

# PENSION PROTECTION? A COMPARATIVE ANALYSIS OF PENSION REFORM IN THE UNITED STATES AND THE UNITED KINGDOM

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## I. INTRODUCTION

Captain Tim Baker, a pilot at US Airways, Inc. for nineteen years, was promised a six-figure retirement pension annually by his employer.<sup>1</sup> Instead, when he retires in twelve years, he is going to receive only \$28,585 per year in pension benefits, plus any amount he can save through his employer's 401(k) plan.<sup>2</sup> Financially troubled US Airways turned their pilot's pension plan, which was a "sinkhole of unfunded liabilities," over to the Pension Benefit Guaranty Corporation (PBGC) to help enable the company to emerge from bankruptcy.<sup>3</sup> Turning the pension plan over to the PBGC means that pilots will collect significantly less benefits than they were promised by the airline: some will collect "less than 50 cents on the dollar."<sup>4</sup>

"It has totally destroyed my life and that of my family and we might even have to sell our home to survive."<sup>5</sup> Englishman John Benson used these words to describe the impact the loss of his pension had on him.<sup>6</sup> John contributed money to his employer's pension fund for thirty-eight years, expecting to receive an annual income of £8,000 to supplement his state pension.<sup>7</sup> The financial collapse of his employer caused John to lose the extra income he had anticipated.<sup>8</sup> Now, John must stock shelves at a store to try to make up for the lost pension income, instead of enjoying his retirement.<sup>9</sup>

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1. Nanette Byrnes & David Welch, *The Benefits Trap; Old-line Companies Have Pledged a Trillion Dollars to Retirees. Now They're Struggling to Compete with New Rivals, and Many can't Pay the Bill*, BUS. WK., July 19, 2004.

2. *Id.* Since pilots are required to retire at age sixty, instead of the usual sixty-two or sixty-five, their benefits through the PBGC are reduced. Ellen E. Schultz & Theo Francis, *Most Workers are in Dark on Health of Their Pensions --- US Airways Killed a Plan that Pilots had no Inkling was in Financial Danger*, WALL ST. J., July 1, 2003, at A1.

3. Byrnes & Welch, *supra* note 1

4. *Id.*

5. Sharlene Goff, *National News Business and Economy: Stark Contrast to Hopes of Happy Retirement*, FIN. TIMES (U.K.), Mar. 15, 2006, available at 2006 WLNR 4305236.

6. *Id.*

7. *Id.*

8. *Id.*

9. *Id.* See also Joseph Watts, *Pay Up on Lost Pensions*, NOTTINGHAM EVENING POST,

Currently, stories about employees losing their retirement benefits litter the media in both the United States and the United Kingdom.<sup>10</sup> Both countries have enacted pension legislation<sup>11</sup> in an attempt to prevent defined benefit pension plan participants, like Tim Baker and John Benson, from losing promised benefits. The economic environment that has led to this most recent pension reform “is a global problem, caused by . . . a combination of lower market returns, an era of low inflation and bond yields, and, arguably, a failure to act by governments, plan sponsors and fund managers.”<sup>12</sup>

When considering pension reform, it is important to take into account risk factors that must be allocated between the employer and the pension plan participant. Two important risk factors considered in this Note are the risk of investment and the risk of longevity.<sup>13</sup> The risk of investment is allocated to the party who “finance[s] and direct[s] the investment;” this party will also be rewarded with investment gains or suffer investment losses.<sup>14</sup> The risk of longevity is the possibility one could outlive his or her retirement savings.<sup>15</sup> Due to the inherent difficulty in balancing the interests of the plan participant and the employer, there is no perfect solution to pension problems.

This Note compares the recent pension legislation in the United States, the Pension Protection Act of 2006 (PPA 2006), and in the United Kingdom, the Pensions Act 2004 (PA 2004).<sup>16</sup> It compares the actual effects of this legislation on employer-sponsored defined benefit plans or final salary schemes

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Nov. 7, 2006, at 6.

10. E.g., Trebor Banstetter, *Pension Shocker: Many Retired Delta Pilots are Forced to Cope with a Sharp Drop in Income*, FORT WORTH STAR-TELEGRAM, Oct. 15, 2006, available at 2006 WLNR 17871167; Byrnes & Welch, *supra* note 1; Schultz & Francis, *supra* note 2; Goff, *supra* note 5; Watts, *supra* note 9.

11. Pension Protection Act of 2006, Pub. L. No. 109-280 (2006) (codified as an amendment to 29 U.S.C.A. ch. 18 (2007)); Pensions Act 2004, 2004, c. 35 (U.K.).

12. Ian Yuill, *Dealing with Pensions Deficits: The Global Problem of Pensions Deficits Will Provide Asset Managers with Some Unique Opportunities—But also Some Troubling Challenges*, EUROMONEY INSTITUTIONAL INVESTOR, July 1, 2006, at 39. This economic environment has been dubbed the “perfect storm.” Robert Kuttner, *The Great American Pension-Fund Robbery*, BUS. WK., Sept. 8, 2003, at 24. However, Kuttner also argues that rather than a “perfect storm,” pension problems are instead “a leaky boat ravaged by pirates,” due to systematic looting of pension plans by corporate sponsors. *Id.*

13. COLLEEN MEDILL, INTRODUCTION TO EMPLOYEE BENEFITS LAW: POLICY AND PRACTICE 108-09 (West 2004). See also Philip Booth & Terry Arthur, Adam Smith Inst., *Submission to the Review on Private Pensions Simplification*, <http://www.adamsmith.org/images/uploads/publications/private-pensions-simplification.pdf> (last visited Jan. 20, 2008) (arguing that regulations should not seek to remove financial risk from retirement schemes).

14. MEDILL, *supra* note 13, at 109.

15. *Id.*

16. Pension Protection Act of 2006, Pub. L. No. 109-280 (2006) (codified as an amendment to 29 U.S.C.A. ch. 18 (2007)). Pensions Act 2004, c. 35 (U.K.). Most of the PA 2004 extends to England, Wales and Scotland; however, some sections also extend to Northern Ireland. DEP’T FOR WORK AND PENSIONS, Pensions Act 2004 Explanatory Notes, 2004, at 4, [http://www.opsi.gov.uk/acts/en2004/ukpgaen\\_20040035\\_en.pdf](http://www.opsi.gov.uk/acts/en2004/ukpgaen_20040035_en.pdf) (last visited Jan. 20, 2008) [hereinafter WORK AND PENSIONS].

with the intentions underpinning the enactment of the legislation. Part I-A and I-B of this Note examine the history of pensions in the United States and the United Kingdom, as well as set out the most recent provisions enacted pertaining to these types of pension plans. Part II provides an in depth discussion of the provisions in each country, the effects of the provisions, and the intent of the drafters of the provisions. Part III compares and contrasts the reform set out by the PPA 2006 and the PA 2004 and the effects, focusing on lessons, if any, the United States can learn from the United Kingdom. Finally, part IV sets out other possible solutions for the United States to correct funding and PBGC deficits.

#### A. *Brief History of Pensions in the United States*

Employee benefits programs came into existence in the United States as early as 1636 when Plymouth Colony created a military program for veterans.<sup>17</sup>

The first official corporate pension plan did not exist until 1875, when American Express provided retirement benefits to its employees.<sup>18</sup> This encouraged other companies to follow suit and create pensions as well.<sup>19</sup> Pensions increased in popularity at a time when industrialization and urbanization were becoming more prevalent.<sup>20</sup> Younger generations were not supporting elderly family members as they had in the past. As a result, the elderly needed savings to fund their retirement.<sup>21</sup>

While savings were needed to retire, people were either unable or unwilling to save sufficient amounts.<sup>22</sup> Thus, elderly employees inefficiently remained in the workforce long after they were able to meet the standards of their jobs.<sup>23</sup> Pensions evolved because employers could not afford to pay elderly employees the same compensation as they paid younger workers, as elderly employees were less able to fulfill their work obligations than younger workers.<sup>24</sup> As an alternative to firing elderly employees, pension plans were created to allow employees to retire voluntarily with financial support during retirement.<sup>25</sup>

These early private retirement pension plans were not required by law to provide the benefits they promised to employees.<sup>26</sup> After World War II, but before 1974, the only government regulation that pertained to employers who

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17. Jill L. Uylaki, *Promises Made, Promises Broken: Securing Defined Benefit Pension Plan Income in the Wake of Employer Bankruptcy: Should We Rethink Priority Status for the Pension Benefit Guaranty Corporation?*, 6 ELDER L.J. 77, 81 (1998).

18. *Id.*

19. *Id.* By 1992 there were more than 708,400 plans. *Id.*

20. DAN M. MCGILL ET AL., *FUNDAMENTALS OF PRIVATE PENSIONS* 3 (8th ed. 2005).

21. *Id.*

22. *Id.*

23. *Id.* at 5.

24. *Id.* at 3.

25. *Id.* at 7.

26. Uylaki, *supra* note 17, at 81.

had retirement plans provided the employers with favorable tax treatment.<sup>27</sup> Therefore, employee retirement plans were generally viewed as a “type of ‘gratuity’ or ‘thank-you’ from the employer to be disbursed only at the employer’s discretion.”<sup>28</sup> The number of pension plans continued to grow until the Depression in 1929.<sup>29</sup> While the Depression slowed the growth of pension plans, financial difficulty and unemployment for the elderly gave rise to the Social Security Act of 1935.<sup>30</sup> After the Depression, “general consciousness about retirement income security, the beneficial way in which Social Security was implemented, and the favorable tax treatment of employer-sponsored retirement programs” caused the number of pension plans to expand quickly from the 1950s through the 1970s.<sup>31</sup>

One of the most important events culminating in the enactment of the Employee Retirement Income Security Act of 1974 (ERISA) was the 1963 closing of the Studebaker automobile plant.<sup>32</sup> When the Studebaker plant closed, the pension plan was also terminated.<sup>33</sup> The plan did not have sufficient assets to cover all of the promised benefits; as a result, only the retired and active employees eligible for retirement as of the date of the plan termination received their full benefits.<sup>34</sup> Some of the younger employees received a lump sum payment, worth only a fraction of their expected benefit, while others received no pension benefits at all.<sup>35</sup> The Studebaker failure was disturbing because it illustrated that a “pension could be funded and operated in accordance with applicable laws and still result in massive numbers of employees receiving little to no benefit” and was considered “a tremendous

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27. *Id.* at 81-82. The government encourages employers to sponsor retirement plans by allowing employer contributions to be a deductible expense, within a specified limit, when they are contributed to the plan. MCGILL ET AL., *supra* note 20, at 54-55. No taxes are assessed on contributions or investment earnings until the retirement benefits are paid to the employees. *Id.* These types of plans are called qualified plans because they meet specific statutory requirements enabling them to receive the tax deductions mentioned above. *Id.* These plans are described in the Internal Revenue Code sections 401 through 416. MICHAEL J. CANAN, QUALIFIED RETIREMENT PLANS, VOL. 1 § 2.1, at 23-24 (2005).

28. Uylaki, *supra* note 17, at 82 n.24. Many plans specifically stated that the employer could “deny benefits to any employee and . . . reduce or terminate benefits that had already commenced.” MCGILL ET AL., *supra* note 20, at 16.

29. MCGILL ET AL., *supra* note 20, at 3.

30. *Id.* at 4. Social security is outside the scope of this Note; however, for more information see *Id.* at 40-51.

31. *Id.* at 4.

32. *Id.* at 83. See generally James A. Wooten, “The Most Glorious Story of Failure in the Business:” *The Studebaker-Packard Corporation and the Origins of ERISA*, 49 BUFF. L. REV. 683 (2001) (discussing in greater detail the effect of the Studebaker plant closing).

33. MCGILL ET AL., *supra* note 20, at 83.

34. *Id.* The United Automobile Workers had negotiated increases in current benefits as well as benefits for past service that Studebaker was not able to fund. *Id.* The retirement age for the plan was sixty. *Id.*

35. Wooten, *supra* note 32, at 684. There were several long term and senior employees who were just shy of age sixty who received significantly less pension benefits than they were promised. MCGILL ET AL., *supra* note 20, at 83.

failing of the federal regulatory regime.”<sup>36</sup>

Thus, ERISA was enacted to provide a “comprehensive legislative scheme designed to obligate an employer to provide a regular program of contributions to fund its pension plan.”<sup>37</sup> ERISA imparts minimum requirements for funding, vesting, participation and benefit accrual for all private retirement pension plans, requiring plans to “provide participants with information about the plan” and requiring accountability for plan fiduciaries.<sup>38</sup> The impetus for the enactment of ERISA was to provide a measure of protection for individual employees and ensure employers are adequately funding their pension plans.<sup>39</sup>

One type of retirement plan ERISA governs is a defined benefit plan, which can be classified as either a single or multiemployer plan.<sup>40</sup> Defined benefit plans are qualified employer-sponsored plans whose “plan document defines the amount of the benefit that will be paid by the plan to the participant at retirement.”<sup>41</sup> The benefit must be definitely determinable, so the plan must define a benefit formula as well as identify how benefits accrue under that formula.<sup>42</sup> Typically, a defined benefit plan calculates its benefit formula using the number of years worked for an employer and the employee’s compensation.<sup>43</sup>

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36. MCGILL ET AL., *supra* note 20, at 83.

37. Uylaki, *supra* note 17, at 82.

38. U.S. Department of Labor Frequently Asked Questions about Pension Plans and ERISA, <http://www.dol.gov/dolfaq/go-dol-faq.asp?faqid=225&faqsub=ERISA&faqtop=Retirement+Plans+%26+Benefits&topicid=4> (last visited Feb. 24, 2008). Prior to 1974, there were no regulations governing any of these aspects of pension plans. MCGILL ET AL., *supra* note 20, at 23.

39. Uylaki, *supra* note 17, at 82.

40. 29 U.S.C. § 1001 (2000). Generally, multiemployer plans are plans maintained by more than one unrelated employer, are created in accordance with at least one collective bargaining agreement, and satisfy any other requirement set out by the Secretary of Labor, including certain related employer requirements pursuant to 26 U.S.C. § 414 (2000). CCH, PENSION PROTECTION ACT OF 2006: LAW, EXPLANATION AND ANALYSIS 143-144 (2006). A “‘single-employer plan’ means a plan which is not a multiemployer plan.” 29 U.S.C. § 1002(b)(41) n.3 (2006).

41. MEDILL, *supra* note 13, at 109 (emphasis omitted). In contrast to the defined benefit plan, the defined contribution plan is another type of qualified retirement plan governed by ERISA. *Id.* As the name “defined contribution” suggests, the plan document defines a contribution amount that the employer must make to the plan each year. *Id.* at 107. This allocation is then divided, as set out in the plan document, into individual accounts for each eligible participant in the plan. *Id.* At retirement or other termination, a participant will receive the nonforfeitable balance of his or her account, which includes contributions and earnings, rather than a designated monthly amount. *Id.*

42. *Id.* at 109.

43. *Id.* Several different types of formulas can be used for the computation of defined benefit plan benefits. These include the flat benefit formula, career average formula and final pay formula. *Id.* at 110. These formulas take into account the employee’s years of service, which “is defined as a twelve consecutive month period during which an employer has worked at least 1,000 hours of service.” *Id.* at 118. A flat benefit formula is calculated by multiplying a fixed dollar amount by the number of years of service. *Id.* at 110. Calculating a career average

In order to pay these promised benefits, employers must contribute enough money to fully fund the plan benefits accrued that year and make up for any previous underfunding.<sup>44</sup> Plans are not required to fund 100% of their plan's liabilities; rather, pension liabilities are considered fully funded when 90% or more of their current liabilities are met.<sup>45</sup> Once an employee reaches normal retirement age, the defined benefit plan will pay a set amount each month for the rest of the employee's life.<sup>46</sup>

Defined benefit plans have several advantages. For employees, an important advantage is that the employer bears the risk of investment and must make up any shortfall that might occur.<sup>47</sup> These types of plans are most advantageous for employees who work for the same employer for a long period of time; otherwise the employees may not accrue significant benefits.<sup>48</sup> Employers also bear the risk of longevity, as they must pay the participants' pension benefit, usually "in the form of a monthly annuity for the life of the participant or the joint lives of the participant and the participant's spouse," until the participant dies.<sup>49</sup> Finally, tax incentives also benefit employees and encourage employers to sponsor qualified plans.<sup>50</sup> Employer-sponsored qualified plans receive three types of tax advantages: earned income is tax-

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formula benefit involves multiplying the "fixed percentage of the participant's compensation" for each year of covered employment and then aggregating such amounts. *Id.* A final pay formula benefit is calculated using a fixed percentage of the employee's compensation over the last five to ten years of their employment. *Id.*

44. U.S. SENATE REPUBLICAN POLICY COMM., H.R. 4- PENSION PROTECTION ACT OF 2006, S. DOC. NO. 53, at 5 (2006). Typically, only employers contribute to defined benefit plans, though sometimes employees are required or allowed to contribute. Internal Revenue Service, Choosing a Retirement Plan: Defined Benefit Plans, <http://www.irs.gov/retirement/article/0,,id=108950,00.html> (last visited Jan. 20, 2008) [hereinafter Choosing a Defined Benefit Plan]. However, "[t]he 2000 Department of Labor survey of employee benefits in private establishments found that 95 percent of participants in defined benefit plans were in noncontributory plans." MCGILL ET AL., *supra* note 20, at 379.

45. U.S. SENATE REPUBLICAN POLICY COMM., H.R. 4- PENSION PROTECTION ACT OF 2006, S. DOC. NO. 53, at 5-6 (2006).

46. MEDILL, *supra* note 13, at 110. Most private defined benefit plans have designated a normal retirement age of sixty-two or sixty-five. CONG. BUDGET OFF., NORMAL RETIREMENT AGE AND MINIMUM-SERVICE REQUIREMENT, [http://www.cbo.gov/OnlineTaxGuide/Page\\_1D2b.htm](http://www.cbo.gov/OnlineTaxGuide/Page_1D2b.htm) (last visited Jan. 21, 2008). Unless waived by the employee or the employee's spouse (if married), the employer will use plan assets to provide an annuity for the employee that will pay the employee's accrued benefit each month. MEDILL, *supra* note 13, at 110.

47. Kathleen H. Czarney, *The Future of Americans' Pensions: Revamping Pension Plan Asset Allocation to Combat the Pension Benefit Guaranty Corporation's Deficit*, 51 CLEV. ST. L. REV. 153, 166 (2004). Unlike defined benefit plans, defined contribution plans shift the investment risk to the employee since employees are only entitled to their individual vested account balance. *Id.* at 169.

48. *Id.* at 167. Accrued benefits from a defined benefit plan will not be recognized by a new unrelated employer. See MEDILL, *supra* note 13, at 110.

49. MEDILL, *supra* note 13 at 110. However, if the plan allows for a lump sum benefit and the participant elects to take his or her defined benefit pension as a lump sum, this transfers the risk of longevity to the participant. *Id.* at 109-10.

50. Czarney, *supra* note 47, at 165.

exempt so long as it remains in a tax-exempt trust, employer contributions within certain limits are tax deductible, and an employee is not treated as having received taxable benefits, even though those benefits are already vested, until the employee actually receives benefits from the qualified plan.<sup>51</sup>

While there are several advantages to defined benefit plans, there are also several disadvantages. Defined benefit plans are complicated to administer and difficult to understand.<sup>52</sup> Additionally, plan sponsors with defined benefit plans must contribute enough money today to ensure that there are enough assets to pay pension benefits in the future; however, there are many formulas involved in calculating the pension plans funding status.<sup>53</sup> Due to the complexity of the formulas, most pension participants do not really understand the nature of their defined benefit pension benefit.<sup>54</sup> It is also difficult for participants to monitor the funding level of their defined benefit plan; accordingly, participants may not be aware that their employer is having difficulty meeting their plan's funding liabilities.<sup>55</sup>

Although companies are required to file pension information with the Securities and Exchange Commission, large employers will often have several pension plans listed together in the filings.<sup>56</sup> A "list of the 50 companies with the most-underfunded pension plans" was published annually until 1997; however, outcry from the companies led to the termination of its publication.<sup>57</sup> Therefore, participants are often forced to rely upon their employers to apprise them of the health of their pension plans.<sup>58</sup> The accuracy of information supplied by employers may also be dubious, as employers might be motivated to either "exaggerate the ill-health" or "mask a deteriorating health of the pension plan."<sup>59</sup>

ERISA also created the PBGC, which is a federal corporation that insures the pensions of American workers and retirees in qualified single-employer and multiemployer defined benefit pension plans.<sup>60</sup> When an employer is unable to

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51. STANLEY N. BERGMAN & DAVID L. REYNOLDS, 350 T.M., PLAN SELECTION- PENSION AND PROFIT-SHARING PLANS A-1 (Supp. 2004).

52. Czarney, *supra* note 47, at 167. Complexity has been cited as one of the reasons that the number of defined benefit plans is decreasing. *Id.*

53. MEDILL, *supra* note 13, at 109-110. The plan's actuary determines "[t]he present value of the plan's benefit obligations . . . on the basis of actuarial assumptions that are reasonable both individually and in the aggregate and represent the actuary's best estimate of anticipated experience under the plan." Deloitte, Securing Retirement: An Overview of the Pension Protection Act of 2006 6, (Aug. 3, 2006), <http://deloitte-tax.12hs.com/S1/C4AUDO/F36Y0NX2/MJ>.

54. Czarney, *supra* note 47, at 167. The plan sponsor hires an actuary to calculate the complex funding formulas. Choosing a Defined Benefit Plan, *supra* note 44.

55. Czarney, *supra* note 47, at 167.

56. Schultz & Francis, *supra* note 2, at A1.

57. *Id.* at 3.

58. *Id.* at A1.

59. *Id.*

60. Welcome to PBGC, <http://www.pbgc.gov/> (Nov. 10, 2007). Plans not insured by the PBGC include individual account plans, church, and government plans. MCGILLET AL., *supra*

meet its pension plan promises to employees, the PBGC effectively takes the plan over and becomes directly responsible for all pensions guaranteed under ERISA.<sup>61</sup> Consequently, the PBGC is now “responsible for the current and future pensions of about 1,271,000 people.”<sup>62</sup> The PBGC was also created to “encourage the continuation and maintenance of . . . defined benefit pension plans, provide timely and uninterrupted payment of pension benefits, and keep pension insurance premiums at a minimum.”<sup>63</sup> While the PBGC is a federal agency, it is not funded with tax dollars, but rather by collecting insurance premiums from all employers who sponsor insured pension plans, as well as money from investments, and from plans that it takes over.<sup>64</sup> The Deficit Reduction Act of 2005 (DRA) recently increased the annual flat rate premium to \$30 per participant for single-employer plans and \$8 per participant for multiemployer plans.<sup>65</sup> Some single-employer plans are also required to pay a variable rate premium of \$9 for every \$1,000 the plan falls below the 90% “full funding limit,” in addition to the flat rate premium.<sup>66</sup> The PBGC is responsible for paying pension benefits to retirees whose plans it has taken over, as well as for the payment of future benefits to participants who have not yet retired.<sup>67</sup>

Employers may voluntarily end their pension plans in either a standard or a distress termination.<sup>68</sup> For an employer to be eligible for a standard termination there must be enough money in the plan to pay all vested nonforfeitable benefits.<sup>69</sup> The PBGC is no longer responsible for guaranteeing the plan once annuities have been purchased for plan participants.<sup>70</sup> Distress terminations occur when the plan does not have enough money to pay all of the

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note 20, at 802.

61. Welcome to PBGC, *supra* note 61.

62. PBGC Who We Are, <http://www.pbgc.gov/about/about.html#1> (last visited Jan. 18, 2008).

63. *Id.*

64. *Id.*

65. Sal L. Tripodi & Teresa T. Bloom, Key Provisions of HR 4 Pension Protection Act of 2006, 4 (Aug. 31, 2006), <http://www.asPPA2006.org/government/comment08-02-06.htm>. The rate was formerly \$19 per participant for single-employers and \$2.60 for multiemployer plans. CONG. BUDGET OFF., COST ESTIMATE S. 1932 DEFICIT REDUCTION ACT OF 2003 74, (2006), <http://www.cbo.gov/ftpdocs/70xx/doc7028/s1932conf.pdf> (last visited Jan. 20, 2008).

66. U.S. SENATE REPUBLICAN POLICY COMM., H.R. 4- PENSION PROTECTION ACT OF 2006, S. Doc. No. 53, at 10. However, the variable rate premium is waived for any plan meeting the 90% “full funding limit,” even if the plan could not meet 100% of its liabilities, since 90% funded is defined as the “full funding limit.” *Id.*

67. PBGC Who We Are, *supra* note 62.

68. 29 U.S.C. § 1341 (2000).

69. PBGC How Pension Plans End, <http://www.pbgc.gov/about/termination.html> (last visited Jan. 20, 2008).

70. *Id.* Employers must use the assets in the pension to purchase an annuity from an insurance company that will pay the participant his or her lifetime vested benefit or, if the plan allows, employers can offer the participant a lump sum payment equivalent to his or her lifetime vested benefit. *Id.* Employers must also give the participants an advance list of insurance companies from whom the employer might purchase annuities. *Id.* The PBGC is no longer responsible for guaranteeing the pension once an annuity has been purchased or the lump sum payment made. *Id.*



benefits.<sup>71</sup> To qualify for a distress termination, the employer must show severe financial distress.<sup>72</sup> Once the employer establishes financial distress, the PBGC will pay guaranteed benefits and will then attempt to recover funds from the employer.<sup>73</sup>

Finally, the PBGC can act to terminate any single-employer plan, without the sponsoring employer's consent, in order to protect the interests of the workers, the plan, or PBGC's insurance fund.<sup>74</sup> A distress termination for a multiemployer plan may occur if the employer cannot pay its guaranteed benefits and it meets one of the PBGC's financial distress tests.<sup>75</sup> If the financial distress test is met, the PBGC will take over the plan, using both its own assets and any remaining assets from the plan, ensuring retirees receive their benefits, subject to the PBGC's legal limits.<sup>76</sup>

The PBGC only pays guaranteed basic benefits, set under ERISA and adjusted on a yearly basis, which are calculated using the guaranteed amount in the plan and the year in which the plan terminates.<sup>77</sup> The basic benefits the PBGC guarantees are: "pension benefits at normal retirement age, most early retirement benefits, annuity benefits for survivors of plan participants, and disability benefits for disabilities that occurred before the date the plan

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71. *Id.*

72. *Id.* It must be shown to either the PBGC or a bankruptcy court that the only way the employer can remain in business is by terminating the pension plan. *Id.*

73. PBGC Distress Terminations, <http://www.pbgc.gov/practitioners/plan-terminations/content/page13261.html> (last visited Jan. 21, 2008). The maximum monthly guarantee is an amount set by law that limits the amount of benefits the PBGC will cover. What PBGC Guarantees, <http://www.pbgc.gov/workers-retirees/benefits-information/content/page13181.html> (last visited Jan. 20, 2008). The limits are based on the year in which the plan terminated and the age at which the participant begins receiving benefits from the PBGC. PBGC Maximum Monthly Guarantee Tables, <http://www.pbgc.gov/workers-retirees/find-your-pension-plan/content/page789.html> (last visited Jan. 20, 2008). If there is a benefit for a survivor, such as a spouse, then the survivor's age is also taken into account. *Id.* A participant whose plan terminated in 2007, and who begins receiving benefits at sixty-five, can receive a monthly maximum of \$4,125 for a straight-life annuity or \$3,712.50 for a joint and 50% survivor annuity. *Id.*

74. How Pension Plans End, *supra* note 70. For example, the PBGC can terminate a plan if there is not enough money to pay the current benefits due. *Id.*

75. PBGC Distress Terminations, *supra* note 73. One of the following financial distress tests must be satisfied: filing a petition to seek liquidation in bankruptcy; filing a petition to seek reorganization in bankruptcy that has been granted with approval for a plan termination because the plan cannot reorganize with the pension plan intact; demonstrating the only way the employer can continue business is if the plan is terminated; or demonstrating the plan is unduly burdened by the pension plan solely due to a declining number of covered employees in the plan. *Id.*

76. *Id.* The PBGC will attempt to collect plan underfunding from the employer and will share any recovered assets with participants and beneficiaries. *Id.* For a discussion on the obstacles the PBGC faces in recovering plan underfunding, see also Nicholas J. Brannick, *At the Crossroads of Three Codes: How Employers are Using ERISA, the Tax Code, and Bankruptcy to Evade Their Pension Obligations*, 65 OHIO ST. L.J. 1577 (2004); Czarney, *supra* note 47, at 157.

77. What PBGC Guarantees, *supra* note 73.

ended.”<sup>78</sup> The PBGC limits what it will guarantee; for instance, benefits of plans that increased their benefit formulas within five years of termination may not be fully covered.<sup>79</sup> Finally, the PBGC does not cover ancillary benefits, such as health and welfare benefits or vacation pay.<sup>80</sup>

After the passage of ERISA and throughout the 1980s, the number of employers with defined contribution plans grew rapidly.<sup>81</sup> As a result of the increase in defined contribution plans, the burden of financing the plans shifted from the employer to the employee.<sup>82</sup> Interestingly, throughout the 1980s and most of the 1990s, an average of 75% of defined benefit plans were overfunded.<sup>83</sup> During this time, the stock market inflated pension assets; however, when the stock market and interest rates declined in value, around the year 2000, many pension funds became underfunded by millions of dollars.<sup>84</sup> The decrease in the ratio of active workers to retirees is also partially responsible for the current deficit.<sup>85</sup> These events also impacted the PBGC, which lost \$11.3 billion in 2002 alone.<sup>86</sup> The main reason for the huge deficit was the termination of underfunded plans sponsored by large companies, such as: Trans World Airlines, Grand Union, Acme, Singer, Polaroid and Bethlehem Steel.<sup>87</sup>

The Pension Funding Equity Act of 2004 (PFEA) was enacted to help relieve some of the financial pressure on employers who sponsored defined benefit plans, which was caused by required pension contributions that were

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78. *Id.*

79. *Id.*

80. *Id.*

81. MCGILL ET AL., *supra* note 20, at 386-87. Many of the employers who adopted defined contribution plans at this time already had defined benefit plans in place. *Id.* at 387.

82. *Id.* at 387.

83. *Id.* at 58, Table 3-2. Plan overfunding refers to a plan with more assets than actuarial accrued benefit or current liability. *Id.* at 58.

84. Uylaki, *supra* note 17, at 82. Two main causes for the deficit are: a decrease in investment returns which cut “into the stockpiles that companies set aside to fund their future pension obligations” and a drop in interest rates which increased the amount companies must set aside to fund future liabilities. Kathy M. Kristof, *Panel to Debate Pension Measure; Firms Would Save. But Critics Say Bill Could Put Payment Security at Risk. Bush Threatens to Veto It*, L.A. TIMES, Feb. 2, 2004, at 1. Pension plan assets declined \$970 billion between 1999 and 2002. MCGILL ET AL., *supra* note 20, at 391. See generally U.S. GOV'T ACCOUNTABILITY OFF., REPORT TO CONGRESSIONAL COMMITTEES, PRIVATE PENSIONS: RECENT EXPERIENCES OF LARGE DEFINED BENEFIT PLANS ILLUSTRATE WEAKNESSES IN FUNDING RULES (May 2005).

85. CCH TAX BRIEFING, PENSION FUNDING EQUITY ACT OF 2004 2 (2004), <http://tax.cchgroup.com/Tax-Briefings/2004-Pension-Funding-Act.pdf>. In 1980 the active worker to retiree ratio was 4:1; it decreased to 1:1 in 2002. *Id.*

86. MCGILL ET AL., *supra* note 20, at 387. The PBGC started 2002 with a surplus of \$7.7 billion, but ended the year with a deficit of \$3.6 billion. *Id.* This loss was greater than any other one-year loss the PBGC had experienced since its inception. *Id.*

87. *Id.* at 387-88. Other plans also terminating in 2002 included retailers Bradlees, Caldor, and Payless Cashways; manufacturers Harvard Industries, Durango, and National Steel. *Id.*

growing increasingly larger.<sup>88</sup> The PFEA was designed to temporarily replace the rate at which pension liabilities are calculated.<sup>89</sup> A portion of the minimum funding requirement for pension funding is determined by comparing the current plan liabilities to the value of plan assets.<sup>90</sup> Prior to the enactment of the PFEA, pension liabilities were calculated using the 30-year Treasury bond rate.<sup>91</sup> This created a problem because the 30-year Treasury bond rate has become extraordinarily low compared with other market interest rates.<sup>92</sup>

To help mitigate these effects, the PFEA allowed plans to calculate pension liabilities using a long-term corporate bond rate for the 2004 and 2005 plan years.<sup>93</sup> The long-term corporate bond rate is considerably higher than the 30-year Treasury bond rate, so it reduces the calculated current liability.<sup>94</sup> In turn, the contribution the employer must make to meet its minimum funding requirement is also reduced.<sup>95</sup> Finally, the PFEA also assisted the struggling airline and steel industries by allowing some employers to elect to use alternate deficit reduction contributions.<sup>96</sup>

The PPA 2006, called the “most significant pension legislation since . . . ERISA was enacted in 1974,” was principally written to ensure that employer sponsored defined benefit plans remained solvent.<sup>97</sup> One of the primary objectives of the PPA 2006 was to require most defined benefit plans to become fully funded.<sup>98</sup> The PPA 2006 has implemented new minimum required contribution rules, requiring most funds to become fully funded within four years,<sup>99</sup> although the airline industry was given a longer period.<sup>100</sup>

The PPA 2006 encourages strong pension plans through both incentives

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88. CCH TAX BRIEFING, *supra* note 85, at 1; 15 U.S.C. § 37b (2004).

89. Internal Revenue Service, Pension Funding Equity Act of 2004, <http://www.irs.gov/retirement/article/0,,id=129503,00.html> (last visited on Jan. 20, 2008).

90. *Id.* Contributions based on this calculation are called deficit reduction contributions, as they are designed to help reduce the pension plan’s deficit. *Id.*

91. Kristof, *supra* note 84. A notice specifying the prior month’s 30-Year Treasury Rate is published in the Internal Revenue Bulletin each month. Internal Revenue Service, *supra* note 89, at n.1.

92. Internal Revenue Service, *supra* note 89.

93. *Id.*

94. *Id.*

95. *Id.* This can reduce the deficit reduction contribution to zero for some plans, which means the employer must only contribute enough to fund its current liabilities. *Id.*

96. *Id.* The alternate deficit reduction contribution allowed the employers to contribute only 20% of their deficit reduction contribution. *Id.*

97. *President Signs Landmark Pension Reform Law*, KAN. EMPLOYMENT LAW LETTER (Foulston Siefkin LLP), Oct. 2006 [hereinafter EMPLOYMENT LAW LETTER].

98. *Id.*

99. *Id.*

100. U.S. SENATE REPUBLICAN POLICY COMM., H.R. 4- PENSION PROTECTION ACT OF 2006, S. DOC. NO. 53, at 10 (2006). Airlines are given additional years based on the status of their pension plan. *Id.* If no future benefits are accruing, then the employer has an additional ten years to fully fund the plan. *Id.* If future benefits are still accruing, the airline has three extra years to fund the plan, but they must follow the other funding rules as well. *Id.*

and penalties.<sup>101</sup> Incentives include a tax deduction for the employer in the amount that it costs to fully fund an underfunded plan and a provision allowing employers to make contributions in excess of the amount required for plans to be fully funded.<sup>102</sup> Allowing employers to contribute extra money to the pension plan during flourishing years can help keep the plan fully funded, even if the employer struggles to fund the plan at a future date.<sup>103</sup> The use of long-term corporate bond rates as set out in the PFEA has also been extended for plan years 2006 and 2007 to give plans more flexibility in attaining fully funded status.<sup>104</sup>

The PPA 2006 also amended several PBGC rules.<sup>105</sup> Since the DRA just increased the flat rate premiums, no changes were made to the rates.<sup>106</sup> However, since pension plans are now required to be 100% fully funded, all underfunded plans are now required to pay the variable rate premium.<sup>107</sup> Finally, all employers who terminate their pension plans and transfer any liabilities to the PBGC must pay \$1,250 per participant per year for three years after plan termination.<sup>108</sup>

### *B. Brief History of Pensions in the United Kingdom*

The first occupational pensions schemes in the United Kingdom date back to the 15th Century, with modern forms emerging in the 17th Century.<sup>109</sup> About one million people were covered by occupational schemes by 1900, though the pensions were still considered to be gratuitous provisions, rather

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101. EMPLOYMENT LAW LETTER, *supra* note 97.

102. *Id.*

103. *Id.*

104. Pension Protection Act of 2006, Pub. L. No. 109-280, §§ 302-03 (2006) (codified as amendment to 29 U.S.C.A. § 1055; 26 U.S.C.A. §§ 417, 415 (2007)); Tripodi & Bloom, *supra* note 65, at 2. For plan years after 2007, employers will have the option to either phase in new interest rate assumptions or to adopt them outright. *Id.*

105. Pension Protection Act of 2006, Pub. L. No. 109-280, §§ 404(c), 405(b), 410(a)(2) (2006) (codified as amendment to 29 U.S.C.A. §§ 1322(c), 1306(b), 1350(a)(2) (2007)).

106. Tripodi & Bloom, *supra* note 65, at 4.

107. U.S. SENATE REPUBLICAN POLICY COMM., H.R. 4- PENSION PROTECTION ACT OF 2006, S. DOC. NO. 53, at 10 (2006).

108. INST. OF MGMT. & ADMIN., *What Benefits Managers Need to Know About the Pension Protection Act of 2006*, 10 HUM. RESOURCES Vol. 2006 No. 10 (Oct. 2006). The premium applies to plans terminated:

- by the PBGC, (1) in a distress termination due to the sponsor's bankruptcy, (2) due to the inability of the employer to pay its debts when due, or (3) due to a determination that a termination is necessary to avoid unreasonably burdensome pension costs caused solely by a decline in the workforce.

THOMSON RIA, RIA'S COMPLETE ANALYSIS OF THE PENSION PROTECTION ACT OF 2006 274-75 (2006). If the employer is reorganizing, the premium does not have to be paid until the employer has completed the reorganization process. *Id.*

109. George Walker, *United Kingdom Pension Law Reform*, 64 BROOK. L. REV. 871, 877 (1998).

than provisions to which an employee was entitled.<sup>110</sup> By the 1950s, concern about financing pensions due to an increasing elderly population emerged, as well as concern about the progressively more complex tax treatment of pensions.<sup>111</sup> Around the same time, pensions stopped being viewed as a gratuity and instead began being viewed as deferred salary compensation.<sup>112</sup>

In the 1990s, pensions underwent further reform in response to The Mirror Group pension scandal.<sup>113</sup> Robert Maxwell purchased the Mirror Group and withdrew £420 million from the pension funds.<sup>114</sup> The Pension Law Review Committee (Committee) was formed to investigate occupational pension schemes and make recommendations for pension reform.<sup>115</sup> The Committee found that employees of occupational pension schemes had a reasonable expectation of a protected benefit which accrued through service at the company.<sup>116</sup> Among a total of 218 recommendations,<sup>117</sup> the Committee found that a “minimum solvency requirement,” which required that certain funding levels be met so that an employer could fund its liabilities to the pension scheme as they were due, was proper and advised how the requirement should be implemented.<sup>118</sup>

The Pensions Act 1995 (PA 1995) was introduced as a result of the recommendations by the Committee seeking in part to “increase confidence in the security of occupational pensions.”<sup>119</sup> The PA 1995 established minimum funding requirements, as recommended by the Committee, which necessitated that scheme assets must be valued at least at 90% of scheme liabilities.<sup>120</sup> Scheme trustees also had to acquire actuarial valuations certifying the adequacy of contributions and adhere to a schedule of contributions to ensure the level of funding complied with the minimum funding requirements.<sup>121</sup>

The Occupational Pensions Regulatory Authority was also established “with new powers of investigation and enforcement and a separate compensation scheme created to protect members against asset withdrawal.”<sup>122</sup> While the PA 1995 did set minimum funding levels, the execution of this Act

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110. *Id.* at 878.

111. *Id.* at 881.

112. *Id.* at 881-82.

113. *Id.* at 885.

114. *Id.* at 887. After Maxwell bought The Mirror Group, he imposed a pensions holiday, which allowed the Mirror Group to avoid making £800,000,000 worth of annual contributions to the pension fund. *Id.* at 885. While Maxwell’s actions were considered unusual, they were not illegal at that time because “precedent involving employer tampering with employee pension funds failed to exist.” *Id.* at 886.

115. *Id.* at 890-91.

116. *Id.* at 893.

117. *Id.* at 910.

118. *Id.* at 894-95.

119. *Id.* at 911.

120. *Id.* at 915.

121. *Id.*

122. *Id.* at 911.

has been criticized since its enactment.<sup>123</sup> The execution of the PA 1995 struggled because “the methodology and actuarial assumptions for assessing funding and determining minimum contributions under the minimum funding requirement were outdated and inflexible and the timescales for rectifying minimum funding requirement funding shortfalls are arguably overly prescriptive.”<sup>124</sup>

As a response to the failings of the PA 1995, the Pensions Act 2004 (PA 2004) was enacted primarily to provide greater protection for members of occupational pension schemes by replacing the minimum funding requirements with the statutory funding objective (SFO).<sup>125</sup> One of the ways the PA 2004 sought to accomplish this was by creating the Pensions Regulator, which replaced the Occupational Pensions Regulatory Authority as the new regulatory agency governing employer-sponsored pension schemes.<sup>126</sup> The Pensions Regulator has a “defined set of statutory objectives, wider powers to investigate schemes and take action where necessary; takes a proactive, risk-focused approach to regulation; and provides practical support for the regulated community.”<sup>127</sup> Finally, the Pensions Regulator can take steps to protect scheme member’s benefits if it determines that the security of their scheme is in danger, and it can also take action to prevent an employer from intentionally avoiding its pension obligations.<sup>128</sup>

The PA 2004 also sought to protect pensions through the creation of the Pensions Protection Fund (PPF).<sup>129</sup> The PPF, partially modeled on the United States’ PBGC,<sup>130</sup> was created to “provide compensation to members of eligible defined benefit pension schemes, when there is a qualifying insolvency event in relation to the employer and where there are insufficient assets in the pension scheme to cover the Pension Protection Fund level of compensation.”<sup>131</sup> An

123. Hymans Robertson, *Farewell to the MFR: The Future of Pension Scheme Funding 2* (May 2005), <http://www.hymans.co.uk/hrllp/templates/research.asp?id=49&research=y>.

124. *Id.*

125. The Pensions Trust, *The Pensions Act 2004*, <http://www.thepensionstrust.org.uk/TPT/SHPS/ForEmployers/LatestCommitteePensions/The+Pensions+Act+2004.htm> (last visited Jan. 20, 2008); *see also* Hymans Robertson, *supra* note 123.

126. The Pensions Regulator About Us, <http://www.thepensionsregulator.gov.uk/aboutUs/powers.aspx> (last visited Jan. 20, 2008).

127. *Id.*

128. *Id.*

129. *Welcome to the Pension Protection Fund Website*, <http://www.pensionprotectionfund.org.uk/> (last visited Jan. 20, 2008) [hereinafter PPF Welcome]; *but see* Yuill, *supra* note 12 (arguing the creation of the PBGC and the PPF contribute to the problem of pension deficit because the existence of those agencies encourages employers to turn over underfunded plans rather than engage in costly measures to fund the plans).

130. John J. Papadakis & Rosalind J. Connor, *The Pensions Act 2004: Pension Protection Fund*, [http://www1.jonesday.com/pubs/pubs\\_detail.aspx?PubID=S1091](http://www1.jonesday.com/pubs/pubs_detail.aspx?PubID=S1091) (last visited Jan. 21, 2008).

131. Main Functions of Pension Protection Fund,

eligible scheme is one that has not started wind up prior to April 5, 2007.<sup>132</sup> The PPF can assume responsibility for an eligible scheme if “a scheme rescue is not possible; and the scheme has a deficit.”<sup>133</sup>

Funding for the PPF is supplied by a levy, calculated based on the size and solvency of the scheme, issued on all defined benefit plans.<sup>134</sup> The PPF is also financed by funds it receives from schemes it takes over and by payments into those schemes by employers.<sup>135</sup> There is great concern that the levy will become significantly larger during times of financial distress, when more employers are likely to become insolvent.<sup>136</sup>

The PPF pays compensation to members of eligible pension schemes on two different schedules.<sup>137</sup> Scheme members who have reached the normal pension age specified by their scheme, or members who are already receiving a pension from the scheme, receive 100% level of compensation from the PPF.<sup>138</sup>

The 100% level of compensation is equal to the amount of compensation paid from the pension scheme immediately before the assessment date, subject to review of the scheme’s rules by the PPF.<sup>139</sup> This amount is increased commensurate with the Retail Price Index, at no more than 2.5% a year, which could be lower than the yearly increase provided for by the pension scheme.<sup>140</sup>

Scheme members below the pension scheme’s normal pension age and not already receiving a pension will receive 90% of their level of compensation accrued prior to the assessment date from the PPF.<sup>141</sup> These scheme members are entitled to an increase proportionate to the increase in the Retail Price Index of no more than 5% per year between the assessment date and the start of payments.<sup>142</sup> All scheme members who have reached normal pensions age or are already receiving a pension are entitled to a maximum compensation which is equivalent to £26,050 at age sixty-five.<sup>143</sup> Once these scheme members start

<http://www.pensionprotectionfund.org.uk/index/main-functions.htm> (last visited Jan. 21, 2008).

132. Qualifying Conditions of Pension Protection Fund, <http://www.pensionprotectionfund.org.uk/index/who-is-eligible/qualifying-conditions.htm> (last visited Jan. 21, 2008).

133. Papadakis & Connor, *supra* note 130.

134. FAQs: Pension Protection Levy 2006/07, [http://www.pensionprotectionfund.org.uk/index/pension\\_protection\\_levy-2/faqs\\_pension\\_protection\\_levy\\_2007\\_08.htm](http://www.pensionprotectionfund.org.uk/index/pension_protection_levy-2/faqs_pension_protection_levy_2007_08.htm) (last visited Jan. 21, 2008).

135. Papadakis & Connor, *supra* note 130.

136. *Id.*

137. Pension Protection Fund – Compensation, <http://www.pensionprotectionfund.org.uk/index/main-functions/compensation.htm> (last visited Jan. 21, 2008) [hereinafter PPF- Compensation].

138. *Id.*

139. *Id.*

140. *Id.*

141. *Id.* But see Johnston Press Plc, *New Deal Call for T&N Pensioners*, BUXTON ADVERTISER, July 27, 2006 (stating employees who took early retirement could lose up to 80% of their benefits, current employees approximately 40%, and pensioners up to 30%).

142. PPF- Compensation, *supra* note 137.

143. *Id.* This includes people of any age who are already receiving a “survivors’ pension or a pension on the grounds of ill health.” *Id.*

receiving payments, their yearly increase will also be commensurate with the Retail Prices Index, up to a maximum of 2.5%.<sup>144</sup> While the PPF has the ability to adjust levies as needed to meet its liabilities, it can reduce compensation in severe situations.<sup>145</sup>

The PA 2004 also sought to protection pensions by creating the Fraud Compensation Fund (FCF), which funds pension schemes that have lost funds due to dishonesty.<sup>146</sup> There are four requirements that must be met before compensation can be received from the FCF: 1) the scheme must be an eligible occupational pension scheme; 2) a qualifying insolvency event must have occurred or, if none has occurred, it is likely that the employer is facing bankruptcy; 3) a notice of no potential for scheme rescue has been issued; and 4) the Board of the Pension Protection Fund has determined that scheme assets are missing due to fraudulent action.<sup>147</sup>

Schemes seeking assistance from the FCF have a twelve month period, the "authorised period," from the occurrence of the insolvency event, or the date when managers or trustees should have known the employer was facing bankruptcy, to file for assistance from the FCF.<sup>148</sup> Funding for the FCF comes from a levy on all eligible occupational pension schemes and must be enough to cover all payments paid out by the FCF.<sup>149</sup> The amount of compensation a scheme receives, if any, is calculated by the Board of the PPF.<sup>150</sup> Payments are generally calculated as the difference between "the value of the assets as stated in the audited scheme accounts, or the Pension Protection Fund valuation . . . and the value of the assets immediately before the application date as reported by an accountant."<sup>151</sup> The FCF is a last resort agency, so all attempts to recover scheme assets must be made before assistance from the FCF is sought.<sup>152</sup>

Another major change perpetuated by the PA 2004 was the enactment of the SFO, which replaced the minimum funding requirements set out by the PA 1995.<sup>153</sup> The premise of the SFO is to ensure that trustees "have sufficient assets to meet their scheme's technical provisions[,]" which means that the plan has enough assets "in today's terms required to meet the payment of future benefits, allowing for prudent assumptions of investment returns and mortality, among other factors."<sup>154</sup> In contrast to the rigid funding requirements previously in effect, the new rules give the trustees and the employer much

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144. *Id.*

145. *Id.*

146. Fraud Compensation Fund, [http://www.pensionprotectionfund.org.uk/index/main-functions/fraud\\_compensation\\_fund.htm](http://www.pensionprotectionfund.org.uk/index/main-functions/fraud_compensation_fund.htm) (last visited Jan. 12, 2008) [hereinafter FCF].

147. *Id.*

148. *Id.*

149. *Id.*

150. *Id.*

151. *Id.*

152. *Id.*

153. Debbie Harrison, *FT Fund Management: More Power for Scheme Guardians to Ensure Solvency*, FIN. TIMES, June 12, 2006, available at 2006 WLNR 10020730.

154. *Id.*



more flexibility and responsibility in determining the level of contributions.<sup>155</sup>

First, the trustees must “assess the strength of the employer’s covenant, which is its opinion of financial position and prospects of the employer as well as its willingness to continue to support the scheme.”<sup>156</sup> Then, the trustees must prepare a statement of investment principles, which shows investment strategy, as well as a statement of funding principles, which states the manner in which the SFO will be met.<sup>157</sup> The statement of investment principles and funding principles are designed to be read cooperatively.<sup>158</sup> In the event that a plan is determined to be underfunded, as many final salary scheme plans will likely be, the statement of funding principles must be supplemented with a recovery plan.<sup>159</sup>

The recovery plan establishes the contribution schedule that the employer must adhere to in order to bring the scheme into compliance with the SFO.<sup>160</sup> While the trustees must rely on the employer to provide information, such as its balance sheet and business plan, the trustees should not rely solely on information provided by the employer.<sup>161</sup> In cases of a plan shortfall, the trustees are expected to negotiate the quickest method the employer can afford to bring the scheme into conformity with the SFO, while still working with the employer.<sup>162</sup> In situations where an employer wants to engage in any actions that might compromise the strength of the covenant, such as taking on new debt, the trustees and the employer should join efforts to seek the authorization of the Pensions Regulator.<sup>163</sup>

## II. PENSION REFORM IN THE UNITED STATES AND THE UNITED KINGDOM

The pension crisis is a global problem due to local forces; however, the solutions tend to be unique to each country.<sup>164</sup> Both the United States’ PPA 2006 and the United Kingdom’s PA 2004 were enacted to deal with pension deficits, but the manner in which each statute has approached the problem is vastly different.<sup>165</sup> Despite disparate local forces, two universal problems

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155. *Id.*

156. *Keeping Everything Ship Shape*, FIN. TIMES, Apr. 13, 2006, available at 2006 WLNR 6229973.

157. Harrison, *supra* note 153.

158. *Id.*

159. *Id.*

160. *Id.*

161. *Id.*

162. *Id.*

163. *Id.*

164. Jennifer C. Rankin, *Leaving the Nest: World Pension Reform*, <http://www.loma.org/res-10-06-world.asp> (last visited Jan. 20, 2008). Such forces include “local politics, budgets, constituents, laws, regulations, and social contracts.” *Id.*

165. *Compare* Pension Protection Act of 2006, Pub. L. No. 109-280 (2006) (codified as an amendment to 29 U.S.C.A. ch. 18 (2007)); Pensions Act 2004, c. 35.

remain.<sup>166</sup> The first problem involves changing world demographics.<sup>167</sup> Birth rates have declined and life expectancy rates have increased;<sup>168</sup> therefore, fewer workers are available to support the increasing number of retirees.<sup>169</sup> The proportion of elderly people in the United States is expected to increase to 23.2% of the population by the year 2080.<sup>170</sup> Since the percentage of retirees is expected to continue to increase, this issue must be addressed for pension reform to succeed.<sup>171</sup>

The second dilemma concerns the impact of market forces, such as the rate of returns on investments and interest rates, on pension funds.<sup>172</sup> Rates of return on investments impact pension funds because plans must contribute enough funds yearly to offset their liabilities in the future.<sup>173</sup> Even with prudent financial planning, the market can make a downward shift which would cause the plan to lose substantial assets.<sup>174</sup> A shift in interest rates can also negatively affect pension plans, because interest rates are also part of the calculation used to determine the amount plans are required to contribute each year.<sup>175</sup> A fluctuation of only 1% in the interest rate assumption used when calculating current pension liabilities can increase or decrease “the long-run cost estimate by about 25%.”<sup>176</sup>

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166. Rankin, *supra* note 164.

167. *Id.*

168. *Id.* In 1900, 4.05% of the United States population was over sixty-five, but that rate grew to 12.43% in 2000. MCGILL ET AL., *supra* note 20, at 10 tbl.1-3. Birthrates in the United States for white women have decreased from just fewer than 4.0 in 1900 to just over 2.01 in 2000. *Id.* at 12 fig. 1-2. In the United States in 1900, the average life expectancy for men was 47.3; however, in 2000 the life expectancy had increased by almost thirty years to 77.1. *Id.* at 13 tbl. 1-4. Finally, the fastest growing segment of the population in the United States is people over the age of eighty-five. *Id.* at 13-14.

169. Rankin, *supra* note 164.

170. MCGILL ET AL., *supra* note 20, at 15. People are considered to be elderly once they reach age sixty-five. *Id.*

171. *See Id.*

172. Rankin, *supra* note 164. The Standard and Poor's 500 stock index decreased significantly from 2000 through 2002. *Subcomm. on Aviation Hearing on Airline Pensions: Avoiding Further Collapse*, <http://www.house.gov/transportation/aviation/06-22-05/06-22-05memo.html> (last visited Jan. 21, 2008) [hereinafter *Aviation Hearing*]. *See also* Internal Revenue Service, *supra* note 89.

173. MCGILL ET AL., *supra* note 20, at 595.

174. Internal Revenue Service, *supra* note 89. Since roughly half of the assets of defined benefit pension plans were invested in the stock market from 1995 to 2000, the decline in the stock market caused many plans to go from overfunded status, to underfunded status in a short time. *Aviation Hearing*, *supra* note 172.

175. Internal Revenue Service, *supra* note 89; *See also* Hymans Robertson, *supra* note 123, at 31.

176. MCGILL ET AL., *supra* note 20, at 612.

### *A. United States' Minimum Required Contribution and United Kingdom's SFO*

Both the minimum required contribution enacted by the United States and the SFO enacted by the United Kingdom strive to improve the security of pension funds.<sup>177</sup> Determining funding for defined benefit plans can be very complex, since funding must be calculated to meet benefits that are payable many years in the future.<sup>178</sup> Planning to pay benefits due years in the future assigns the risk of investment and the risk of longevity to the employer.<sup>179</sup> The question remains as to whether legislation in either the United States or the United Kingdom will succeed in shoring up funding for defined benefit pensions.

#### *1. The United States' Minimum Required Contribution*

The new minimum required contribution, which becomes effective in the 2008 plan year, consists of only a single funding method, which is a simplification over the current two-tiered funding system.<sup>180</sup> The new minimum required contribution requires single-employers to contribute enough funds to cover the cost of the benefits accrued that plan year, plus any other liabilities that have been amortized over a period of time.<sup>181</sup> A funding shortfall occurs when the plan assets are less than the plan liabilities in a plan year.<sup>182</sup> According to the new minimum required contribution, the funding shortfall is amortized over a seven-year period and must be paid in installments each year, starting the year the funding shortfall occurs<sup>183</sup> Each subsequent year, the employer must recalculate "the amount of underfunding based on that year's assets and liabilities."<sup>184</sup> If the funding shortfall increases, then this additional

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177. See generally Pension Protection Act of 2006, Pub. L. No. 109-280 (2006) (codified as an amendment to 29 U.S.C.A. ch. 18 (2007)); Pensions Act 2004, c. 35.

178. See *supra* p. 23 and note 172.

179. MEDILL, *supra* note 13, at 108-09.

180. CCH, *supra* note 40, at 90. Pension Protection Act of 2006, Pub. L. No. 109-280 (2006) (codified as an amendment to 26 U.S.C.A. § 179 (2007)). The previous minimum funding standard consisted of the minimum funding standard account rule and the deficit contribution. Tripodi & Bloom, *supra* note 65, at 1.

181. THOMSON RIA, *supra* note 108, at 61. Pension Protection Act of 2006, Pub. L. No. 109-280 (2006) (codified as an amendment to 26 U.S.C.A. § 179 (2007)); see also THOMSON RIA, *supra* note 108, at 60-130 (providing additional information regarding calculation of the minimum required contribution).

182. Deloitte, *supra* note 53, at 8. Funding shortfalls can stem from "unfunded past service liability and changes in past service liability due to plan amendments, assumption changes, and experience gains and losses over a period that can exceed 30 years." CCH, *supra* note 40, at 91.

183. Deloitte, *supra* note 53, at 8; Pension Protection Act of 2006, Pub. L. No. 109-280, § 102 (codified as an amendment to 29 U.S.C.A. § 1083 (2007)).

184. Tripodi & Bloom, *supra* note 65, at 6; Pension Protection Act of 2006, Pub. L. No. 109-280, § 102 (codified as amendment to 29 U.S.C.A. § 1083 (2007)). Amortization payments are not required if the assets of the plan are greater than its liability target. Tripodi & Bloom,

funding shortfall amount must be amortized separately over a new seven-year period.<sup>185</sup> The PPA 2006 now defines a fully funded plan as one with enough assets to meet 100% of its current liabilities.<sup>186</sup> Therefore, employers are only required to make contributions to the plan up to the full funding limitation of 100% of their current liabilities.<sup>187</sup>

As a continuation of the ideas behind the PFEA, actuarial assumptions and means of calculating present value have also been significantly modified.<sup>188</sup> The PPA 2006 requires that “determination of present value and other funding computations will be made on the basis of reasonable actuarial assumptions and methods that take into account the experience of the plan and offer the actuary’s best estimate of the anticipated experience under the plan.”<sup>189</sup> For plan years beginning prior to 2007, the PPA 2006 has extended the use of corporate bond rates outlined in the PFEA;<sup>190</sup> however, for plan years beginning after 2008 present value will be determined “based on the performance of corporate bonds as reflected in a segmented yield curve that reflects the age of an employer’s work force.”<sup>191</sup> The Secretary of the Treasury will set the yield curve, which will be calculated using the yields on investment grade bonds.<sup>192</sup> The yield curve will then be divided into segments based on when the benefits are expected to be paid.<sup>193</sup> Accordingly, employers who have an elderly work force will be using a short-term corporate rate, which will require them to make higher contributions.<sup>194</sup> Any plan that existed before 2008 will have the option to implement the segmented yield curve over a three-year period.<sup>195</sup>

As an alternative to the segment yield rates, however, employers may choose to use the full yield curve, which consists of the “interest rates under the corporate bond yield curve for the month preceding the month in which the plan year begins.”<sup>196</sup> Selection of mortality tables used to compute present

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*supra* note 65, at 6.

185. Deloitte, *supra* note 53, at 8.; Pension Protection Act of 2006, Pub. L. No. 109-280 § 102 (codified as an amendment to 29 U.S.C.A. § 1083 (2007)).

186. CCH, *supra* note 40, at 95. Formerly plans were considered fully funded when they had enough assets to pay 90% of their total liabilities. *Id.*

187. *Id.*

188. *Id.*

189. *Id.* at 104.

190. *Id.* at 105.

191. *Id.*

192. *Id.* at 106. The corporate bonds used will be of “varying maturities that are in the top three levels available.” *Id.*

193. *Id.* at 104. The segments will be divided into the following categories: “0-5 years, 5-20 years, or over 20 years.” *Id.*

194. *Id.* The yield curve illustrates the relationship between funding liabilities and the age of the plan’s participants. *Id.* Companies with a younger demographic have a smaller funding obligation, “because [those companies’] liabilities would be discounted at short-term interest rates.” *Id.*

195. *Id.* at 106. While employers are not required to phase in the segmented yield rates, this election can only be revoked with permission from the Secretary of the Treasury. *Id.* at 107.

196. *Id.* at 106. However, this alternative election can only be rescinded with the

value or required funding have also been impacted by the PPA 2006.<sup>197</sup> The Secretary of the Treasury is now required to select tables “based on the actual experience of pension plans and projected trends in experience.”<sup>198</sup> Unlike the new interest rates, the mortality tables are not going to be phased in, so neither will the differences in assumptions between the old and new tables.<sup>199</sup>

While multiemployer plans are currently treated as single-employer plans by ERISA and the Internal Revenue Code for funding rule purposes,<sup>200</sup> the PPA 2006 sets out funding requirements that treat multiemployer plans differently than single-employer plans.<sup>201</sup> All multiemployer plans have a standard funding account that is credited with employer contributions and debited with plan expenses each year.<sup>202</sup> The PPA 2006 reduces amortization of costs debited or credited to funding standard accounts established on or after 2008 to a standardized fifteen-year amortization schedule.<sup>203</sup> However, plans that obtain Internal Revenue Service approval can adopt an amortization schedule that is as long as twenty-five years.<sup>204</sup> For plan years beginning after 2007, “actuarial assumptions and methods used to determine costs, liabilities, interest rates and other factors” must be independently reasonable and take “into account the plan’s experience and reasonable expectations.”<sup>205</sup>

A new set of minimum required contributions, effective through 2014, has been created to help shore up plans whose status is “endangered” or “critical.”<sup>206</sup> Plans in “endangered” or “seriously endangered” status are required by the PPA 2006 to formulate and execute a funding improvement plan, with the goal of decreasing underfunding in endangered plans by one-third and seriously endangered plans by one-fifth.<sup>207</sup> A plan in “critical” status

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authorization of the Secretary of the Treasury. *Id.*

197. *Id.* at 107

198. *Id.* These tables must be updated at least every ten years and must continue to take into account the experience of the plans and projected trends. *Id.*

199. *Id.*

200. U.S. SENATE REPUBLICAN POLICY COMM., H.R. 4- PENSION PROTECTION ACT OF 2006, S. DOC. NO. 53, at 6 (2006).

201. Deloitte, *supra* note 53, at 10.

202. CCH, *supra* note 40, at 144.

203. *Id.* at 145-46. Prior to the PPA 2006, amortization schedules could be as long as thirty years. Deloitte, *supra* note 53, at 11. These changes in the amortization periods align multiemployer plans with the amortization periods of single-employer plans. CCH, *supra* note 40, at 146. However, this means employers will have to make larger contributions to fund any increased costs, since the payments on those costs will be spread out over a fewer number of years. *Id.*

204. Deloitte, *supra* note 53, at 11.

205. CCH, *supra* note 40, at 148. Formerly, the actuarial assumptions and methods were only required to be reasonable in the aggregate. *Id.*

206. Deloitte, *supra* note 53, at 10. Plans must be less than 80% funded or have or estimated in the next six years to have an accumulated funding deficiency for its status to be considered “endangered.” *Id.* A plan’s status is considered to be “seriously endangered” if both the previously mentioned circumstances are met. *Id.* Finally, a plan is in “critical” status when it is projected that it will be unable to fulfill the minimum funding requirements or it become insolvent with three to six years. *Id.* at 11.

207. *Id.* The funding improvement plans should require an increase in contributions and a

must formulate a rehabilitation plan with the goal of emerging from critical status within ten years.<sup>208</sup> The plan's actuary must certify that the plan is following its stated plan to increase funding yearly.<sup>209</sup> Finally, while these provisions sunset in 2014, a plan is permitted to follow its funding plan until it achieves its goals or the applicable time period expires.<sup>210</sup>

Concern with the financial situation in the commercial passenger airline industry caused Congress to set out provisions within the PPA 2006 specifically for that industry.<sup>211</sup> Congress was primarily concerned that if the commercial airlines had to make the minimum required contribution, it would divert cash that was needed to keep the companies solvent.<sup>212</sup> Plans that are sponsored by commercial airlines can choose to apply either the alternative funding schedule or a relaxed version of the new funding requirements.<sup>213</sup> If an employer elects to adopt the relaxed version of the new funding requirements, then beginning in the 2008 plan year, the plan would amortize any funding shortfall over a ten-year period, rather than the normally required seven-year period.<sup>214</sup> The alternative funding schedule requires the plan to "freeze benefit accruals and restrict benefit increases, and provide for contributions that pay for the plan's unfunded liability over 17 years."<sup>215</sup> Measures required by the alternative funding schedule, however, will not reduce the employee's accrued benefits.<sup>216</sup>

Minimum required contributions are calculated by dividing the amount of the unfunded plan liability by the seventeen-year amortization period.<sup>217</sup> This minimum required contribution amount is recalculated each year in the same manner.<sup>218</sup> As a result, the benefit of the amortization period decreases every year while the number of years remaining in the amortization period also decreases.<sup>219</sup> Finally, at the end of the amortization period, the plan will once again be subject to the regular minimum funding contribution standards.<sup>220</sup>

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decrease in benefits over a ten-year period (fifteen-year period for seriously endangered plans) so that the funding percentage is increased. *Id.* Plans that do not comply or adopt these measures may be subject to civil penalties and excise taxes. CCH, *supra* note 40, at 150.

208. Deloitte, *supra* note 53, at 11. A 10% surcharge, though this is reduced to only 5% the first year, is levied on the employer's contribution each year the plan remains in "critical" status. *Id.*

209. *Id.* Penalties could also be assessed if the plan's funding goals are frustrated. *Id.*

210. *Id.*

211. CCH, *supra* note 40, at 138.

212. *Id.*

213. THOMSON RIA, *supra* note 108, at 116.

214. *Id.* This election must be made by December 31, 2007. *Id.*

215. *Id.* Specifically, pension, death or disability, and social security benefits must be frozen and all other benefits must be eliminated. CCH, *supra* note 40, at 138.

216. THOMSON RIA, *supra* note 108, at 117.

217. CCH, *supra* note 40, at 139.

218. *Id.*

219. *Id.*

220. *Id.* Note, however, any carryover balance will be zero beginning the plan year after the alternative funding schedule ends. *Id.*

## 2. *United Kingdom's SFO*

The PA 2004 replaced the minimum funding requirements that were set out in the Pensions Act of 1995 with a SFO.<sup>221</sup> The new SFO apply to all plans that were subject to the minimum funding requirements, including “most private sector defined benefit occupational pension schemes.”<sup>222</sup> Instead of requiring all pensions to meet a universal funding requirement, the SFO is more individualized and takes into account the circumstances particular to each pension.<sup>223</sup> The plan’s trustees, managers and sponsoring employer must all work together to formulate an actuarially advised “strategy for funding the pension commitments and for correcting any funding deficits, and to set this out in a statement of funding principles.”<sup>224</sup>

The SFO must, however, be formulated to cover the plan’s actuarially calculated liabilities.<sup>225</sup> The plan’s trustees or managers are permitted to choose which methods and assumptions are suitable to use when calculating the plan’s liabilities.<sup>226</sup> The PA 2004 requires the Pensions Regulator to issue a code of practice that will provide guidance to the plan’s trustees regarding their duties in determining scheme funding.<sup>227</sup> However, plans cannot use any provision that allows the plan’s liabilities to be limited by the plan’s assets.<sup>228</sup> Once the plan has formulated its SFO, the plan must issue a written statement of funding principles which contains “the trustees’ policy for ensuring that the statutory funding objective is met.”<sup>229</sup> The Pensions Regulator may impose a civil penalty on the plan’s trustees or managers if they do not use reasonable measures to meet the requirements established in the statement of funding principles.<sup>230</sup>

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221. WORK AND PENSIONS, *supra* note 16, § 220 ¶ 792. The new provisions are also subject to “the requirements of the European Directive 2003/41/EC on the activities and supervision of institutions for occupation retirement provision (the IORP Directive). *Id.* § 221 ¶ 794; *see generally* OFFICIAL J. OF THE EUROPEAN UNION, *European Directive 2003/41/EC of the European Parliament and of the Council of June 3, 2003 on the Activities and Supervision of Institutions for Occupational Retirement Provision*, 2003 O.J., 10 (L235), available at [http://eur-lex.europa.eu/LexUriServ/site/en/oj/2003/l\\_235/l\\_23520030923en00100021.pdf](http://eur-lex.europa.eu/LexUriServ/site/en/oj/2003/l_235/l_23520030923en00100021.pdf)., as this directive is outside the scope of this Note.

222. WORK AND PENSIONS, *supra* note 16, § 220 ¶ 792.

223. *Id.* § 220.

224. *Id.*

225. *Id.* § 222 ¶ 795. Current liabilities are also referred to as the “technical provisions” of the plan. *Id.* § 220 ¶ 796.

226. *Id.* § 222 ¶ 797.

227. *Id.*

228. *Id.* § 222 ¶ 798.

229. *Id.* § 223 ¶ 799. The statement of funding principals must be periodically reviewed and revised as necessary or at least every three years. *Id.* § 223 ¶ 801. The statement must set out any decisions made regarding “the methods and assumptions to be used in calculating the scheme’s technical provisions; and the period over which a failure to meet the statutory funding objective would be rectified and the manner in which it will be rectified.” *Id.* § 223 ¶ 800.

230. *Id.* § 223 ¶ 801.

In order to comply with the requirements of the PA 2004, an actuarial valuation must be prepared yearly,<sup>231</sup> however, the trustees of the plan are allowed to order actuarial valuations every three years if an actuarial report is obtained in the intervening years.<sup>232</sup> The actuary must certify the calculations of the plan's current liabilities and that they are within the guidelines of the plan's SFO when completing actuarial valuations.<sup>233</sup> Finally, the trustees are required to make available to the employer within seven days any actuarial valuation or report.<sup>234</sup>

In the event that the trustees or managers determine by using the plan's actuarial valuation that the scheme is not going to meet its SFO, they are either required to create a recovery plan, or if one is in place, to reevaluate its terms.<sup>235</sup>

A recovery plan must specify what steps will be taken to satisfy the SFO, as well as the timeframe in which the SFO must be achieved.<sup>236</sup> The recovery plan "must be appropriate having regard to the nature and circumstances of the scheme," and the trustees must consider any prescribed matters.<sup>237</sup> While the trustees have some discretion in creating the recovery plan, they are still subject to regulations that might require other conditions in which the recovery plan must be reviewed or revised.<sup>238</sup> In these situations, the trustees must provide a copy to the Pensions Regulator within a reasonable time of the recovery plan's preparation or revision.<sup>239</sup>

The trustees are also responsible for preparing a schedule of contributions, as well as regularly reviewing and revising the schedule when necessary.<sup>240</sup> A schedule of contributions must include the rates at which the employer will contribute to the scheme as well as the dates on which the contributions will be paid.<sup>241</sup> While the trustees maintain some degree of control over the schedule of contributions, it is still subject to regulations and certification by the actuary before it will become effective.<sup>242</sup> The schedule of contributions is subject to regulations that govern when the schedule must be

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231. Pensions Act 2004, c. 35, § 224(1)(a). "An actuarial evaluation is a written report, valuing the scheme's assets and calculating its technical provisions, prepared and signed by the scheme actuary." WORK AND PENSIONS, *supra* note 16, § 224 ¶ 804.

232. Pensions Act 2004, c. 35, § 224(1)(a). "An actuarial report is a written report, prepared and signed by the scheme actuary, on changes to the scheme's technical provisions since the last actuarial valuation." WORK AND PENSIONS, *supra* note 16, § 224 ¶ 804.

233. Pensions Act 2004, c. 35, § 225. The Pensions Regulator can issue a fine against any actuary who does not supply this information within a reasonable time frame. WORK AND PENSIONS, *supra* note 16, § 225 ¶ 813.

234. Pensions Act 2004, c. 35, § 224(7).

235. *Id.* § 226(1).

236. *Id.* § 226(2).

237. *Id.* § 226(3)-(4).

238. *Id.* § 226(5).

239. *Id.* § 226(6). A trustee who does not comply will be subject to civil penalties. *Id.* § 226(7).

240. *Id.* § 227(1).

241. *Id.* § 227(2).

242. *Id.* § 227 (3)-(6).



prepared, reviewed, revised, and becomes effective.<sup>243</sup>

The schedule of contributions is also not considered to be complete or effective until the scheme's actuary has certified it.<sup>244</sup> The actuary's certification must state that in his or her opinion the schedule of contributions is in agreement with the statement of funding principles.<sup>245</sup> It must also certify that the rates in the contribution schedule are ample enough that in periods when the SFO was not met, it could be met within the time laid out in the recovery plan.<sup>246</sup> The rates must also be sufficient enough so that when the SFO is met for a period, it can be also expected to be met for the entire timeframe in which the schedule of contributions is in effect.<sup>247</sup> In the event that the SFO is not met for any period, the trustees are required to send a copy of the schedule of contributions to the Pensions Regulator.<sup>248</sup> The trustees are also responsible for reporting any missed contributions to the Pensions Regulator if they believe that failure is "of material significance."<sup>249</sup>

While the trustees have a great amount of responsibility for administering and guiding the pension scheme, they must obtain the approval of the employer:

to any decision about the methods and assumptions which are to be used by the actuary in calculating the scheme's technical provisions; to any matter which is to be included in the scheme's statement of funding principles; to any recovery plan; and to any matter to be included in the schedule of contributions.<sup>250</sup>

Amendments can be made, but they cannot negatively affect rights of the scheme participants, or those of the participant's beneficiaries.<sup>251</sup> Finally, if the trustees cannot come to an agreement with the employer on any matter mentioned above, the trustees must inform the Pensions Regulator of this in writing.<sup>252</sup>

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243. *Id.* § 227(3).

244. *Id.* § 227(5).

245. *Id.* § 227(6)(a).

246. *Id.* § 227(6)(b)(i).

247. *Id.* § 227(6)(b)(ii).

248. *Id.* § 227(7). Again, failure to comply with this requirement subjects the trustees to civil penalties. *Id.* § 227(8). If for some reason the actuary cannot certify the schedule of contributions, they must report this to the Pensions Regulator or also be subject to civil penalties. *Id.* § 227(9).

249. *Id.* § 228(2). Civil penalties apply when the trustees have not taken reasonable steps to inform the Pensions Regulator or when the employer does not have a "reasonable excuse" for nonpayment of a contribution. *Id.* § 228(4).

250. WORK AND PENSIONS, *supra* note 16, § 229 ¶ 833. However, if the trustees think they cannot obtain approval from the employer in a timely manner, the trustees can adopt a resolution to amend the future accrual of benefits, with the employer's permission. Pensions Act 2004, 2004, c. 35, § 229(2).

251. Pensions Act 2004, c. 35, § 229(3).

252. *Id.* § 229(5). Again, civil penalties apply to any trustee who does not attempt to

The scheme's trustees and the employer must also consider information provided by the scheme's actuary.<sup>253</sup> The scheme's actuary must be consulted on matters such as: "the methods and assumptions which are used by the actuary in calculating the scheme's technical provisions; preparing or revising the scheme's statement of funding principles; preparing or revising a recovery plan; preparing or revising the schedule of contributions; or modifying the scheme as regards the future accrual of benefits."<sup>254</sup> The scheme's actuary is also required to consider any guidance set out by approved organizations.<sup>255</sup>

The scheme's trustees, employer, and actuary must all work together to create the scheme's funding provisions,<sup>256</sup> which can sometimes lead to disagreement amongst the parties.<sup>257</sup> In situations where a disagreement occurs, the Pensions Regulator is authorized to intervene and help resolve the disagreement.<sup>258</sup> If there is a failure to meet any of the funding requirements mentioned above, or there is a dispute between the scheme's employer and trustees, the Pensions Regulator has the authority

to modify future benefit accruals under the scheme; to give directions about the manner in which the scheme's technical provisions should be calculated, including the methods and assumptions which should be used in the calculation; to give directions about how, and over what period any failure to meet the statutory funding objective should be rectified; to impose a schedule of contributions on the scheme setting out the contributions to be paid and the dates they are to be paid.<sup>259</sup>

The Pensions Regulator, however, must refrain from making any amendments to the funding requirements that would negatively affect the existing rights of any scheme participants or their beneficiaries.<sup>260</sup>

## *B. United States' PBGC Compared with United Kingdom's PPF and FCF*

### *1. United States' PBGC*

The new provisions in the PPA 2006 pertaining to the PBGC were

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comply with these regulations. *Id.* § 229(6).

253. *Id.* § 230.

254. WORK AND PENSIONS, *supra* note 16, § 230 ¶ 839.

255. *Id.* § 230 ¶ 841. Approved organizations include the Faculty and Institute of Actuaries, which also has the approval of Secretary of State. *Id.* Again, civil penalties apply if these regulations are not followed, or not even attempted to be followed, by the scheme's trustees. Pensions Act 2004, c. 35, § 230(4).

256. WORK AND PENSIONS, *supra* note 16, at §220 ¶ 793.

257. *Id.* § 231 ¶ 843.

258. *Id.*

259. *Id.* § 231 ¶ 844-45.

260. *Id.* § 231 ¶ 846.

enacted to address two basic problems with the PBGC's premium structure which have contributed to the PBGC's deficit.<sup>261</sup> The first problem was that "the premium structure did not adequately reflect the different levels of risk posed by plans of strong and weak companies."<sup>262</sup> The second problem was the premium structure did not raise enough income to reduce the current or expected future shortfall.<sup>263</sup> The PPA 2006 made permanent the temporarily DRA increased flat rate premiums, from \$10 to \$30 per participant for single-employer plans.<sup>264</sup> While the DRA raised the flat rate premium, this increase, without raising the variable rate premium, was still not sufficient to raise additional needed revenue.<sup>265</sup>

In response to these problems, the PPA 2006 now requires all employers who do not have enough assets to meet 100% of their current liabilities to pay the variable rate premium.<sup>266</sup> This should help solve two problems for the PBGC, as it encourages employers to fully fund their plans, which will decrease the number of underfunded plans, and will also raise more revenue for the PBGC.<sup>267</sup> However, for small employers, the PPA 2006 capped the variable premium rate at \$5, instead of \$9, per plan participant for each \$1,000 the plan is below the 90% full funding limit.<sup>268</sup> The reasoning behind this cap is that the variable rate premium has been viewed as responsible for the decline in the number of small employers who maintain defined benefit plans.<sup>269</sup>

The PPA 2006 also included several provisions pertaining to plans that enter bankruptcy.<sup>270</sup> One of these provisions made permanent the \$1,250 termination premiums initially set out in the DRA.<sup>271</sup> Another provision "provides for an earlier plan termination date where a contributing sponsor

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261. CCH, *supra* note 40, at 204.

262. *Id.*

263. *Id.*

264. *Id.* at 202.

265. *Id.* at 204. The flat rate premium was not sufficient for two reasons. *Id.* First, allowing plans that are only 90% funded to be exempt from the variable rate premium meant only a few plans actually paid the variable rate premium. *Id.* Second, "variable rate premium revenue is artificially low because current liability 'understates liabilities at plan termination, often dramatically so.'" *Id.* (quoting former PBGC executive director Bradley Belt's testimony before the Committee on Budget, US Senate June 12, 2005).

266. *Id.*

267. *Id.*

268. *Id.* at 205. Small employers have twenty-five or less employees. *Id.*

269. *Id.* at 206. "This provision will provide sorely needed relief for many small plan for which the PBGC variable rate premium, which is calculated as a percentage of underfunding for *vested* benefits, has been excessive in relation to underfunding for *guaranteed* benefits." *Id.* "There has often been, a large gap between vested and guaranteed benefits for small plans due to the special limitations on the guarantee for substantial owners." *Id.*

270. Pension Protection Act of 2006, Pub. L. No. 109-280, §§ 401(b)(1), 404(a)-(b) (codified as an amendment to 29 U.S.C.A. §§ 1306, 1322, 1344 (2007)).

271. CCH, *supra* note 40, at 205. This provision is often referred to as the "exit fee" and could be substantial for a large plan. *Id.* This could then lead to employers having difficulty reorganizing after bankruptcy which might result instead in asset sales. *Id.*

enters into a bankruptcy proceeding before the date that would otherwise have been treated as the plan termination date for purposes of determining the amount of PBGC's guarantee of benefits . . . ."<sup>272</sup> This means that the amount of benefits guaranteed by the PBGC is frozen once the employer has entered bankruptcy.<sup>273</sup>

Treating the date of the employer's bankruptcy petition "as the plan termination date shortens the time frame for participants to establish entitlement to benefits, for benefits to become nonforfeitable, for participants to establish disability, and/or for a plan account to be valued at less than the \$5,000 lump-sum distribution threshold."<sup>274</sup> Essentially, this may lead to a reduction in the amount of benefits for which the PBGC is responsible.<sup>275</sup>

## 2. United Kingdom's PPF and FCF

The PPF was created by the PA 2004 to insure qualified defined benefit pension schemes in case the scheme's sponsoring employer does not have enough assets to meet the obligations to the scheme.<sup>276</sup> The PPF is funded by levies collected from covered schemes, any money borrowed, interest earned from investment of assets, and any amounts recovered, transferred from or repaid from schemes.<sup>277</sup> When the PPF began operating on April 6, 2005,<sup>278</sup> an initial levy on eligible schemes took place to provide preliminary funding.<sup>279</sup> The initial levy was assessed on a per plan basis, determined by the number of participants in the scheme and their status.<sup>280</sup> The levy was £15 for each participant and each retiree, or beneficiary who was collecting a retiree's benefit, and £5 for each deferred member.<sup>281</sup> The initial levy was estimated to bring in about £150 million in funding for the PPF.<sup>282</sup>

Starting in the 2006 financial year, a pension protection levy, consisting of risk-based and scheme-based factors, will be issued yearly to all eligible

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272. THOMSON RIA, *supra* note 108, at 278.

273. *Id.*

274. *Id.* at 278-79.

275. *Id.* at 279.

276. Welcome to PBGC, *supra* note 60.

277. Pensions Act 2004, c. 35, § 173(1).

278. Welcome to PBGC, *supra* note 60.

279. Pensions Act 2004, c. 35, § 174(1).

280. Pension Protection Fund, A Guide to the Pension Protection Levies 2005/06 4, [http://www.pensionprotectionfund.org.uk/guide\\_to\\_levies.pdf](http://www.pensionprotectionfund.org.uk/guide_to_levies.pdf) (last visited Jan. 19, 2008) [hereinafter Guide to Levies].

281. *Id.* at 4. A deferred member is a participant in a scheme "who has rights due to their past pensionable service under the scheme." *Id.* at 11. The amount of the initial levy for deferred members reflects the fact that typically they have a lower vested benefit than other scheme participants. *Id.* at 4.

282. Pension Protection Fund-The Levies, <http://www.pensionprotectionfund.org.uk/index/main-functions/the-levies.htm> (last visited Jan. 20, 2008) [hereinafter PPF Levies].

schemes.<sup>283</sup> The risk-based levy is calculated by taking into account several factors, including:

the difference between the value of a scheme's assets . . . and the amount of its protected liabilities, . . . [as well as] the likelihood of an insolvency event occurring in relation to the employer in relation to a scheme, and . . . if appropriate one or more other risk factors . . . .<sup>284</sup>

Other risk factors could include a possible high risk when comparing the scheme's investments with its liabilities and any other matters the Board of the PPF considers relevant.<sup>285</sup> Schemes are classified as underfunded for purposes of assessing the risk based levy by periodically submitting actuarial valuations and any other requested information that might show the financial health of the scheme to the Board or Pensions Regulator.<sup>286</sup>

Scheme-based levies are determined by examining "the amount of a scheme's liabilities to or in respect of members," and any other factors the Board of the PPF finds relevant,<sup>287</sup> such as: the number of participants or beneficiaries of the scheme; "the total annual amount of pensionable earnings of active members of a scheme[;]" and any other factors the Board may decide to examine.<sup>288</sup> Each year, the Board is required to state factors it will consider when assessing levies, the rate of the levies, the time frame for calculating the levies, and when payment of the levies is due.<sup>289</sup>

However, before the Board sets out these provisions each year, it must determine how much revenue it needs to collect that year to not exceed the "levy ceiling for the financial year."<sup>290</sup> Eighty percent of the estimated pension

283. Pensions Act 2004, c. 35, § 175(1).

284. *Id.* § 175(2)(a).

285. *Id.* § 175(3).

286. *Id.* § 179(1).

287. *Id.* § 175(2).

288. *Id.* § 175(4).

"Pensionable earnings," in relation to an active member under a scheme, means the earnings by reference to which a member's entitlement to benefits would be calculated under the scheme rules if he ceased to be an active member at the time by reference to which the factor within subsection (4)(b) is to be assessed.

*Id.* § 175(8).

289. *Id.* § 175(5).

290. *Id.* § 177(1)-(2). The levy ceiling is set by the Secretary of State before each financial year begins. *Id.* § 178(1). The levy ceiling must "be increased each year by the percentage increase in the level of earnings in Great Britain for the review period." WORK AND PENSIONS, *supra* note 16, § 178 ¶ 652. The review period refers to "the period of 12 months ending with the prescribed date in the previous financial year." Pensions Act 2004, c. 35, § 178(4). However, with the permission of the Board and the Treasury, the Secretary of State can increase the levy ceiling beyond the amount "which exceeds the increase in the level of earnings." *Id.* § 178(8).

levies set for a year must be funded by the risk-based levy.<sup>291</sup> Beginning the second financial year after the initial levy, has been collected, the Board cannot raise a scheme's pension levy by more than 25% of the levy collected the previous year.<sup>292</sup> Finally, an administrative levy was also assessed to help fund the start up and administrative costs for the PPF.<sup>293</sup> The administrative levy is based upon the number of participants in a scheme and a charge per participant is determined.<sup>294</sup>

While the PPF was established to fund pensions schemes where there is "a qualifying insolvency event in relation to the employer and where there are insufficient assets in the pension scheme"<sup>295</sup> to meet the funding requirements of the PPF, the FCF was created "to provide compensation to occupational pension schemes that suffer a loss that can be attributable to dishonesty."<sup>296</sup>

There are several ways that a scheme might qualify for payment from the FCF.<sup>297</sup> First, the FCF will make payments if the scheme's employer has suffered "a qualifying insolvency event, a binding scheme failure notice . . . where a scheme rescue is not possible and a cessation event has not occurred and is not a possibility."<sup>298</sup> The FCF will also make payments if the scheme's sponsoring employer has applied for payment because it "is unlikely to continue as a going concern, the prescribed requirements are met in relation to the employer [as set out by the regulations]," and the Board "has issued a notice . . . confirming that a scheme rescue" is impracticable.<sup>299</sup>

The application for FCF payments must be "made within the period of 12 months beginning with the later of the time of the relevant event, or the time when the auditor or actuary of the scheme, or the trustees or managers, knew or ought reasonably to have known that a reduction of value" had occurred or the Board can grant a longer time frame if they deem it to be appropriate.<sup>300</sup> Even though a scheme may be eligible for fraud compensation payments, the trustees are still required to make reasonable efforts to recover lost assets.<sup>301</sup> The Board will set a timeframe for making payments, while taking into account the

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291. *Id.* § 177(3).

292. *Id.* § 177(5). However, this percentage can be modified by the Secretary of State, so long as the Board "consult[s] appropriate persons before making" that modification. *Id.* § 177(6)-(7).

293. PPF Levies, *supra* note 282. "The initial start up costs will be collected over a three year period." *Id.*

294. Guide to Levies, *supra* note 280, at 7. "Minimum levies are set out so that a scheme with fewer participants has to pay a smaller levy than a scheme with more participants. *Id.* The 2005-2006 minimum levies range from £24, for schemes with 2 to 11 participants, to £10,600, for schemes with 10,000 or more participants. *Id.*

295. PPF Welcome, *supra* note 129.

296. FCF, *supra* note 146.

297. WORK AND PENSIONS, *supra* note 16, § 182 ¶ 661.

298. *Id.* § 182 ¶ 662.

299. Pensions Act 2004, c. 35, § 182(4). The Board's notice must be binding. *Id.*

300. *Id.* § 182(6). A scheme cannot apply for FCF payments once the Board has taken over the scheme. *Id.* § 182(7).

301. *Id.* § 184(1).

likelihood of any more assets being recovered.<sup>302</sup>

The Board will also be responsible for making fraud compensation payments as they deem appropriate;<sup>303</sup> however, the amount cannot “exceed the value of the loss less any recovered funds.”<sup>304</sup> If the responsibility for the scheme has already been taken over by the Board, then the Board would also be entitled to collect fraud compensation payments on behalf of the PPF.<sup>305</sup> Since the Board would stand in the shoes of the trustees, they must also make reasonable efforts to recover any assets<sup>306</sup> and are not entitled to payments that “exceed the value of the loss less any recovered funds.”<sup>307</sup>

Finally, the FCF is funded by income from the fraud compensation levy, interest earned on its assets, and any other amounts transferred, paid or borrowed.<sup>308</sup> A fraud compensation levy is calculated by “tak[ing] into account estimated current and future expenditure as well as actual expenditure already incurred.”<sup>309</sup> All schemes that are eligible to receive payments from the FCF will be required to pay the fraud compensation levy.<sup>310</sup>

### III. COMPARING AND CONTRASTING PENSION REFORM IN THE UNITED STATES AND THE UNITED KINGDOM

#### *A. The United States’ Minimum Funding Contribution and the United Kingdom’s SFO*

While both the minimum funding contribution and the SFO strive to eliminate defined benefit pension plan deficits, the United States and the United Kingdom have taken very different approaches in crafting their solutions.<sup>311</sup> The minimum funding requirement has set out a uniform schedule which requires all plans to become 100% fully funded,<sup>312</sup> while the SFO allows the scheme’s plan sponsor, trustees and actuary to work together with the Pensions Regulator to formulate a custom funding plan.<sup>313</sup>

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302. *Id.* § 184(2).

303. *Id.* § 185(2).

304. WORK AND PENSIONS, *supra* note 16, § 185 ¶ 676. Notice of the Board’s decision regarding fraud compensation payments must be provided to the Pensions Regulator, the scheme’s trustees, and the employer or an insolvency practitioner. Pensions Act 2004, c. 35, § 187(5).

305. Pensions Act 2004, c. 35, § 187(2). Payments made in these situations are known as fraud compensation transfer payments. *Id.*

306. *Id.* § 187(3).

307. *Id.* § 187(5).

308. *Id.* § 188(1).

309. WORK AND PENSIONS, *supra* note 16, § 189 ¶ 692.

310. PPF Levies, *supra* note 282.

311. *See* CCH, *supra* note 85, at 84; *see generally* The Pensions Trust, *supra* note 125.

312. CCH, *supra* note 85, at 95.

313. WORK AND PENSIONS, *supra* note 16, § 220 ¶ 792.

The United Kingdom originally tried to deal with pension scheme deficits by creating minimum funding requirements when it enacted the PA 1995<sup>314</sup> that were similar to the minimum funding contribution required by the United States' PPA 2006.<sup>315</sup> The effects of the minimum funding requirements, however, were considered to "be counterproductive to the extent that it gives trustees a spurious sense of certainty about funding levels and weakens the fiduciary responsibility that should be at the heart of protection for members of defined benefit schemes."<sup>316</sup> The minimum funding requirement has also been called "outdated and inflexible and the timescales for rectifying [the minimum funding requirement] funding shortfalls are arguably overly prescriptive."<sup>317</sup>

It could be argued that the United States' PPA 2006, due to the rigidity of its provisions, is vulnerable to the same problems that caused the criticism, and ultimately the demise, of the United Kingdom's PA 1995.<sup>318</sup> One of the main criticisms of the United Kingdom's PA 1995 was of "its use of a set of reference assets to calculate discount rates for liabilities . . ."<sup>319</sup> The United States' PPA 2006 also requires pension plans to use a statutorily prescribed set of references; for example, the interest rate at which a plan's current liability is determined is a "yield curve" based on investment grade corporate bonds, even though that is not the amount of interest the plan is actually earning on its investments.<sup>320</sup>

Another criticism of the minimum funding standard is that "any fixed standard such as the [minimum funding requirement] is only of limited use."<sup>321</sup>

The United States' PPA 2006 also requires a fixed standard of funding; plan sponsors must fund 100% of their current liabilities,<sup>322</sup> which is problematic because it only records the financial health of the plan at one point in time.<sup>323</sup> However, "financial markets and economic conditions change constantly," so a false sense of security regarding the funding of the pension plan can occur.<sup>324</sup> Finally, the rigid approach required by a fixed standard of funding can encourage plan sponsors to close their defined benefit pension plans.<sup>325</sup>

In contrast, the United Kingdom's PA 2004 requires plan sponsors, trustees, actuaries and the Pensions Regulator to work together to formulate a

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314. The Myners Report, Institutional Investment in the UK: A Review 114 (Mar. 2001), <http://www.hm-treasury.gov.uk/media/1/6/31.pdf> [hereinafter Myners].

315. See generally CCH, *supra* note 40, at 95; Myners, *supra* note 314, at 114.

316. Hymans Robertson, *supra* note 123, at 1.

317. *Id.* at 2.

318. See Myners, *supra* note 314, at 115.

319. *Id.*

320. CCH, *supra* note 40, at 93, 95.

321. Myners, *supra* note 314, at 115. "It simply records that state of the fund at one point in time, but financial markets and economic conditions change constantly." *Id.* Therefore, stating that a fund has met "an annual target can create a misleading sense of security." *Id.*

322. CCH, *supra* note 40, at 95.

323. Myners, *supra* note 314, at 115.

324. *Id.*

325. *Id.*



funding plan that is most advantageous for the goals of the defined benefit pension scheme, as well as the business sponsoring the scheme.<sup>326</sup> However, allowing plans to have this kind of flexibility can culminate in its own set of problems. It is more costly for the plan sponsor and the Pensions Regulator to allow plans to formulate their own SFO. Trouble could also arise for a smaller plan sponsor who may not have sophisticated business people employed and will therefore have to employ additional people besides the trustees to protect the plan sponsor's interest when formulating the SFO. Since the United Kingdom's PA 2004 has been in effect less than two years,<sup>327</sup> it remains to be seen whether the SFO will be more successful in protecting pensions than the United Kingdom's PA 1995.

*B. The United States' PBGC compared and contrasted with the United Kingdom's PPF*

Both the United States and the United Kingdom have a governmental agency, the PBGC and the PPF respectively, which insures defined benefit pension plans so that plan participants do not lose all of their pension benefits in the event their employer becomes insolvent.<sup>328</sup> There are, however, two big differences between the structure of the United States' PBGC and the United Kingdom's PPF. The first difference relates to how the agencies are funded<sup>329</sup> and the second difference involves the function of the agencies.<sup>330</sup>

The United States' PPA 2006 funds the PBGC with a flat rate premium, as well as a variable rate premium assessed to pension plans whose current liabilities are less than 100% funded.<sup>331</sup> Conversely, the United Kingdom's PA 2004 requires that the PPF be funded by assessing risk and scheme based funding.<sup>332</sup> The United Kingdom's PA 2004 also allows the PPF to determine how much revenue they need to generate yearly, though it cannot raise its scheme funded levy by more than 25% of the amount of the levy the previous year.<sup>333</sup> The United States' PPA 2006 sets out a different method of funding for the PBGC, as a set charge per participant is statutorily prescribed.<sup>334</sup> Arguably, allowing the agency that is responsible for insuring pensions to determine its premiums, as the United Kingdom's PA 2004 allows the PPF to

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326. WORK AND PENSIONS, *supra* note 16, § 220 ¶ 792.

327. The Pensions Trust, *supra* note 125. "Most of the provisions are expected to be effective between April 2005 and April 2006." *Id.*

328. Welcome to PBGC, *supra* note 60; Pension Protection Fund- Main Functions, *supra* note 131.

329. CCH, *supra* note 40, at 202-07; FAQs: Pension Protection Levy 2007/08, *supra* note 134.

330. PBGC Who We Are, *supra* note 62; PPF Welcome, *supra* note 129.

331. CCH, *supra* note 40, at 95.

332. Pensions Act 2004, c. 35 § 175(1).

333. *Id.* § 177(5).

334. CCH, *supra* note 40, at 202.

do,<sup>335</sup> is a more prudent way to generate revenue for that agency than by allowing Congress to determine the revenue, as the United States' PPA 2006 does for the PBGC.<sup>336</sup> However, allowing the United Kingdom's PPF to determine how much revenue it needs to generate,<sup>337</sup> then collecting different designated amounts from each pension scheme is more complicated and likely more costly than charging a flat rate per participant.<sup>338</sup> Finally, both the United States' PPA 2006 and the United Kingdom's PA 2004 do assess a risk based premium, so that pension plans that are more likely to terminate, and thus be taken over by the appropriate agency, are paying a higher premium than pension plans that pose less risk of being taken over.<sup>339</sup>

Finally, while the United States' PBGC was created to protect pension income for pension plan participants, the United Kingdom's PA 2004 has broken up this function into two different agencies. The United Kingdom's PA 2004 created both the PPF, to insure against a "qualifying insolvency event,"<sup>340</sup> and the FCF, which protects against losses "that can be attributable to dishonesty."<sup>341</sup> While it is interesting that the United Kingdom's PA 2004 created these agencies to address two different types of funding problems, to address employer insolvency and underfunding due to dishonesty, the two agencies still work together to insure pension benefits and recover lost assets.<sup>342</sup>

It is debatable that two agencies are needed to address this problem, especially when they work closely together. Having two agencies insuring pensions, albeit against different types of losses, creates more government bureaucracy and could potentially cause delay if it was unclear why the loss to the pension plan occurred. Finally, it should not matter what specifically caused the loss, as the most important factor is that pension plan participant benefits are insured.

#### IV. OTHER SOLUTIONS TO PENSION DEFICITS

##### *A. Funding Pensions*

The defined benefit plan has serious design flaws that may not be corrected by the PPA 2006. Since these plans are heavily influenced by market forces, such as interest rates and the stock market, it is very difficult to make accurate actuarial assumptions when trying to fund defined benefit plans. The United States should consider adopting a more plan specific funding requirement, like the United Kingdom has recently done through the PA 2004.

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335. Pensions Act 2004, c. 35, § 177(5).

336. CCH, *supra* note 40, at 202.

337. Pensions Act 2004, c. 35, § 177(5).

338. CCH, *supra* note 40, at 202.

339. *Id.* at 203-05; Pensions Act 2004, c. 35, § 175.

340. PPF Welcome, *supra* note 129.

341. FCF, *supra* note 146.

342. Pensions Act 2004, c. 35, § 188.

This would enable employers to tailor their funding plan in a way that would allow them to take into account circumstances that impact them in particular. Allowing employers to have more control over their funding requirements would also prevent Congress from having to write legislation to address industry specific problems, as it did for the airline industry in the PPA 2006. Though allowing plan sponsors to customize their own funding plans would be more costly to both the plan and the entity that approved the plans, ultimately the benefits of allowing plans to take ownership in their funding plans would be worth the extra administrative cost.<sup>343</sup>

It is very important to recognize that there are no perfect solutions for pension reform. There are always risks involved with pension plans and those risks must be balanced between the plan sponsor and the plan participant. The two risks most emphasized in this Note are again, the risk of longevity, meaning that a participant might outlive their retirement benefits,<sup>344</sup> and the risk of investment, which refers to who bears the risk or reward of investment choices.<sup>345</sup> When examining pension reform, deciding whether a reform is feasible is often a matter of determining who can best bear these risks.

Ultimately, employers should stop opening and funding defined benefit plans. Due to people living substantially longer, it is unrealistic for an employer to think that they will be able to provide retirement income to an employee for their entire retired lifetime. Other countries, for example Mexico, have instituted reform that created a new entity that dealt directly with employee's retirement funds, cutting out the employer entirely.<sup>346</sup> Therefore, a possible solution is to implement a centralized federal retirement plan for all American workers, like Mexico has done.

Having a government administered centralized plan for all American workers has several advantages. First, the government is better able to fund pension administration costs and is more secure than a private employer, as it is less likely to go out of business. The longevity and centralization of using the government, rather than an employer, is much better suited to funding pensions for a person's lifetime. A system could be established that would require employees to contribute a certain amount of their earnings to these individual government funds. These types of plans are better for helping employees amass retirement wealth because unlike 401(k) contributions, these contributions would be mandatory.

There would also not be a problem with employees losing track of their retirement funds after switching jobs or with having to wait a certain amount of

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343. Currently, the Department of Labor (DOL) polices whether employers are following ERISA rules. See Department of Labor, <http://www.dol.gov/opa/aboutdol/mission.htm> (last visited Jan. 20, 2008). Therefore, the DOL is the logical choice to assume the duties the Pensions Regulator assumes for plans in the United Kingdom.

344. See *supra* pp. 2-3 and note 15.

345. See *id.* pp. 2-3 and notes 13, 14.

346. Rankin, *supra* note 164.

time before being allowed to participate in the employer's retirement plan. Both of these problems are becoming more common in a society where employees switch jobs more and more frequently.<sup>347</sup> Administrative costs would also be less than in a defined benefit plan or even a defined contribution plan, as the employer would just send the government the money it withheld from its employees' earnings. This is something employers are used to doing, since they do this already for tax withholding. This solution, however, also has several problems. First, this type of government run system is very similar to social security. While each employee would have their own individual account, unlike social security, it is still possible that the government could "borrow" from these accounts, in the same manner that it is "borrowing" from social security.<sup>348</sup> This could lead to funding shortfalls in the long term, which is also a problem social security is currently facing.<sup>349</sup> Second, it is a very paternalistic solution that would shift the burden of administering retirement plans to the government. Finally, unlike a defined benefit plan, employees would only get their contributions plus earnings, which will not ensure they will have a steady retirement income throughout their retirement years.

A better alternative is to allow employers to continue to fund retirement plans for employees; however they should move toward the defined contribution model. Most importantly, since the plan participant's retirement lifestyle will be dependent upon their retirement benefit or lack thereof, the participant ultimately should be responsible for bearing the risk of longevity and investment. One possible solution already in existence is a money purchase plan. A money purchase plan requires that the sponsoring employer make a minimum contribution each year.<sup>350</sup> For example, an employer could decide that they would implement a money purchase plan that would contribute 5% of every employee's compensation each year.<sup>351</sup> One way a money purchase plan differs from defined benefit plan is that the employer puts the contribution into individual accounts designated for each participant, rather than into a general pool for all the participants.<sup>352</sup> Contributions to money purchase plans are subject to ERISA's vesting rules, since they are funded by employer

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347. A worker who changes jobs more frequently and is required to sit out a year before being eligible to participate in a 401(k) plan, which is the maximum allowed under ERISA, can significantly decrease the amount a worker can save for retirement. *MEDILL*, *supra* note 13, at 120. *See also* 29 U.S.C. § 1053(b)(1) (2000).

348. *See* CNN, *CBO: Social Security Funds Needed to Balance the Books*, Aug. 29, 2001, <http://archives.cnn.com/2001/ALLPOLITICS/08/28/budget/>.

349. *MCGILL ET AL.*, *supra* note 20, at 50-51.

350. Internal Revenue Service, *Choosing a Retirement Plan: Money Purchase Plan*, <http://www.irs.gov/retirement/article/0,,id=108949,00.html> (last visited Jan. 20, 2008) [hereinafter *IRS*]. This yearly required minimum contribution is the reason that a money purchase plan was suggested instead of other defined contributions plans like profit sharing or 401(k) plans. *Id.* A required employer contribution means that all plan participants, even those who cannot or will not contribute themselves, still receive a retirement benefit. *Id.*

351. *Id.*

352. *CANAN*, *supra* note 27, at 294.

contributions.<sup>353</sup> Money purchase plans can be set up by any employer, including employers who already sponsor other types of retirement plans.<sup>354</sup> Finally, because “pre-approved money purchase plans are available” administering these types of plans can be relatively simple.<sup>355</sup>

Since the contributions to the participants’ accounts would be participant directed, meaning the participants would be responsible for choosing the investment vehicle for their own account, the participants will need some investment education to help them make an informed decision.<sup>356</sup> The PPA 2006 has addressed this issue and provides that qualified

“fiduciary advisers” can offer personally tailored professional investment advice . . . pursuant to “eligible investment advice arrangement” under which (1) portfolio recommendations are generated for a participant based on an unbiased computer model that has been certified and audited by an independent third party, or (2) fiduciary advisers provide their investment advice services by charging a flat fee that does not vary depending on the investment option chosen by the participant.<sup>357</sup>

Now, employers can also provide investment information such as: “plan information; general financial and investment information; asset allocation models; and interactive investment materials” without acquiring liability as investment advisors.<sup>358</sup>

Replacing defined benefit plans with money purchase plans would solve many of the problems that defined benefit plans are currently facing. The participant should bear the risk of investment, as only they know what goals they have for retirement. Allowing the participant to bear the risk of investment enables the participant to benefit from gains on his or her investment and to

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353. MCGILL ET AL., *supra* note 20, at 108. The PPA 2006 expanded the accelerated vesting schedule that applied to employer matching contributions to all employer contributions in defined contribution plans. CCH, *supra* note 40, at 272. If a plan uses cliff vesting, all participants must be fully vested in all employer contributions by the end of their third year of service. *Id.* at 274. Plans using graduated vesting must vest participants in all employer contributions “at the rate of 20% per year, beginning with the second year of service.” *Id.* “The faster vesting schedules may increase an employer’s cost of maintaining a defined contribution plan because they may decrease forfeitures that could otherwise be used to pay administrative expenses or reduce future employer contributions.” *Id.*

354. MCGILL ET AL., *supra* note 20, at 108. Unlike other retirement plan types, there are no restrictions on the size of an employer who sponsors a money purchase plan. *Id.*

355. *Id.*

356. 29 U.S.C. § 1104(c) (2003).

357. CCH, *supra* note 40, at 236. While many companies already provided investment education materials to their plan participants, there has been concern that providing specific advice would violate ERISA’s fiduciary liability rules. *Id.* at 238.

358. *Id.* at 238.

plan accordingly for retirement based on his or her account balance. A money purchase plan has individual accounts for each participant, so it is much easier for the participant to monitor the health of his or her retirement benefit than with a defined benefit plan.<sup>359</sup> Having individual accounts also makes it easier for the participants to understand how their retirement benefit accrues, as many employees have no idea due to the complexity of the benefit accrual formulas.<sup>360</sup>

Defined benefit pension plans do not always provide the benefit that the employee thinks it will, especially if the PBGC takes over the plan.<sup>361</sup> It is extremely important for plan participants not to be disillusioned about the benefits they should expect to receive at retirement, so that they can plan accurately for retirement.

Another benefit is that once an employee has a vested balance in the money purchase plan, that vested balance can be portable.<sup>362</sup> If the plan allows, the participant can rollover their vested balance to an individual retirement account or possibly to their new employer's retirement plan when they terminate service with their previous employer.<sup>363</sup> Portability is increasingly more important in our society where people switch jobs with more regularity than in previous years.<sup>364</sup> Defined contribution plans, such as money purchase plans, are also less expensive to administer than defined benefit plans, because no actuarial assumptions are required to predict how much money will be needed in the future. Finally, since employer contributions must be made each year, a funding shortfall is less likely to occur with a money purchase plan, than with a defined benefit plan.<sup>365</sup>

While money purchase plans could solve some of the problems defined benefit plans are facing, there are several disadvantages to money purchase plans as well. Since money purchase plans are defined contributions plans, the benefit the employee receives is only the account balance plus earnings, rather

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359. It is often difficult for employees to monitor the health of their pension plan, as often companies do not want to provide current information about the pension plan. Schultz & Francis, *supra* note 2, at A1. The PPA 2006 requires that a benefits statement must be provided "at least once each calendar quarter to each participant or beneficiary who has the right to direct the investment of assets in his or her account under the [defined contribution] plan . . ." CCH *supra* note 40, at 231.

360. MEDILL, *supra* note 13, at 110.

361. *See supra* note 74.

362. MEDILL, *supra* note 13, at 109. While pension plans can be written so that a plan participant can receive payment of their pension benefits when they terminate service with his or her employer, it can also be written so that plan participants cannot receive their pension benefits until normal retirement age. 26 U.S.C. § 401(a)(14) (2000).

363. MEDILL, *supra* note 13, at 109.

364. "Part of [the defined contribution plans] appeal has been that a more mobile workforce can take their benefits with them as they hop from job to job." Byrnes, *supra* note 1.

365. MEDILL, *supra* note 13, at 107. The Internal Revenue Code imposes an excise tax on employers who do not meet "the amount dictated by the terms of the plan document." *Id.* at 107-08. *See also* 26 U.S.C. §§ 412(a), 4971 (2000).

than an annuity payment each month as provided by a defined benefit plan.<sup>366</sup> This means that the risk of longevity is shifted to the participant and they bear the risk that they will out live the account balance in their money purchase plan account.<sup>367</sup> Since it would be the participant's responsibility to invest the money according to their retirement goals, the participants also stand to lose retirement assets, if their investment strategy does not provide adequate returns.<sup>368</sup> Finally, elderly workers will not benefit as much from a money purchase plan as younger workers would, mainly because they have fewer years to earn interest on the money in their accounts.

### *B. Insuring Pensions*

It is very important that the United States' PBGC is adequately funded so that they can meet their liabilities.<sup>369</sup> Even if no new defined benefit plans are opened and all the existing plans are closed today, the PBGC is still responsible for the liabilities they have already taken on, even though the liabilities may not become payable for many years in the future. The United States' PPA 2006 requires employers with at-risk plans to pay a premium based on the amount of risk the employer's plan has of transferring liabilities to the PBGC.<sup>370</sup> These statutes force plans that are more likely to be taken over by the PBGC to help fund the risk that they are creating.<sup>371</sup> Requiring at-risk plans to help defray any future costs the plans may have is a prudent move. However, since the method by which the risk-based premium is calculated has recently changed,<sup>372</sup> only

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366. IRS, *supra* note 350; *but see* U.S. GOV'T ACCOUNTABILITY OFF., REPORT TO CONGRESSIONAL REQUESTERS: PRIVATE PENSIONS PARTICIPANTS NEED INFORMATION ON RISKS THEY FACE IN MANAGING PENSION ASSETS AT AND DURING RETIREMENT 13 (2003) (finding that plan sponsors are offering lump sum payments as an option in pension plans because employees "generally prefer them to annuities.").

367. *See supra* pp. 2-3 and notes 13, 15.

368. *Id.* at pp. 2-3 and notes 13-14.

369. *But see* Richard A. Ippolito, *How to Reduce the Cost of Federal Pension Insurance*, POL'Y ANALYSIS, No. 523, Aug. 24, 2004, at 13-15, available at <http://www.cato.org/pubs/pas/pa523.pdf> (last visited Jan. 20, 2008). Ippolito, who formerly served as the PBGC's chief economist, argues "that Congress [should] convert defined benefit pension insurance from a government sponsored and guaranteed program to a private pooling mechanism, through which all plan sponsors would collectively bear the risk of an individual plan sponsor's termination and market and sponsor-specific factors would set premiums." BRANNICK, *supra* note 76, at 1617. The PBGC would be terminated after the federal government made up the difference between the PBGC's assets and its liabilities. *Id.* Then "plan sponsors would belong to a self-insurance pool that would have a governing board to set premiums and policy." *Id.* Eventually, plan sponsors could opt out of the self-insurance pool by obtaining private insurance. *Id.* "Sponsors of underfunded plan will then have an interest in reducing their reliance on payments from well-funded plans so as to keep them as a source of some help in solving the underfunding problem." Ippolito, *supra*, at 14.

370. CCH, *supra* note 40, at 203-05.

371. *See* Brannick, *supra* note 76, at 1618.

372. The risk based premiums for the PBGC are effective "[f]or plan years beginning after 2007." THOMSON RIA, *supra* note 108, at 270.

time will tell if the revenue from these premiums is sufficient to meet future liabilities.

While increasing revenues will help defray the costs of insuring defined benefit pension plans, it still may not be enough to make up for the increasing liabilities the PBGC is incurring.<sup>373</sup> The increase in premiums for cash strapped employers may be the final straw and could encourage employers to terminate their plans, "rather than continuing to make contributions and pay[ing] high premiums."<sup>374</sup> Finally, increasing premiums may not generate enough revenue to cover liabilities.

One alternative, suggested in a student note, is a "mandatory allocation of 20 percent of an individual's defined benefit pension funds, to be put into a low-risk [Federal Depository Insurance Corporation] FDIC insured [Individual Retirement Account] IRA."<sup>375</sup> The FDIC is similar to the PBGC, in that it is a nonprofit government organization, but "the FDIC insures deposits if the bank becomes insolvent."<sup>376</sup> Moving a portion of the defined benefit plan's assets to an FDIC insured IRA requires the employer to shift "assets into a low-risk investment."<sup>377</sup> This would help ensure that guaranteed income can be paid to the participants during their lifetime, which is the primary goal of a defined benefit pension plan.<sup>378</sup> This security is achieved by shifting "the excessive burden of underfunded and unfunded pension plans away from the PBGC and onto the FDIC."<sup>379</sup> Since FDIC insured IRAs are a low-risk investment they "will increase or maintain a safe level of earnings for the employer in the long-run" and will also prevent employers from "taking unreasonable investment risks at the cost of the employee."<sup>380</sup> Since the PBGC will not have to insure the funds in the FDIC insured IRAs, it could instead focus these resources on its deficit.<sup>381</sup>

This solution is not ideal, as shifting such a small portion of the burden of insuring pension plans to the FDIC does not really address the funding problems that the PBGC is facing. First, this suggestion requires the employer to create a second pension plan called a simplified employee pension (SEP) plan.<sup>382</sup> SEP plans consist of "IRAs that are set up and financed for each

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373. In January 2007 alone, the PBGC assumed responsibility for the pension plans of Kaiser Aluminum & Chemical, Venture Holdings Corp and Foss Manufacturing, as well as became trustee for the Delta Pilots Pension Plan. PBGC 2007 News Releases Index, <http://www.pbgc.gov/media/news-archive/news-releases/2007/index.html> (last visited Jan. 20, 2008). Those plans have a combined shortfall of \$3.03 billion, though the PBGC will not have to make up for the entire amount of the shortfall. *Id.*

374. Brannick, *supra* note 76, at 1618.

375. Czarney, *supra* note 47, at 191.

376. *Id.* at 187. Note FDIC insurance only covers \$100,000 per depositor. *Id.*

377. *Id.* at 186.

378. *Id.*

379. *Id.* at 191.

380. *Id.* at 192.

381. *Id.*

382. *Id.* at 188.



individual employee by the employer.”<sup>383</sup> This means that administration costs for the plan sponsor will increase, as they must now maintain a SEP plan and a defined benefit plan. Also, since the assets will no longer be considered part of the defined benefit pension plan, the PBGC will no longer be responsible for insuring them. Therefore, it will not really lessen the PBGC’s burden, as the PBGC is still responsible for guaranteeing participant’s remaining accrued benefit in the defined benefit plan.<sup>384</sup>

Second, moving a portion of the plan’s assets into low-risk FDIC insured IRAs could also subject the rest of the pension plan’s assets to more risky investments, since the rest of the assets will need to earn greater returns to make up for the small returns that the assets in the low-risk IRAs are earning. In a volatile investment market, this could expose the pension plan to large losses, which could exacerbate existing underfunding. Finally, using the FDIC to insure a portion of the plan assets fails to bring more revenue into the PBGC, which is needed to fund liabilities the PBGC has already incurred.

Many people have suggested over the years that the PBGC be given some sort of lien priority status.<sup>385</sup> Professor Daniel Keating has proposed that “no assets of a company with a terminated pension program be transferred until the reimbursement claim of the PBGC is satisfied fully.”<sup>386</sup> This would give the PBGC priority over even secured creditors, which would help ensure the security of the participant’s pensions.<sup>387</sup> It would also prevent sponsoring employers from dumping their pension obligations on the PBGC and gaining a competitive edge over their competitors who are still funding their pensions.<sup>388</sup>

Another solution, proposed in a student note, is “that the PBGC’s lien against employers with unfunded or underfunded defined benefit pension plans should receive an eighth priority status under § 507(a)(8) of the Bankruptcy Code of 1978.”<sup>389</sup> Allowing the PBGC to have lien priority status would make employers more accountable for promises that they make to employees by forcing the plan sponsor, and not the PBGC, to fund the pension liabilities.<sup>390</sup> The burden of policing plan sponsor debt would also shift to the plan sponsor’s creditors, since the lien priority status of the PBGC would make it less likely that a creditor could recover amounts loaned to the plan sponsor in the event of plan sponsor insolvency.<sup>391</sup>

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383. *Id.* at 188-89.

384. *See supra* p. 12 and note 77.

385. *See generally* Daniel Keating, *Pension Insurance, Bankruptcy and Moral Hazard*, 1991 WIS. L. REV. 65 (1991); Uylaki, *supra* note 17; Brannick, *supra* note 76 (discussing various ideas as to how the PBGC could obtain more assets from plan sponsors going through bankruptcy).

386. Keating, *supra* note 385, at 100.

387. *Id.* at 101.

388. *Id.* at 101-02.

389. Uylaki, *supra* note 17, at 110.

390. *Id.* at 77.

391. *Id.* at 111.

Finally, another student note suggested that a floating lien mechanism be created to protect the PBGC.<sup>392</sup> This would enable the PBGC

to perfect a lien against employers in the amount by which minimum funding contributions prove inadequate (in light of market realities) at the end of each tax year, [then] the PBGC would not be left with a wholly unperfected security interest when an employer files Chapter 11 [bankruptcy] and then seeks to terminate its pension plan.<sup>393</sup>

Under this theory, the PBGC would establish reasonable actuarial assumptions for a group of comparable employers and then determine how ERISA should be amended to enable the PBGC "to perfect a lien against the assets of those who fail to meet minimum funding standards at the end of each taxable period, and by moving the power to grant waivers for minimum funding from the IRS to the PBGC, which actually bear the risk of allowing such waivers."<sup>394</sup>

Since the new risk-based premiums set out by the PPA 2006 will not be in effect until the 2008 plan year,<sup>395</sup> it is difficult to predict if these premiums will significantly boost the PBGC's revenues. However, given the amount of liabilities the PBGC is now responsible for,<sup>396</sup> the premiums likely will not be enough on their own to significantly increase revenues. Therefore, Congress should consider granting the PBGC one of the priority lien status proposals previously mentioned.<sup>397</sup> This will also make plan sponsors more accountable and could in the long run deter plan sponsors from making decisions that will ultimately lead to their pension plans being taken over by the PBGC. Allowing the PBGC to have priority lien status in conjunction with the new risk based premiums will help shore up the finances of the PBGC by bringing in significant amounts of revenue.

## V. CONCLUSION

Underfunded defined benefit pensions are a problem in both the United States and the United Kingdom. Within the last two years, both of these countries have enacted statutes to try to repair underfunded pensions, though in very different ways. The United States enacted more stringent requirements for

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392. Brannick, *supra* note 76, at 1623.

393. *Id.* at 1621.

394. *Id.*

395. CCH, *supra* note 40, at 203.

396. "As of September 30, 2005, the end of the 2005 fiscal year, PBGC reported a \$22.8 billion deficit in the financial statements for its single-employer pension insurance program." PBGC Understanding the Financial Condition of the Pension Insurance Program, <http://www.pb.gc.gov/media/key-resources-for-the-press/content/page15247.html> (last visited Jan. 20, 2008).

397. See *supra* notes 333-42 and accompanying text.

funding, while the United Kingdom took a more flexible, plan specific approach. Both countries should also consider establishing lien priority status for the PBGC, PPF and FCF. This could help these agencies meet their future funding requirements, even if defined benefit plans become obsolete and the agencies do not take responsibility for additional plans. Only time will tell if these approaches can succeed in curbing pension underfunding; however, both countries should monitor the other's progress, as predicting the effectiveness of either solution to pension underfunding is difficult.

Ultimately, defined benefit plans are facing a bleak future in their current state.<sup>398</sup> It is of utmost importance that employers do not promise pension plan participants retirement benefits that they will be unable to provide. The best solution for both employers and employees is to move toward funding individual accounts with employer money. While moving from a defined benefit pension model to a defined contribution model will shift the risk of investment and longevity to the participant, the participant is the party who is best situated to ensure that these risks are managed in a way that is appropriate for their retirement.

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398. MCGILL ET AL., *supra* note 20, at 96.

