of Treasury/Internal Revenue Service. Treasury/IRS has primary authority over the funding rules.<sup>45</sup>

Because qualified plans are tax advantaged, Congress has historically used the qualification rules to promote broader pension coverage and other pension policy goals. For example, the Tax Code nondiscrimination rules, introduced by the Revenue Act of 1942, are designed to ensure that rank-and-file workers get some of the benefits that top management does.<sup>46</sup> But fiscal concerns have also led Congress to adjust the funding rules to reduce deductible contributions, so as to raise revenue or permit a spending bill to “erore” well.<sup>47</sup>

### C. PENSION INSURANCE UNDER ERISA

The rallying cry for pension reform was the failure of the Studebaker Company. The automaker was unable to compete with GM, Ford and Chrysler, and it was forced to liquidate in 1963. Studebaker had a defined benefit plan with a formula similar to the ones at the Big Three. As was

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<sup>44</sup> 26 U.S.C. § 4971 (2014) (noting the funding rules, however, are not conditions of tax qualification. The IRS enforces funding by assessing excise taxes, 10% of the annual shortfall, and 100% if the shortfall is not made up.); 26 U.S.C. § 430(k) (2015) (noting PBGC also enforces the funding rules by perfecting and enforcing liens when contributions of more than \$1 million are delinquent).

<sup>45</sup> Reorganization Plan No. 4 of 1978, *reprinted* in 43 Fed. Reg. 47,713 (Oct. 17, 1978); *See Panel 3: Negotiating the Agency Peace Treaty: Reorganization Plan No. 4*, 6 DREXEL L. REV. 319-39 (Spring 2014). (For a discussion of the administration of ERISA in its infancy).

<sup>46</sup> Another purpose of the nondiscrimination rules, though, was to prevent tax evasion by firms seeking to shelter executives' compensation. The 1942 nondiscrimination provision was “particularly anemic.” Not surprisingly, the main purpose of the bill was to “extract the maximum contribution from taxpayers . . . during the austere and expensive years of the Second World War.” *See* Madeline Sexton Lewis, *The Legislative History of the Nondiscrimination Provision of Qualified Retirement Plans*, 2014-7 N.Y.U. REV. EMP. BENEFITS § 7.03 & 7.04 (2015) (Alvin D. Lurie ed., 2015).

<sup>47</sup> *See* Alan Cole, *The Highway Bill "Pension Gimmick": A Primer*, The Tax Policy Blog (Jul 15, 2014), <http://taxfoundation.org/blog/highway-bill-pension-gimmick-primer>; *See generally*, Lewis, *supra* note 30, at 1-12 (in the 1980s and early 1990s, “retirement income policy took a back seat to revenue-driven exigencies of budget deficit politics,” and it was not until the economic boom of the mid-1990s that Congress would refocus on retirement income policy.)

common, the plan document provided that plan assets would first be allocated to the benefits of retirees. Retirees' benefits were fully funded, but 4,000 vested employees between ages 40 and 60 got only 15% of what they were promised. Two thousand nine hundred under age forty got nothing.<sup>48</sup> That squarely presented the problem of default risk.<sup>49</sup>

Federal insurance became the solution. Originally deemed "reinsurance," pension insurance was the brainchild of the United Auto Workers.<sup>50</sup> PBGC was largely modeled on the Federal Deposit Insurance Corporation.<sup>51</sup> Thus, for example, pension insurance is mandatory for covered plans.<sup>52</sup> And there are limits that serve as a form of co-insurance.<sup>53</sup>

PBGC guarantees benefits under single-employer plans and (since 1980 amendments) multiemployer plans.<sup>54</sup> The insurable event for a single-

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<sup>48</sup> Wooten, *supra* note 42, at 731.

<sup>49</sup> *Id.*

<sup>50</sup> Wooten, *supra* note 42, at 716-17. On reinsurance generally, see Marcus A. Mendoza, *Reinsurance as Governance: Governmental Risk Management Pools as a Case Study in the Governance Role Played by Reinsurance Institutions*, 21 CONN. INS. L. J. 53 (2014).

<sup>51</sup> 120 CONG. REC. S29950 (daily ed. Aug. 22, 1974) (statement of Sen. Bentsen).

<sup>52</sup> 29 U.S.C. § 1306(a), (c) (2016).

<sup>53</sup> Richard A. Ippolito, *The Economics of Pension Insurance* 21-24, 37-38 (1989) (One might loosely analogize PBGC to financial guarantee, or monoline, insurance. Monoline insurers typically backstop municipal bonds or mortgage obligations). See J.M. Pimbley, *Bond Insurers*, 22 J. OF APPLIED FIN. 35 (Spring/Summer 2012), [https://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=2689888](https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2689888); Sebastian Schich, *Challenges Related to Financial Guarantee Insurance*, 2008 FIN. MARKET TRENDS 81 (Jun. 2008) (State laws confine them to that line of business, hence the term "monoline." Like a monoline insurer, PBGC insures against a third party's default. And because the third-party obligations are homogeneous, the risk is not diversified. Telephone conversation with Christopher Anderson, Principal, Anderson Insights, Inc. (May 9, 2016).

<sup>54</sup> For single-employer plans, the maximum guaranteed amount is about \$60,000 per year at age 65. For multiemployer plans, the guarantee is much lower. The maximum is a function of the participant's service and the benefit accrual rate under the plan, e.g., about \$13,000 per year with 30 years of service, \$8,600 per year with 20 years of service, and so on. The guaranty of benefit increases is phased in over five years for single-employer plans, but benefit increases under multiemployer plans are not guaranteed at all if they are less than five-years old. Premiums for single-employer plans are \$64 per participant per year, plus \$30 per \$1,000 of unfunded vested benefits, with scheduled increases to \$80 and \$41, respectively, by 2019. For multiemployer plans, premiums are \$27 per participant per year. The

employer plan is plan termination.<sup>55</sup> A plan sponsor can terminate an underfunded single-employer plan only if it demonstrates financial distress—liquidation in bankruptcy or inability to reorganize in bankruptcy or to continue in business unless it sheds its pension plan. PBGC can initiate termination if a plan fails ERISA’s minimum funding standard, if it will be unable to pay benefits when due, or if PBGC’s long-run loss may increase unreasonably if the plan is not terminated (for instance, if the sale of a profitable subsidiary would lessen the employer’s ability to fund the plan).<sup>56</sup>

On termination of an underfunded plan, PBGC becomes trustee, taking over the plan’s assets and its obligations. When a plan terminates, the employer is liable to PBGC for the difference between the plan’s benefit liabilities and its assets.<sup>57</sup> Employer liability is meant to keep plan sponsors from promising benefits they cannot afford, thereby shifting the financial burden to the insurance program and to other sponsors whose premiums support the program.<sup>58</sup> A PBGC regulation provides that liabilities are valued using surveys of closeout annuity prices. The regulation uses a constant mortality factor, so the higher the surveyed price the lower the interest factor.<sup>59</sup> The employer is also liable to the agency for any unpaid contributions, and for an exit fee known as a termination premium.<sup>60</sup> PBGC has taken in more than 4,000 single-employer plans, and its single-employer insurance fund has a \$24 billion deficit.<sup>61</sup>

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premium rates are indexed for inflation. 29 U.S.C §§ 1306, 1322, 1322A. PBGC is financed by premiums, assets of terminated plans, recovery on claims, and investment earnings. 2015 PBGC ANN. REP. 10, <http://www.pbgc.gov/Documents/2015-annual-report.pdf>.

<sup>55</sup> 29 U.S.C. § 1361 (2016).

<sup>56</sup> 29 U.S.C. §§ 1341(c), 1342(a) (2016). ERISA makes all 80% commonly owned corporations or unincorporated businesses (a “controlled group”) jointly and severally liable for pension contributions. 26 U.S.C. §§ 412(b)(2), 414(b), (c), 26 C.F.R. §§ 1.414(b)(1), 1.414(c)-1-(c)-5 (2016). The controlled group is also liable to PBGC for the obligations described in nn. 59, 62, and to multiemployer plans for those described in nn. 67-68, post. 29 U.S.C. §§ 1301(a)(14), 1301(b)(1), 1362(a), 29 C.F.R. § 4001.2 (2016).

<sup>57</sup> 29 U.S.C. §§ 1301(a)(18), 1362(c) (2016).

<sup>58</sup> S. REP. NO 93-383, at 87 (1973), *reprinted in* 1974 U.S.C.C.A.N. 4971.

<sup>59</sup> 29 C.F.R. §§ 4044.41-.75 (2016); 70 Fed. Reg. 72,205 (Dec. 2, 2005) (*codified as* 29 C.F.R. pt. 4044).

<sup>60</sup> 29 U.S.C. §§ 1306(a)(7), 1362(b) (2016).

<sup>61</sup> 2015 PBGC ANN REP., *supra* note 54, at 23. PBGC is not backed by the full faith and credit of the United States. *See id.* at 10.

Multiemployer plans can terminate, by mass withdrawal or by plan amendment.<sup>62</sup> The insurable event, however, is insolvency, the inability to pay benefits in a given year.<sup>63</sup> PBGC doesn't become trustee of multiemployer plans, but provides them with financial assistance to pay benefits at the guaranteed level.<sup>64</sup>

Multiemployer plans spread the risk of business failure. When an employer withdraws, by going non-union or ceasing business, it incurs withdrawal liability for its share of the plan's unfunded vested benefits.<sup>65</sup> It pays that liability in installments designed to approximate its contributions at their highest point.<sup>66</sup> Withdrawal liability is meant to slow the "vicious downward spiral" when employers start to abandon a troubled plan. It does that by neutralizing incentives to withdraw, shoring up plans affected by withdrawals, and keeping faith with remaining employers.<sup>67</sup> Nevertheless, PBGC provides financial assistance to more than 50 insolvent plans, and its multiemployer insurance fund has a \$52 billion deficit.<sup>68</sup>

#### D. EXEMPTION OF PUBLIC PLANS FROM ERISA

Congress exempted state and local plans from ERISA's vesting, funding, and insurance regimes. Congress had several reasons including:

- public plans' vesting provisions were then more generous than those of private plans;
- "the ability of the governmental entities to fulfill their obligations to employees through their taxing powers was an adequate substitute for both minimum funding standards and plan termination insurance"<sup>69</sup>; and

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<sup>62</sup> 29 U.S.C. § 1341A (2016).

<sup>63</sup> 29 U.S.C. § 1426 (2016).

<sup>64</sup> 29 U.S.C. § 1322A, 1431 (2016).

<sup>65</sup> 29 U.S.C. § 1381 (2016).

<sup>66</sup> 29 U.S.C. § 1399(c)(1) (2016).

<sup>67</sup> On the characteristics of multiemployer plans and withdrawal liability, *See* Jayne E. Zanglein et al., *Erisa Litigation* 1393-95, 1407-13 (5th ed. 2014 and 2015 Supp.).

<sup>68</sup> 2015 PBGC ANN REP., *supra* note 54, at 3, 23.

<sup>69</sup> *Rose v. Long Island R. Pension Plan*, 828 F.2d 910, 914 (2d Cir. 1987) (internal quotations and citations omitted).

- “imposition of the minimum funding and other standards would entail unacceptable cost implications to governmental entities.”<sup>70</sup>

Congress also did not want to intrude on areas of state concerns. For example, the House Committee on Education and Labor report stated:

There are literally thousands of public employee retirement systems operated by towns, counties, authorities and cities in addition to the state and Federal plans. Eligibility, vesting, and funding provisions are at least as diverse as those in the private sector with the added uniqueness added by the legislative process. For this reason the Committee is convinced that additional data and study is necessary before any attempt is made to address the issues of vesting and funding with respect to public plans.<sup>71</sup>

On the other hand, some were concerned that public pensions were so generous that it was unlikely that adequate taxes would be allocated to them. Congressman John Erlenborn of Illinois, for example, noted that lawsuits in Philadelphia, Detroit, and Illinois were seeking to compel funding in amounts that ranged from \$18 million to \$1.7 billion.<sup>72</sup>

Congress commissioned a study to determine "the necessity for Federal legislation and standards with respect to such plans."<sup>73</sup> In 1978, the House Committee on Education and Labor issued a Pension Task Force Report on Public Employee Retirement Systems. The Report found that plan members, government officials, and the general public were kept in the dark about the true costs of public pensions, and that there was compelling need

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<sup>70</sup> *Id.*

<sup>71</sup> *Id.*; See also *Younger v. Harris*, 401 U.S. 37, 44 (1971) (Three years earlier, the Supreme Court had emphasized “Our Federalism,” a “system in which there is sensitivity to the legitimate interests of both State and National Governments.”); *National League of Cities v. Usery*, 426 U.S. 833 (1976), *overruled*, *Garcia v. San Antonio Metropolitan Transit Authority*, 469 U.S. 528 (1985) (The Court held that the Tenth Amendment prevents the national government from imposing minimum wages on local government employees based on the reach of the Commerce Clause); See generally Heather K. Gerken, *Our Federalism(s)*, 53 WM. & MARY L. REV. 1549 (2012) (Federalism enjoyed another revival in the last decade).

<sup>72</sup> H.R. REP. NO. 93-533, at 43 (1974), *reprinted in* 1974 U.S.C.C.A.N. 4667-68.

<sup>73</sup> 29 U.S.C. § 1231(a)(3) (2016).

for uniform actuarial measures to assess their funding requirements. The Report also found serious deficiencies in reporting and disclosure, and a need for fiduciary standards.<sup>74</sup>

Bills were regularly introduced after ERISA was passed to establish minimum reporting, disclosure, and fiduciary standards for public plans. Initially dubbed “PERISA,” later versions were called “PEPPRA”—the Public Employee Pension Plan Reporting and Accountability Act—to reflect their more limited scope.<sup>75</sup> No such bill was ever enacted.

### III. FEDERAL MINIMUM FUNDING STANDARDS

ERISA and the Internal Revenue Code set minimum funding standards for defined benefit plans. The initial standards were a significant improvement on pre-ERISA law. The standards were strengthened over two decades, including limits on actuarial discretion, shorter amortization periods, better enforcement tools, and stricter rules for poorly funded plans. More recently, some of the standards were relaxed.

#### A. SINGLE-EMPLOYER PLANS

A plan sponsor must make an annual contribution. To determine the annual contribution, the plan actuary will first calculate the “funding target,” or the present value of plan benefits at the beginning of the year. From the funding target, she will subtract the value of plan assets, to derive the “shortfall.” Next, she will set up a schedule to amortize the shortfall over seven years, netting out unamortized charges from prior years, to derive the “shortfall amortization charge.” The actuary will also calculate “normal cost,” or the present value of benefits expected to be earned in the year plus an estimate of expenses in the year.<sup>76</sup> Finally, the actuary will add the shortfall amortization charge and normal cost. The sum is the year’s required contribution.

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<sup>74</sup> COMM. ON EDUC. & LAB. 95th Cong., *Pension Task Force Report on Public Employee Retirement Systems* (Comm. Print 1987).

<sup>75</sup> *Pub. Employee Pension Benefit Plans: J. Hearings Before the Subcomm. on Oversight of the Comm. on Ways & Means & Subcomm. on Labor-Mgmt. Relations of the Comm. on Educ. & Labor*, 98th Cong., (Nov. 15, 1983) at 2.

<sup>76</sup> 26 U.S.C. § 430(a)-(c). See 29 U.S.C. §§ 1133-1135; Lynn A. Cook & James E. Holland, Jr., 371-6TH U.S. INCOME: EMPLOYEE PLANS—DEDUCTIONS, CONTRIBUTIONS AND FUNDING, TAX MGMT. PORT. at A-113-75 (2015).

As noted, the lower the interest assumption, the higher the present value, and thus the greater the potential shortfall.<sup>77</sup> The interest assumption is based on an average of yields on high-quality corporate bonds, using a yield curve (or segments of the curve) to fit maturity to expected benefit payments. Mortality is to be prescribed by the Treasury Department at least once every ten years.<sup>78</sup> Mortality is currently based on the RP-2000 table (with improvements).<sup>79</sup>

Contributions are generally due in quarterly installments, 15 days after the close of the quarter. Any deficiency must be paid off in a “catch-up payment” no later than 8-1/2 months after the close of the year. For instance, contributions for the 2016 year are due April 15, July 15, and October 15, 2016, and January 15, 2017, with the catch-up payment due September 15, 2017.<sup>80</sup>

A sponsor may elect to create a prefunding balance if it contributes more than the minimum required. It may then apply the prefunding balance in lieu of cash contributions.<sup>81</sup>

A sponsor experiencing temporary substantial business hardship may apply to IRS for a waiver of the year’s contribution. The waived amount then becomes an additional amortization charge in the next five years. IRS may require that security be given to the plan, enforceable by PBGC.<sup>82</sup>

Poorly funded plans are subject to greater discipline. A liquidity shortfall contribution is required to the extent a plan’s liquid assets do not equal three times its annual disbursements.<sup>83</sup> Additional funding is required if a plan is “at risk,” less than 80% funded. At-risk plans cannot increase benefits; they must assume that employees will retire as early as possible and take benefits in the most expensive form; and their funding is subject to a 4% “load” or surcharge. A pre-funding balance cannot be used instead of cash contributions if the plan is at risk.<sup>84</sup>

Payment of shutdown benefits or other unpredictable contingent event benefits is prohibited to the extent a plan is less than 60% funded, as is payment of lump sums or purchase of annuities to the extent a plan is less than 60% funded (100% funded if the sponsor is in bankruptcy). Benefit

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<sup>77</sup> McGill, *supra* note 4, at 207-09.

<sup>78</sup> 26 U.S.C. § 430(h)(2), (3) (2016).

<sup>79</sup> Cook & Holland, *supra* note 75, at A-122.

<sup>80</sup> 26 U.S.C. § 430(j) (2016).

<sup>81</sup> 26 U.S.C. § 430(f)(3) (2016).

<sup>82</sup> 26 U.S.C §§ 412(c), 430(a)(1)(c), (e) (2016).

<sup>83</sup> 26 U.S.C. § 430(j)(4) (2016).

<sup>84</sup> 26 U.S.C § 430(i) (2016).

accruals must cease to the extent the plan remains less than 60% funded. Partial restrictions apply if the plan is between 60% and 80% funded.<sup>85</sup>

If the annual contribution is not made by the catch-up date, an “accumulated funding deficiency” results, and an excise tax of 10% of the deficiency is imposed. The tax increases to 100% if the deficiency is not timely corrected.<sup>86</sup>

A plan fiduciary, a participant or beneficiary, or the Secretary of Labor can bring suit to enforce the minimum funding standards.<sup>87</sup> Case law and Labor Department guidance require a fiduciary to pursue full collection unless it would result in hardship and reduced collection.<sup>88</sup>

PBGC also enforces the minimum funding requirements. If the unpaid balance exceeds one million dollars, a lien arises in favor of the plan on all property of the controlled group. PBGC has sole authority to perfect and enforce this lien.<sup>89</sup>

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<sup>85</sup> 26 U.S.C. § 436 (2016).

<sup>86</sup> 26 U.S.C. § 4971 (2012).

<sup>87</sup> 29 U.S.C. § 1132(a)(3), (5) (2012).

<sup>88</sup> In *McMahon v. McDowell*, 794 F.2d 100 (3d Cir. 1986), the employer obtained a funding waiver based on the required showing of temporary substantial business hardship, and later filed bankruptcy and terminated the pension plan. Former employees sued plan fiduciaries for failing to seek contributions. In affirming a grant of summary judgment for the fiduciaries, the court said, “whenever an employer seeks to avoid making its pension plan payments, whether pursuant to [a funding waiver] or in any other manner, trustees have a duty to investigate the relevant facts, to explore alternative courses of action and, if in the best interests of the plan participants, to bring suit against the employer.” But “[i]t normally will be reasonable,” the court continued, “for plan fiduciaries to refrain from action which might send the employer into bankruptcy or lead to the termination of the plan.” *Id.* at 112. A fiduciary’s compromising a claim for delinquent contributions or giving extended payment terms would ordinarily be a prohibited transaction under 29 U.S.C. § 1106(a)(1) (2012). The Labor Department’s Prohibited Transaction Exemption 76-1 permits trustees of a multiemployer plan to do so only if they make “systematic, reasonable, and diligent efforts” to collect delinquent contributions and only if they can demonstrate that the arrangement in a given case is reasonable and likely to maximize the net collection. Employee Benefit Plan, 41 Fed. Reg. 12,740 (March 26, 1976).

<sup>89</sup> 26 U.S.C. § 430(k) (2012). The lien has the status of a federal tax lien. Thus, for example, it may become senior to advances under a revolving credit arrangement after 45 days or notice to the lender, whichever occurs first. 26 U.S.C. § 6323 (2012), incorporated by reference in 26 U.S.C. § 430(k)(4)(C) (2012) and 29 U.S.C. § 1368(c)(1) (2012).

## B. MULTIEMPLOYER PLANS

Contributions are set by collective bargaining agreements, usually at an hourly rate. The hourly rate is calibrated so that, when multiplied by an estimate of hours to be worked, contributions will meet the statutory minimum.

The minimum is set by a “funding standard account,” to which specified charges and credits are made each year. If the total charges to the funding standard account are greater than the total credits (including contributions), there is a funding deficiency. In computing the charges and credits, the plan’s actuary must use assumptions that are individually reasonable and that in combination represent her best estimate of future experience.<sup>90</sup>

A funding waiver can be granted if 10% of the employers would otherwise suffer substantial business hardship, with the waived amount amortized over 15 years. A plan can also seek an extension of the amortization period from 15 to 20 years if it has adopted a funding improvement plan (see below), or to 25 years if necessary to avoid plan termination or a substantial benefit curtailment.<sup>91</sup>

The trustees of a multiemployer plan can bring suit to collect unpaid contributions. ERISA provides for a simple collection suit with virtually no defenses, and adds interest, liquidated damages, and attorney fees to the judgment.<sup>92</sup>

Multiemployer plans in endangered or critical status (less than 80% or 65% funded, respectively) must also adopt funding improvement plans (FIP) or rehabilitation plans (RP). An endangered or “yellow zone” plan’s FIP must project a one-third funding improvement over ten years. The FIP typically contains a negotiated schedule of contribution increases and a

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<sup>90</sup> 26 U.S.C. § 431(a), (c)(3) (2012).

<sup>91</sup> 26 U.S.C. §§ 412(c), 431(d) (2012).

<sup>92</sup> 29 U.S.C. §§ 1132(g)(2), 1145 (2012). A third-party beneficiary is ordinarily subject to the same defenses as the obligee, but, as a matter of federal labor law, union misconduct is no defense to a multiemployer plan’s collection suit. *Lewis v. Benedict Coal Corp.*, 361 U.S. 459 (1960). By declaring that “[e]very employer who is obligated to make contributions to a multiemployer plan under the terms of the plan or under the terms of a collectively bargained agreement shall, to the extent not inconsistent with law, make such contributions,” 29 U.S.C. § 1145 (2012), Congress invalidated other defenses that make the contract merely voidable and not void. An example is fraud in the inducement, as distinct from fraud in factum. *Sw. Adm’rs, Inc. v. Rozay’s Transfer*, 791 F.2d 769 (9th Cir. 1986).

default schedule if no agreement is reached. The default schedule typically requires decreases in benefit accruals as well.<sup>93</sup>

A critical or “red zone” plan’s RP must project emergence from the red zone in ten years. Red zone plans generally may suspend early retirement subsidies and other ancillary benefits not in pay status and restrict lump sums, in addition to reducing future accruals. If emergence is not possible, a red zone plan must at least take reasonable measures to forestall insolvency.<sup>94</sup>

Under the Multiemployer Plan Reform Act of 2014,<sup>95</sup> there is a new category, “critical and declining.” A plan that is projected to be insolvent within 20 years (fifteen years if its ratio of inactive to active participants is less than two to one) may permanently reduce benefits, even those in pay status, except for people who are older than 80 or are disabled. The reductions must be approved by the Treasury Department, in consultation with the Labor Department and PBGC, and the plan may not reduce benefits below 110% of the PBGC guaranteed level.<sup>96</sup> MPRA also authorizes PBGC to partition such a plan to reduce its own expected loss and maintain plan solvency. In that event, the partitioned plan pays guaranteed benefits from PBGC financial assistance.<sup>97</sup>

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<sup>93</sup> 26 U.S.C. § 432(c) (2012).

<sup>94</sup> 26 U.S.C. § 432(e) (2012).

<sup>95</sup> Consolidated and Further Continuing Appropriations Act, 2015, Pub. L. No. 113-235, 128 Stat. 2130, 2773-822 (2014).

<sup>96</sup> 26 U.S.C. § 432(b) & (e) (2014). In the first major test of these rules, *Central States, Southeast and Southwest Areas Pension Plan*, the Treasury Department denied a benefit reduction application, finding that earnings and entry-age assumptions were not reasonable, and that the proposed reductions were not reasonably estimated to prevent insolvency. Letter from Kenneth R. Feinberg, Special Master, Dep’t of the Treasury, to Gary Ford, Esq., Principal, Groom Law Group, Thomas C. Nyhan, Exe. Director & the Bd. of Trs., Cent. States, Se. & Sw. Areas Pension Plan (May 6, 2016), <https://www.treasury.gov/services/Responses2/Central%20States%20Notification%20Letter.pdf>.

<sup>97</sup> 29 U.S.C. § 1413 (2012). In *Road Carriers Local 707 Pension Plan*, PBGC denied a partition application, finding that employment and contribution projections were unduly optimistic, and that there was insufficient evidence to reasonably expect that the Plan would remain solvent following partition. Letter from PBGC to Kevin McCaffrey, Interim Fund Manager & Bd. of Trs., Road Carriers Local 707 Welfare & Pension Funds (June 2016), <http://www.pbgc.gov/documents/PBGC-Letter-June-2016.pdf>.

### C. HISTORY OF ERISA'S FUNDING RULES

#### 1. ERISA's Reforms

Before ERISA, the Internal Revenue Code required that an employer contribute only normal cost plus interest on unfunded accrued liability.<sup>98</sup> Thus, the unfunded liability might never be amortized. It was a recognized "best practice" to amortize past service liability over 30 years, but even that did not prevent the Studebaker disaster.<sup>99</sup>

The ERISA rules were a considerable improvement. ERISA required plans to maintain a funding standard account, to which charges and credits were added each year. Among those charges were amortization of past service liability (generally over 30 years), losses from change in actuarial assumptions (20 years), and experience losses (15 years). For multiemployer plans, losses from both changes in assumptions and experience were amortized over 15 years. Credits included gains from changes in assumptions or experience, and they were similarly amortized.<sup>100</sup>

If the sum of charges and credits was a net charge, or "accumulated funding deficiency," there was a contribution due that year. Conversely, if there was a "credit balance," it could be used in future years in lieu of cash contributions.<sup>101</sup>

Contributions were subject to the full funding limit, generally the difference between the present value of accrued benefits projected for salary increases and the lesser of market or actuarial value of assets. They were also subject to the deductible limit, which involved a more complex calculation, but was capped at the full funding limit.<sup>102</sup>

There were six approved funding methods.<sup>103</sup> A funding method identifies gains and losses each year and amortizes them (as in the unit credit method), or spreads gains and losses by rolling them into normal cost (as in the frozen initial liability method). The methods differ in how much they backload funding costs.<sup>104</sup>

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<sup>98</sup> Steven Sass, *ERISA'S Treatment of Default and Forfeiture Risk in Defined Benefit Pension Plans: Reflections From ERISA at 40: What Were They Thinking?*, 6 DREXEL L. REV. 495, 496 (2014).

<sup>99</sup> *Id.* at 496-97.

<sup>100</sup> 26 U.S.C. § 412(b) (1976).

<sup>101</sup> 26 U.S.C. § 412(a) (2012).

<sup>102</sup> 26 U.S.C. §§ 404(a)(1), 412(c)(6) (2014).

<sup>103</sup> 26 U.S.C. § 412(c)(3) (2012); 29 U.S.C. § 1002(3) (2012).

<sup>104</sup> McGill, *supra* note 4, at 647-51; SOC'Y OF ACTUARIES, WHICH PENSION FUNDING METHOD IS RIGHT FOR YOU? 21-23 (No. 1, Session 54PD (Vol. 23 1997)),

Assumptions and methods had to be reasonable in the aggregate and represent the actuary's best estimate of anticipated experience.<sup>105</sup> This gave the actuary considerable discretion. For example, conservative assumptions could be offset by anti-conservative ones, and asset values could be "smoothed" (gains and losses averaged) over five years, to dampen volatility.<sup>106</sup> The legislative history made clear that these choices were for the actuary, and that the actuary was to exercise independent judgment.<sup>107</sup>

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<https://www.soa.org/Library/Proceedings/Record-Of-The-Society-Of-Actuaries/1990-99/1997/January/rsa97v23n154pd.aspx>.

<sup>105</sup> 26 U.S.C. § 412(c)(3) (2012).

<sup>106</sup> 26 C.F.R. § 1.412(c)(2)-1(b) (2016). In some cases, the IRS challenged assumptions on grounds that they were overly conservative and led to improperly large deductions for contributions. The courts generally deferred to the actuaries' judgments, emphasizing that assumptions needed only to be reasonable in the aggregate, not individually. *Rhoades, McKee & Boer v. United States*, 43 F.3d 1071 (6th Cir. 1995); *Wachtell, Lipton, Rosen & Katz v. Comm'r*, 26 F.3d 291 (2d Cir. 1994); *Vinson & Elkins v. Comm'r*, 7 F.3d 1235 (5th Cir. 1993).

<sup>107</sup> ERISA "requires that, for purposes of the minimum funding standard, all plan costs, liabilities, rates of interest, and other factors under the plan are to be determined on the basis of actuarial assumptions and methods which, in the aggregate, are reasonable. Actuarial assumptions are to take into account the experience of the plan and reasonable expectations. These assumptions are expected to take into consideration past experience as well as other relevant factors. In addition . . . the actuarial assumptions in combination are to offer the actuary's best estimate of anticipated experience under the plan." H.R. REP. NO. 93-1280, at 284-85 (1974), *reprinted in* 1974 U.S.C.C.A.N. 5038, 5065. Moreover, actuarial assumptions must be "independently determined by an actuary." It would be "inappropriate for an employer to substitute his judgment for that of a qualified actuary," and "if such a circumstance were to arise an actuary would have to refuse giving his favorable opinion . . ." S. REP. NO. 93-383, at 70 (1973), *reprinted in* 1974 U.S.C.C.A.N. 4890, 4955. Congress initially rejected any attempt to standardize assumptions. The House Ways and Means Committee stated, "[T]he proper actuarial assumptions may differ substantially between industries, among firms, geographically, and over time. Further...each actuarial assumption may be reasonable over a significant range and it would appear that the proper test would be whether all actuarial assumptions used together are reasonable. These considerations strongly indicate that any attempt to specify actuarial assumptions and funding methods for pension plans would in effect place these plans in a straitjacket... and would be likely to result in cost estimates that are not reasonable." H.R. Rep. No. 93-807 (1974), *reprinted in* 1974 U.S.C.C.A.N. 4670, 4694. Though suits against pension actuaries are subject to defenses, actuarial malpractice is actionable. *See, e.g., Gerosa v. Savasta & Co.*, 329 F.3d 317 (2d Cir. 2003) (holding actuarial malpractice claim under state law is not preempted by ERISA).

## 2. Amendments to the Minimum Funding Standards and the Need for Further Reform

For single-employer plans, the funding rules have been amended many times. For the first few decades after ERISA's enactment, the rules were mainly strengthened. For example, Congress adopted a deficit reduction contribution in 1987. A sponsor whose plan was less than 90% funded using prescribed assumptions (GAM-83 mortality and up to 105% of the four-year average of 30-year Treasury yields) had to contribute an additional amount to eliminate the deficit within three to seven years.<sup>108</sup> In the mid-2000s, however, Congress exempted plans in the airline and steel industries from the deficit reduction contribution for a number of years, and allowed them to use a higher interest rate to compute their contributions.<sup>109</sup>

The 1987 amendments also introduced the quarterly contributions and the lien, and joint and several liability among controlled group members.<sup>110</sup> The 1994 amendments prohibited benefit increases during bankruptcy by poorly funded plans.<sup>111</sup>

Nevertheless, critics pointed out continuing weaknesses in ERISA's funding standards, either standing alone or when combined with regulatory gaps in other areas. For example, PBGC Executive Director Steven Kandarian testified before Congress in 2003 that:

- funding targets are the result of legislative compromise rather than an objective measure of full funding, don't recognize that business reverses often result in subsidized early retirements, and don't recognize the cost of annuitization;
- credit balances permit funding holidays, despite possible investment losses in the interim;
- funding rules do not take employer credit risk into account;

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<sup>108</sup> Pension Protection Act of 1987, Title IX, Subtitle D of the Omnibus Budget Reconciliation Act of 1987, Pub. L. No. 100-203 § 9303, 101 Stat. 1330-333-343 (1987), (codified as 26 U.S.C. § 412(I) (1988)).

<sup>109</sup> Pension Funding Equity Act of 2004, Pub. L. No. 108-218, §102, 118 Stat. 596, 599-602 (Apr. 10, 2004), *codified as* 26 U.S.C. § 412 (I)(12) (2006).

<sup>110</sup> 101 Stat. 1330-344-347, 1330-348-50, 1330-352-53 (codified as 26 U.S.C §§ 412(b)(2), 430(c)(11), (j), (k)).

<sup>111</sup> Retirement Protection Act of 1994, Title VII, Subtitle F of the Uruguay Round Agreement Act/General Agreement on Tariffs and Trade, Pub. L. No. 103-465, § 766, 108 Stat. 4809, 5036-37 (codified as 26 U.S.C. § 401(a)(33) (2006)).

- the full funding limit and maximum deductible limit do not allow plans to build up an adequate surplus for bad times;
- funding rules do not take account of lump sum elections;
- funding is too volatile, in part because smoothing rules don't work as well as they should.<sup>112</sup>

Kandarian cited the example of Bethlehem Steel, whose plan terminated with a \$3.9 billion shortfall. Due to credit balances, Bethlehem made no contributions for the three years leading up to plan termination.

Kandarian also noted that pension liabilities are correlated with bond yields but not equity returns. Equity investments therefore result in greater volatility, and tend to shift risk from employers and employees to the insurance system.<sup>113</sup>

David Walker, the U.S. Comptroller General, and Barbara Bovbjerg, the Government Accountability Office's Director of Education, Workforce and Income Security Issues, echoed some of these observations. They also noted that Bethlehem's plan was heavily invested in equities, leading to significant losses in the run-up to plan termination in 2003, and that Polaroid's plan was severely underfunded at termination partly because contributions had been capped by the deductible limit.<sup>114</sup>

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<sup>112</sup> *Hearing Before the H. Comm. on Educ. & the Workforce*, H.R. (2003) (Statement of Steven A. Kandarian, Executive Director, Pension Benefit Guaranty Corporation), <http://archives.republicans.edlabor.house.gov/archive/hearings/108th/fc/pbge090403/kandarian.htm>.

<sup>113</sup> Under ERISA's fiduciary standards, no investment is per se prudent or imprudent. Under a Labor Department "safe harbor," an investment is prudent if a fiduciary has "given appropriate consideration to those facts and circumstances that, given the scope of such fiduciary's investment duties, the fiduciary knows or should know are relevant to the particular investment," and has "acted accordingly." "Appropriate consideration" includes whether the investment is "reasonably designed . . . to further the purposes of the plan, taking into consideration the risk of loss and the opportunity for gain (or other return)," "the composition of the portfolio with regard to diversification," "liquidity and current return . . . relative to . . . anticipated cash-flow requirements . . .," and "projected return . . . relative to the funding objectives of the plan." 29 C.F.R. § 2550.404a-1 (2015).

<sup>114</sup> U.S. GOV'T ACCOUNTABILITY OFF., GAO-03-873T, PENSION BENEFIT GUARANTY CORPORATION: SINGLE-EMPLOYER PENSION INSURANCE PROGRAM FACES SIGNIFICANT LONG-TERM RISKS: TESTIMONY BEFORE THE H. COMM. ON EDUC. & THE WORKFORCE, H.R. (2003), <http://www.gao.gov/assets/120/110278.pdf>; U.S. GOV'T ACCOUNTABILITY OFF., GAO-04-176T, PRIVATE PENSIONS: CHANGING FUNDING RULES AND ENHANCING INCENTIVES CAN

David Wilcox, Deputy Director of the Federal Reserve, noted that weak restrictions on lump sums and early retirement benefits could lead to significant deterioration of plan funding. He added that the funding standards did not permit, let alone require, pre-funding of shutdown benefits or other unpredictable contingent event benefits.<sup>115</sup>

### 3. PPA and Beyond

The 2006 Pension Protection Act made a major overhaul, removing virtually all remaining actuarial discretion in the case of single-employer plans, and imposing strict rules to shore up the defined benefit system.<sup>116</sup> For single-employer plans, there is no longer a set of charges and credits, to be amortized over various periods. Rather, each year, the shortfall is reckoned, the unamortized portions of prior year shortfalls are netted, and the yearly contribution is computed based on seven-year amortization, plus normal cost.

The assumptions were constrained, as noted, to the corporate-bond yield curve and mortality factors prescribed by the Treasury Department. Asset values could be smoothed over no more than two years, and the result had to be within a 90-100% corridor of fair market value. A single actuarial method (the unit benefit method) was required. The special funding rules and benefit restrictions were adopted for “at-risk” plans.<sup>117</sup> And the deductible limit was increased to normal cost plus 150% of the funding target, less assets.<sup>118</sup>

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IMPROVE PLAN FUNDING: TESTIMONY BEFORE THE COMM. ON EDUC. & THE WORKFORCE, H.R. (2003), <http://www.gao.gov/assets/120/110468.pdf>.

<sup>115</sup> David W. Wilcox, *Reforming the Defined-Benefit Pension System*, BROOKINGS, 235 (2016), [http://www.brookings.edu/~media/projects/bpea/spring-2006/2006a\\_bpea\\_wilcox.pdf](http://www.brookings.edu/~media/projects/bpea/spring-2006/2006a_bpea_wilcox.pdf).

<sup>116</sup> The pre-PPA rules are summarized in Cook & Holland, *supra* note 75, at A-141-75, and in STAFF OF J. COMM. ON TAXATION, 109TH CONG., PRESENT LAW AND BACKGROUND RELATING TO EMPLOYER-SPONSORED DEFINED BENEFIT PENSION PLANS AND THE PENSION BENEFIT GUARANTY CORPORATION (Feb. 28, 2005), <http://www.jct.gov/x-3-05.pdf>. The PPA changes are summarized in PATRICK PURCELL, CONG. RESEARCH SERV., RL 33703: SUMMARY OF THE PENSION PROTECTION ACT OF 2006 (2006), <https://www.worldatwork.org/waw/adimLink?id=15322>.

<sup>117</sup> Pension Protection Act of 2006 §§ 112, 113, 120 Stat. at 839-42, 847-51.

<sup>118</sup> Cook & Holland, *supra* note 75, at A-113-40.

While multiemployer plan actuaries retained discretion on funding methods and assumptions, the amortization period for post-PPA experience was shortened to fifteen years.<sup>119</sup>

But the new rules largely took effect just as the Great Recession began. So Congress adopted relief provisions.<sup>120</sup> For single-employer plans, they included allowing the smoothing of asset values for the bleak years 2008 and 2009, the averaging of interest rates over a 25-year look-back period, and, in lieu of the standard seven-year amortization schedule, an election of interest-only payments for two years followed by seven-year amortization (“2 and 7”) or fifteen-year amortization. For multiemployer plans, they included allowing 30-year amortization of investment losses that occurred in 2008 or 2009, and ten-year averaging of those losses for asset-valuation purposes.<sup>121</sup>

These provisions gave sponsors more flexibility, but traded off PPA’s goal of shoring up the system as a whole. By 2013, the ERISA agencies were reporting that, despite improvements, many multiemployer plans could still fail. In 2014, the Congressional Research Service reported that the PBGC multiemployer insurance system itself was at risk of failing within a decade or so.<sup>122</sup> MPRA followed, as part of the “Cromnibus” spending bill at the end of 2014.

Funding legislation is often enacted as part of a larger package. For example, the 1987 amendments were part of the Omnibus Budget Reconciliation Act, and the 1994 amendments were part of the General

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<sup>119</sup> Pension Protection Act of 2006, Pub. L. No. 109-280, § 201, 120 Stat. 780, 858-68 (2006), *codified as* 26 U.S.C. § 431(b).

<sup>120</sup> PPA itself provided relief to airlines, allowing them to use pre-PPA funding rules with generous interest assumptions and seventeen-year amortization. Pub. L. No. 109-208, § 402(e)(2), 120 Stat. 780, (codified at 925-28, 26 U.S.C. § 430 note (2012)).

<sup>121</sup> Preservation of Access to Care for Medicare Beneficiaries and Pension Relief Act of 2010, Pub. L. No. 111-192, §§ 201-02, 211, 124 Stat. 1280, 1283-85, 1290-93, 1297-99, 1302-06 (2010); Moving Ahead for Progress in the 21st Century Act, Pub. L. No. 112-141, § 40211, 126 Stat. 405, 846-50 (codified as 26 U.S.C. § 404 (2012); 29 U.S.C. § 1021 (2012)).

<sup>122</sup> U.S. DEP’T OF LABOR, U.S. DEP’T OF TREASURY & PENSION BENEFIT GUARANTY CORP., MULTIEMPLOYER PENSION PLANS: REPORT TO CONGRESS REQUIRED BY THE PENSION PROTECTION ACT OF 2006, 113TH CONG. (2013), <http://www.pbgc.gov/documents/pbgc-report-multiemployer-pension-plans.pdf>; JOHN J. TOPOLESKI, CONG. RESEARCH SERV., R43305, MULTIEMPLOYER DEFINED BENEFIT (DB) PENSION PLANS: A PRIMER AND ANALYSIS OF POLICY OPTIONS (2015), <https://www.fas.org/sgp/crs/misc/R43305.pdf>

Agreement on Tariffs and Trade. But, that leaves the pension changes open to revenue-scoring objectives. For example, recent rounds of legislation that provided funding relief—as well as PBGC premium increases—helped to raise federal revenue estimates as part of federal budget legislation and to keep the Highway Trust Fund afloat.<sup>123</sup> Two bills have recently been introduced to prevent use of PBGC premium increases this way: one would take PBGC off-budget, and the other would prohibit use of PBGC premium increases as an offset to pay for other federal spending.<sup>124</sup>

#### IV. REPORTING AND DISCLOSURE AND OTHER CONTROLS

Disclosure to plan participants, investors, and, for pooled funds, to employers and their stakeholders, can influence funding.<sup>125</sup> Both single-employer and multiemployer plans must file an Annual Report (Form 5500) with the ERISA agencies. A defined benefit plan's Annual Report must include:

- statements of assets and liabilities and changes in net assets available for benefits (including revenue and expenses);
- schedules of investment assets and related-party transactions, among others;
- footnote disclosures on significant plan amendments and their impact on benefits and on the plan's funding policy and any changes to it;
- a certified public accountant's opinion that the financial statements are presented fairly in conformity with generally accepted accounting principles; and

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<sup>123</sup> Title V of the Bipartisan Budget Act of 2015, Pub. L. No. 114-74, §§ 501-04, 129 Stat. 591-594 (codified as 29 U.S.C. § 1306(a)(3)(A)(i)(VI) - (VIII), (G), (a)(8)(C); 29 U.S.C. § 1307(a); 26 U.S.C. § 430(h)(2)(C)(iv)(II)); Title II of the Highway and Transportation Funding Act ("HATFA") of 2014, Pub. L. No. 113-159, § 2003, 128 Stat. 1839, 1849-51 (codified as 26 U.S.C. § 430(h)(2)(B) & (C)(iv) (2012)); *see* PBGC, TECH. UPDATE 14-1: EFFECT OF HATFA ON PBGC PREMIUMS (2014), <http://www.pbgc.gov/prac/other-guidance/tu/tu14-1.html>.

<sup>124</sup> Pension and Budget Integrity Act of 2016, H. R. 4955, 114th Cong. (2016) (would take PBGC off-budget); Pension and Budget Integrity Act of 2016, S. 3240, 114th Cong. (2016) (would prohibit use of PBGC premium increases as an offset for other federal spending).

<sup>125</sup> Fitzpatrick & Monahan, *supra* note 1, at 1347-49; Shnitser, *supra* note 1, at 688-91.

- an enrolled actuary’s statement of the required contributions, including the normal cost, funding target, and asset values; current-year and unreported prior-year-contributions; the methods and assumptions and any changes to them; and a statement that the report is complete and accurate and the assumptions are reasonable.<sup>126</sup>

Under PPA, a plan with a funding shortfall must provide participants and beneficiaries with an annual funding notice (“AFN”). The AFN must disclose:

- the amount of the shortfall;
- that the shortfall is based on a 25-year average of interest rates;
- what it would be using a two-year average;
- the funding target attainment percentage;
- the minimum funding contributions for the past three years; and
- the limits of PBGC’s guaranty.<sup>127</sup>

Statement of Financial Accounting Standards No. 87 requires a public company to record its net periodic pension expense on its financial statements. Net periodic pension expense is a spreading of the total cost of the plan over the plan’s lifetime, using a prescribed method. For more than a decade, FAS 158 (and now Accounting Standard Codification 715) has also required a company to record the shortfall or surplus on the balance sheet, on both an Accumulated Benefit Obligation (current service and salary) and a Projected Benefit Obligation (current service and projected salary) basis.<sup>128</sup>

For that purpose, the Financial Accounting Standards Board (“FASB”) requires that the interest assumption reflect closeout costs, *e.g.*, using rates on high-quality corporate bonds with maturities consistent with

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<sup>126</sup> 29 U.S.C. §§1023(a), (b), (d).

<sup>127</sup> 29 U.S.C. § 1021(f) (2012); 29 C.F.R. § 2520.101-4(a).

<sup>128</sup> FIN. ACCOUNTING STANDARDS BD., CONCEPT STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 87 5 (1985); FIN. ACCOUNTING STANDARDS BD., CONCEPT STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 132 6 (1998).

expected payouts.<sup>129</sup> Annual surveys by consulting firms reflect the range of mainstream assumptions.<sup>130</sup>

As of 2011, FASB also requires a company participating in a multiemployer plan to disclose information about the plan's zone status, among other things. The company need not disclose potential withdrawal liability, except (under rules on accounting for contingencies) when withdrawal is probable or reasonably possible.<sup>131</sup>

The annuity marketplace provides a useful benchmark. Insurers regularly bid on pension plan closeout annuity contracts. PBGC's regulatory method for valuing benefit liabilities is based on this market. PBGC has historically based its valuation assumptions on annuity prices, ascertained from double-blind surveys of annuity issuers. Financial economists generally support using risk-free rates to value pension liabilities, which generally provides similar results.<sup>132</sup>

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<sup>129</sup> *News Release: FASB Improves Employer Disclosures for Multiemployer Pension Plans*, FIN. ACCOUNTING STANDARDS BD. (Jul. 27, 2011) [http://www.fasb.org/cs/ContentServer?pagename=FASB/FASBContent\\_C/NewsPage&cid=1176158794021](http://www.fasb.org/cs/ContentServer?pagename=FASB/FASBContent_C/NewsPage&cid=1176158794021) (noting the pooling effect of state "cost-sharing multiple-employer" plans, akin to private-sector multiemployer plans, can obscure an individual employer's obligations and shield them from the scrutiny of lenders and other stakeholders); Shnitser, *supra* note 1, at 689-91.

<sup>130</sup> *E.g.*, KEN STOLER, KEVIN HASSAN & DEBBIE RUDIN, PENSION/OPEB 2014 ASSUMPTION AND DISCLOSURE SURVEY (PRICEWATERHOUSECOOPERS, 2014).

<sup>131</sup> *Media Advisory 09/21/11: FASB Issues Accounting Standards Update to Improve Employer Disclosures for Multiemployer Pension Plans*, FIN. ACCOUNTING STANDARDS BD. (Sept. 21, 2011), [http://www.fasb.org/cs/ContentServer?pagename=FASB/FASBContent\\_C/NewsPage&cid=1176158943432](http://www.fasb.org/cs/ContentServer?pagename=FASB/FASBContent_C/NewsPage&cid=1176158943432); *see* Shnitser, *supra* note 1, at 705 (noting that the contribution of the ARC has been considered a measure of funding discipline); KEITH BRAINARD & ALEX BROWN, SPOTLIGHT ON THE ANNUAL REQUIRED CONTRIBUTION EXPERIENCE OF STATE RETIREMENT PLANS, FY 01- TO FY 13 9 (NAT'L ASS'N. OF ST. RETIREMENT ADMINS., 2015).

<sup>132</sup> Fitzpatrick & Monahan, *supra* note 1, 1324; *In re US Airways Group*, 303 B.R. 784, 795-96 (E.D. Va. 2003) (stating "The real issue is one of risk. Annuity issuers base their pricing on returns offered by low-risk investments (typically high-quality corporate bonds). Those returns are lower than the returns that might be achieved by investing in the stock market. The stock market, however, is highly volatile and far from certain . . . [N]o one can predict with certainty what returns the stock market will produce over the next 50 years. Given the strong societal interest in protecting pension benefits, a risk-free or nearly risk-free rate to value the pension liability is more appropriate than a rate based on optimistic projections (even if those projections are widely-shared by fund managers) as to the stock market's future long-term performance.").

Actuarial independence and licensure are important controls.<sup>133</sup> Under ERISA, an enrolled actuary (one licensed by a federal board, the Joint Board for Enrollment of Actuaries, or “JBEA”) must certify the required contribution. The JBEA can suspend or terminate an actuary’s enrollment for misfeasance.<sup>134</sup> More generally, actuaries are subject to a uniform Code of Conduct, whose main Precept reads, “An Actuary shall act honestly, with integrity and competence, and in a manner to fulfill the profession’s responsibility to the public and to uphold the reputation of the actuarial profession.” The Code also requires adherence to Actuarial Standards of Practice (“ASOP”).<sup>135</sup> ASOP 4, Measuring Pension Obligations, and Determining Pension Plan Costs or Contributions, is the principal standard in this area.<sup>136</sup>

#### V. WHAT LESSONS CAN BE LEARNED FROM THE EXPERIENCE UNDER ERISA?

Like PBGC-insured plans, public plans involve risks to workers and retirees and uncertainties for sponsors and their stakeholders. Based on the private-sector experience, reformers might propose that state lawmakers:

*A. Adopt responsible funding rules, and avoid the cycle of tightening and relaxing them.* The history of ERISA’s funding rules suggests that funding rules should be strong but should have enough flexibility to obviate temporary relief measures. That observation seems fully applicable to the public sector.

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<sup>133</sup> Fitzpatrick & Monahan, *supra* note 1, at 1349-52, 1361 (noting not all state laws require actuarially based contributions. Of those that do, not all require that assumptions be reasonable).

<sup>134</sup> 29 U.S.C. §§ 1241, 1242 (2011).

<sup>135</sup> AM. ACAD. OF ACTUARIES, CODE OF PROFESSIONAL CONDUCT 2 (2001).

<sup>136</sup>ACTUARIAL STANDARDS BD., ACTUARIAL STANDARDS OF PRACTICE NO. 4: MEASURING PENSION OBLIGATIONS AND DETERMINING PENSION PLAN COSTS OR CONTRIBUTIONS (Dec. 2013), [http://www.actuarialstandardsboard.org/wp-content/uploads/2013/12/asop004\\_173-3.pdf](http://www.actuarialstandardsboard.org/wp-content/uploads/2013/12/asop004_173-3.pdf); *see, e.g.*, Press Release, Society of Actuaries, Society of Actuaries Response to Actuarial Standards Bd. Request for Comments-ASOPS & Pub. Pension Plan Funding & Accounting (Oct. 30, 2014), <https://www.soa.org/News-and-Publications/Newsroom/Press-Releases/Society-of-Actuaries-Response-to-Actuarial-Standards-Board-Request-for-Comments-%E2%80%93-ASOPS-and-Public-Pension-Plan-Funding-and-Accounting.aspx>.

B. *Require actuarial independence.* ERISA's emphasis on actuarial independence removes discretion from the employer. Because public plans are inherently political, this could be a useful complement to other governance reforms suggested by the literature.

C. *Require conservative actuarial assumptions.* Under ERISA, actuarial discretion has become more and more constrained at least for single-employer plans. But even a facially sound assumption can be weakened by a gimmick, like the 25-year lookback on corporate bond yields. Given the dynamics of budget politics, it would be hard to put gimmicks off-limits, but model legislation could help to define best practices.

D. *Provide self-executing enforcement tools.* The ERISA funding lien requires only perfection to have the status of a federal tax lien. It may then become senior to a revolving credit arrangement, which tends to bring the parties to the table. That remedy would almost certainly not apply in the public sector, due to sovereign immunity and concerns about holding municipal services hostage. But for local plans, withholding of state revenue-sharing funds seems an even more effective way of ensuring that pension contributions are made.

E. *Make funding status and its implications transparent to stakeholders.* ERISA's reporting and disclosure regime is a robust model, and its Annual Funding Notice highlights the relationship between poor funding and potential loss of benefits. Accounting standards have advanced in both the private and public sectors. They may generate pressure for funding discipline by lenders and other stakeholders. Disclosure of the ARC/ADC would promote that objective.

F. *Encourage pre-funding to provide a reserve against lean times.* The experience with the Tax Code's full funding and deductible limits illustrates the tension between revenue and social objectives, and the effect on plans of weak employers. Income tax treatment is not relevant for public plans, but, as shown by events in Illinois and New Jersey, pension funding always competes with other budget imperatives.

G. *Invest with an eye to funding level, risk, and demographics.* Public plan investing and risk management strategies are beyond the scope of this article, though they also have a significant effect on plan funding. ERISA has no per se investment constraints. The core guidance emphasizes the need to consider risk, return, and cash-flow objectives, which logically requires an understanding of the plan's funding level, risk tolerance, and plan population.

H. *Guard against undue cross-subsidies.* ERISA's withdrawal liability helped to hold multiemployer plans together for three decades, ameliorating the shift of legacy costs from some employers to others. Though some multiemployer plans now are severely distressed, the situation surely would have been worse if there had been no cost for withdrawal. Many state systems are multiple-employer arrangements. As illustrated by the Stockton case, statutory and contractual withdrawal fees may help to keep employers in the fold.

I. *Guard against extraordinary payouts.* The ERISA experience with lump sums and contingent event benefits demonstrates the risk, at least for plans that are poorly funded or whose employers are declining. If these benefits are triggered by workforce reductions, the plan may be less sustainable.

J. *Set a balance between funding and benefit promises.* The PPA regime for troubled multiemployer plans includes reductions of future accruals, and MPRA introduced reductions of accrued benefits for the most troubled. Neither is possible under most state constitutions, except for local plans in a bankruptcy context. Rather, as the Illinois Supreme Court held, a constitutional protection of pensions may imply a taxpayer guaranty. This suggests the importance of setting a balance between benefit promises and expected funding.