

COMMENT

TOO LITTLE, TOO LATE: WHY THE PENSION PROTECTION ACT OF 2006 WILL NOT LIVE UP TO ITS NAME*

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I. INTRODUCTION

Failure by Congress to ensure adequate funding of America’s pension system over the last forty years resulted in spectacular defaults on pension promises made to retirees.¹ Regulations permitting plan sponsors to underfund their pension plans, in concert with U.S. bankruptcy laws giving little protection to pension plans, have stripped retirees of the financial security they contemplated for their golden years.² Factors contributing to the pension failure include funding rules that bear little relationship to economic reality,³ high

1. See *infra* notes 4, 9–12 and accompanying text (documenting the bankruptcies of Bethlehem Steel, WorldCom, United Airlines, and Delta).

2. See Donald L. Barlett & James B. Steele, *The Broken Promise*, TIME, Oct. 31, 2005, at 32, 34–38 (giving an example of one retiree who, after losing the pension benefits promised to her, now collects and sells recyclable cans to help pay her medical bills).

3. *Id.* at 44 (“[P]ension accounting has a lot in common with Enron accounting, but with one exception: it’s perfectly legal.”). Since the Barlett & Steele article was written, the Financial Accounting Standards Board (FASB) has issued Statement of Financial Accounting Standards (SFAS) No. 158, requiring companies to include the amount of pension underfunding or overfunding as a liability or asset, respectively, on the firm’s balance sheet. FIN. ACCOUNTING STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING

legacy costs in many mature industries,⁴ and recent low investment returns.⁵

In addition, Congress asked the Pension Benefit Guaranty Corporation (PBGC)⁶ to do too much with far too few resources. Congress mandated that the PBGC: (1) “encourage the continuation and maintenance of voluntary private pension plans for the benefit of their participants”; (2) “provide for the timely and uninterrupted payment of pension benefits”; and (3) “maintain premiums . . . at the lowest level consistent with carrying out its obligations.”⁷ The tension between these policy goals, coupled with the inadequate tools Congress gave the PBGC to carry out its mandate, caused the agency to fail in its role as guardian of America’s pension plans.⁸

Against the backdrop of spectacular plan failures at WorldCom,⁹ United Airlines,¹⁰ Delta,¹¹ and others,¹² Congress

STANDARDS NO. 158: EMPLOYERS’ ACCOUNTING FOR DEFINED BENEFIT PENSION AND OTHER POSTRETIREMENT PLANS (2006), available at <http://www.fasb.org/pdf/fas158.pdf> [hereinafter SFAS NO. 158]. This rule will drastically affect the amount of owner’s equity a firm reports. For example, General Motors calculates that, when SFAS NO. 158 goes into effect, its shareholder’s equity will decrease by an *after tax* amount of \$18 billion to \$25 billion. Gen. Motors Corp., Quarterly Report (Form 10-Q), at 10 (Nov. 7, 2006), available at <http://www.sec.gov/Archives/edgar/data/40730/000095012406006514/k09170e10vq.htm>. On Sept. 30, 2006, GM had \$11.1 billion in total stockholder’s equity. *Id.* at 5.

4. For example, at the time it declared bankruptcy and terminated its pensions, Bethlehem Steel had an active workforce of 12,000 employees to support 95,000 retirees. See Mary Williams Walsh, *Whoops! There Goes Another Pension Plan*, N.Y. TIMES, Sept. 18, 2005, § 3, at 1 (quoting Thomas Conway, vice president of the United Steel Workers of America, “It just staggers us that America’s not caught on to what’s happening to it. . . . Here’s Ford and General Motors, now competing against a lot of U.S.-based transplant companies that have no obligations to any work force. . . . That’s a tremendous advantage. How does a mature American industry that has obligations to its work force compete with that?”).

5. The Dow Jones Industrial Average has averaged a 5.47% annualized return for the past decade. See Dow Jones Indexes, <http://djindexes.com/mdsidx/> (last visited Apr. 11, 2008) (annualized return information changes monthly; the data given is as of March 31, 2008).

6. Created in 1974 by the Employee Retirement Income Security Act of 1974 (ERISA), Pub. L. 93-406, 88 Stat. 829 (codified at 29 U.S.C. §§ 1001–1461 (2000)), the PBGC operates as a self-funding government-owned insurer of defined benefit pension plans. Pension Benefit Guaranty Corporation, Who We Are, <http://www.pbgc.gov/about/about.html> (last visited Apr. 11, 2008).

7. 29 U.S.C. § 1302(a)(1)–(3) (2000).

8. See U.S. GOV’T ACCOUNTABILITY OFFICE, GAO-05-294, PRIVATE PENSIONS: RECENT EXPERIENCES OF LARGE DEFINED BENEFIT PLANS ILLUSTRATE WEAKNESSES IN FUNDING RULES 37–39 (2005) [hereinafter GAO FUNDING REPORT] (discussing the competing policy goals that have deterred adequate pension funding).

9. See Luisa Beltran, *WorldCom Files Largest Bankruptcy Ever*, CNNMONEY.COM, July 22, 2002, http://money.cnn.com/2002/07/19/news/worldcom_bankruptcy/ (detailing the bankruptcy of America’s then-No. 2 long distance carrier, WorldCom).

10. *United Airlines Files for Bankruptcy*, BBCNEWS.COM, Dec. 9, 2002, <http://news.bbc.co.uk/2/hi/business/2556225.stm> (describing the bankruptcy of the world’s then-No. 2 airline, United Airlines).

11. See *infra* notes 27–28 and accompanying text (discussing Delta’s recent plan termination).

12. See *supra* note 4 (discussing the bankruptcy of Bethlehem Steel).

enacted the Pension Protection Act of 2006 (PPA 2006) to remedy the chronic problems of underfunded pension plans.¹³ Unfortunately, despite its name and stated purpose, PPA 2006 “would not pass a truth in advertising test.”¹⁴ While it improves funding requirements¹⁵ and plan transparency,¹⁶ PPA 2006 does not encourage companies to offer pensions;¹⁷ it instead leads to a net decrease in funding for the first five years after its enactment,¹⁸ relaxes funding requirements for airlines that urgently need to improve the health of their pensions,¹⁹ and does nothing to prevent the termination of pensions in bankruptcy.²⁰

The lack of any reform for the process by which plan sponsors discharge pension obligations through bankruptcy proceedings represents perhaps the most important failure of the PPA 2006 to protect pension plans and their beneficiaries.²¹ Of the \$350 billion of underfunding in America’s single-employer pension plans reported by plan sponsors to the PBGC in 2006, \$73 billion came from below investment-grade²² companies for whom the PBGC believes a plan termination is “reasonably possible.”²³ Companies

13. Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat. 780 (purporting “[t]o provide economic security for all Americans . . .”).

14. See Marie Cocco, *Pension Act Won’t Resolve Anything*, TIMES UNION (Albany, N.Y.), Aug. 7, 2006, at A9 (describing the PPA as a “remarkable feat of legislative engineering, with all the strength of a New Orleans levee”).

15. See *infra* Part V.A (discussing three specific ways in which the act strengthens funding requirements).

16. See *infra* Part V.D (describing how the act changes asset and liability value calculations to increase transparency).

17. See *infra* note 214 and accompanying text (noting that pension regulation reform might actually discourage companies from offering pensions).

18. See *infra* note 242 and accompanying text (discussing Congressional Budget Office predictions regarding pension contributions).

19. See *infra* Part V.A.4 (describing specialty provisions for the airline industry that do not protect the solvency of its pension plans).

20. See Cocco, *supra* note 14 (stating that the PPA 2006 does nothing to prohibit companies from terminating their pension plans in bankruptcy, thereby passing responsibility to the PBGC for payment of the pensions).

21. See *id.* (labeling the practice of shedding pension responsibilities through bankruptcy as an “obnoxious corporate strategy”).

22. Standard & Poor’s (S&P) quantifies credit ratings using a letter grade scale, ranging from AAA to D. Standard & Poor’s Rating Definitions, <http://www2.standardandpoors.com/portal/site/sp/en/us/page/article/2,1,1,4,1204834067208.html> (last visited Apr. 11, 2008). S&P considers a firm rated below BBB- speculative, and a firm BBB- or above “investment grade.” See *Making the Investment Grade*, BUS. WK. ONLINE, Dec. 19, 2005, http://www.businessweek.com/investor/content/dec2005/pi20051216_8541_pi083.htm (noting that S&P refers to its investment grade credit issuers as “rising stars”).

23. PENSION BENEFIT GUAR. CORP., ANNUAL MANAGEMENT REPORT: FISCAL YEAR 2006, at 15 (2006), available at <http://www.pbgc.gov/docs/2006AMR.pdf>. The problems of the private sector pension industry appear relatively tame when compared to those facing

facing financial difficulty prefer not to terminate their pensions while still solvent, but instead wait until they are within the more favorable confines of bankruptcy proceedings.²⁴ Choosing this path allows plan sponsors to shift responsibility for their workers' retirement security to the PBGC, while concurrently unlocking substantial value in the bankrupt firm.²⁵ This surprisingly legitimate turnaround strategy often proves irresistible to corporate managers.²⁶ Most recently, Delta Airlines unloaded the pensions of 13,000 current and former pilots onto the PBGC.²⁷ The plan contained only \$1.7 billion in assets to fund \$4.7 billion in liabilities—constituting a 64% shortfall—of which the PBGC must pay \$920 million.²⁸ Pilots will never receive the balance of roughly \$2.08 billion, or \$160,000 per person.²⁹ Free of its retirees, Delta has become so attractive³⁰ that rival US Airways, which itself only recently emerged from its second trip through bankruptcy,³¹ raised its hostile bid to take over Delta by almost 20% to \$10.2 billion.³²

public pensions given to city, state, and federal employees. Barclays Global Investors estimated in 2005 that U.S. public employee pension funds are underfunded by \$700 billion nationwide. Donald L. Barlett & James B. Steele, *Where Pensions are Golden*, TIME, Oct. 31, 2005, at 34, 34. For example, the State of Illinois was underfunded by \$43.1 million in 2004, nearly twice the state's annual budget. *Id.* at 35. In contrast to private pensions, courts generally uphold the promises made to public employee pensioners. *Id.*

24. See *infra* notes 245–46 and accompanying text (arguing that voluntary plan termination would prove too costly for unhealthy firms outside the bankruptcy framework due to the more conservative investment return assumptions used by private insurers compared to plan sponsors).

25. See *infra* Part II (explaining how firms shed pension assets through bankruptcy).

26. Cf. Nanette Byrnes, *The Coming Pensions Crunch*, BUS. WK. ONLINE, Sept. 15, 2004, http://www.businessweek.com/bwdaily/dnflash/sep2004/nf20040915_8863.htm (quoting the PBGC's Executive Director, Bradley Belt, "Bankruptcy should not be the path of least resistance to deal with your pension obligations.").

27. Press Release, Pension Benefit Guar. Corp., PBGC Becomes Trustee of Delta Pilots Pension Plan (Jan. 5, 2007), <http://www.pbgc.gov/media/news-archive/news-releases/2007/pr07-09.html>.

28. *Id.*

29. See *id.*

30. See Mary Williams Walsh, *Offer for Delta Raises Questions on Some Pensions*, N.Y. TIMES, Nov. 17, 2006, at C2 (stating that Delta might be more attractive without its pension obligation).

31. See *US Air Files for Bankruptcy*, CNNMONEY.COM, Aug. 12, 2002, <http://money.cnn.com/2002/08/11/news/companies/usair/> (describing US Airways' 2002 bankruptcy in the wake of its filing). Ironically, US Airways itself caused the second largest pension default ever at the time of its own reorganization, changing its cost structure to the tune of \$3 billion and giving it the financial strength to bid for Delta. See Press Release, Pension Benefit Guar. Corp., PBGC Takes \$2.3 Billion Pension Loss from US Airways (Feb. 2, 2005), <http://www.pbgc.gov/media/news-archive/news-releases/2005/pr05-22.html> (announcing that the PBGC "assumed responsibility for the pensions of more than 51,000 flight attendants, machinists and other employees of US Airways").

32. *'Let's Make a Deal' Starts a New Season*, WASH. POST, Jan. 14, 2007, at F2.

Secured and priority creditors, debtor-in-possession financiers, and subsequent purchasers of bankrupt firms' assets receive the greatest benefit from current bankruptcy law permitting firms to make no allowance for their pension plans while reorganizing.³³ This statutory loophole in bankruptcy law allows *voluntary* creditors such as banks to "jump the line" and get paid back before pension plan participants.³⁴ Most pensioners of bankrupt firms likely never realized that they, in effect, loaned their plan sponsors money by deferring part of their compensation in return for a promise of secure retirement income.³⁵ One commentator argues that the ability of a firm to discharge its pension obligations onto the PBGC and emerge from bankruptcy as a going concern resembles "paying life insurance benefits to individuals who are in poor health but not necessarily fatally ill."³⁶

This Comment seeks to explain the shortcomings of pension regulation, trace the effects of these shortcomings on pension plan funding, and analyze the impact PPA 2006 will have on the field. Part II examines the mechanics through which a firm may shed its pension assets in bankruptcy. Part III explains how flaws in the Employee Retirement Income Security Act of 1974 (ERISA)³⁷ and the PBGC contributed to pension underfunding and losses, and discusses the role of moral hazard in bringing about these same results. Part IV discusses past proposals for reform of pension underfunding and bankruptcy abuse, including the proposal offered by the Bush Administration prior to the

33. See Nicholas J. Brannick, *At the Crossroads of the Three Codes: How Employers Are Using ERISA, the Tax Code, and Bankruptcy to Evade Their Pension Obligations*, 65 OHIO ST. L.J. 1577, 1584–85 (2004) ("The biggest losers are retirees and current employees whose retirement income or expectations of income are reduced and the PBGC." (citations omitted)).

34. See *id.* at 1584 & n.29 (pointing to specific voluntary creditors that are benefited by plan terminations and noting that "[t]reating the PBGC's claim as an unsecured claim rather than secured frees up resources . . . and increases the potential dividend among the unsecured creditors, which would be significantly diminished if the PBGC's claims were treated as secured and had to be paid in full").

35. See RICHARD IPPOLITO, *THE ECONOMICS OF PENSION INSURANCE* 18–19 (1989) (arguing that evidence demonstrates workers accept lower cash wages in return for pensions); Bradley D. Belt, Executive Dir., Pension Benefit Guar. Corp., Remarks by Bradley D. Belt to the American Bankruptcy Institute (Apr. 22, 2006), <http://www.pbgc.gov/media/news-archive/speeches/sp15734.html> (describing the relationship between ERISA and the Bankruptcy Code as more collision than intersection, and contrasting an intentional, volitional lender to a pensioner who becomes an unintended creditor to an underfunded pension plan); see also *infra* Part III.E.2 (criticizing plan sponsors' ability to increase pension benefits when a plan already faces a serious funding shortfall).

36. IPPOLITO, *supra* note 35, at 197.

37. Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 (codified at 29 U.S.C. §§ 1001–1461 (2000)).

passage of PPA 2006. Part V analyzes the effects of the recently enacted PPA 2006. Part VI offers further proposals for reform to remedy PPA 2006's shortcomings. Congress should pass these reforms because PPA 2006 does not do enough to ensure pensioners actually receive the benefits they earn. The proposals for further reform include private supplemental pension insurance, higher risk-based premiums for underfunded plans, and a more diversified investment strategy for the PBGC. Part VII concludes.

II. EXAMINATION OF THE MECHANICS OF PENSION TERMINATION THROUGH BANKRUPTCY

ERISA and the tax code³⁸ regulate pension plans outside of bankruptcy. However, once a firm files for Chapter 7 or Chapter 11, the bankruptcy code trumps the other sets of laws by preventing the PBGC from perfecting a lien on the assets of the plan sponsor for the amount owed to the plan.³⁹ The analysis below demonstrates the shortcomings of regulating pensions under the laws of two government agencies with competing policy aims.⁴⁰

Plan sponsors can terminate their plans in three ways: through a standard termination, distressed termination by the plan sponsor, or a forced termination initiated by the PBGC.⁴¹ In a standard termination, a plan with adequate or excess assets purchases a full pension for each of its workers from a private insurer.⁴² In contrast, a distressed termination occurs when a plan sponsor itself chooses and receives permission from the PBGC to terminate an underfunded plan.⁴³ The PBGC considers a plan distressed when any of the following are met: (1) the plan is in bankruptcy; (2) the plan is not in bankruptcy, but cannot

38. 26 U.S.C.A. § 401 (West Supp. 2007) (listing the requirements for a trust that forms part of a pension of an employer to constitute a qualified trust for tax purposes).

39. 11 U.S.C. §§ 362(a), 545(2) (2000) (allowing the trustee to prevent the fixing of a lien that "is not perfected or enforceable at the time of commencement of the case," and applying a stay of "any act to create, perfect, or enforce any lien" after the filing of a bankruptcy petition).

40. See Brannick, *supra* note 33, at 1600–01 (describing the breakdown in alignment of interests between a tax-gathering agency and a pension insurance agency due to their differing statutory mandates).

41. See GAO FUNDING REPORT, *supra* note 8, at 8 n.20 (describing the three types of plan terminations).

42. See 29 U.S.C. § 1341(b)(3)(A) (2000) (describing the distribution of assets under a standard termination to purchase insurance or otherwise fully provide for plan liabilities).

43. See Daniel Keating, *Chapter 11's New Ten-Ton Monster: The PBGC and Bankruptcy*, 77 MINN. L. REV. 803, 808 (1993) (defining distressed termination as a "voluntary termination").

pay its debts without terminating the pension plan; or (3) the plan has such a high proportion of retirees to plan participants that continuing the plan would prove “unreasonably burdensome” on the sponsor.⁴⁴ Finally, a forced termination occurs at the behest of the PBGC, to protect itself when it believes allowing the plan sponsor to continue to manage the plan will magnify the loss the PBGC will likely have to cover at a later date.⁴⁵ This provision gives the PBGC some enforcement power beyond the carrot of tax deductibility⁴⁶ to prod firms into compliance with the law.⁴⁷ Because of its extreme nature, however, the PBGC generally hesitates from using this “nuclear option.”⁴⁸

Outside of bankruptcy, the PBGC can hold a plan sponsor terminating a plan accountable for the amount of unfunded liabilities.⁴⁹ Termination of a plan creates a lien in favor of the PBGC for up to 30% of the sponsor’s equity.⁵⁰ Owner’s equity, also known as retained earnings, is calculated as the difference between a firm’s assets and its liabilities.⁵¹ Using 30% of owner’s equity as the statistic to set the maximum lien lost its effectiveness when the Financial Accounting Standards Board passed Statement of Financial Accounting Standard (SFAS) No.

44. 29 U.S.C.A. § 1341(c)(2)(B) (West Supp. 2007).

45. See 29 U.S.C.A. § 1342(a)(1)–(4) (West Supp. 2007) (listing situations where the PBGC may institute proceedings to terminate a plan). Technically, the PGBC may also terminate if a plan is unable to make pension obligations, but this condition is for practical purposes redundant with the others. *Id.*

46. See 26 U.S.C.A. § 404 (West Supp. 2007) (prescribing the rules for deductibility of “contributions of an employer to an employees’ trust or annuity plan and compensation under a deferred-payment plan”).

47. See 29 U.S.C.A. § 1342(a)(1)–(4) (West Supp. 2007) (establishing that the PBGC may terminate when any of the following conditions are met: “(1) the plan has not met the minimum funding standard required under section 412 of Title 26 . . . ; (2) the plan will be unable to pay benefits when due; (3) the reportable event described in section 1343(c)(7) of this title has occurred [refers to a plan participant who is also a “substantial owner” withdrawing \$10,000 or more and leaving the plan underfunded]; or (4) the possible long-run loss of the corporation with respect to the plan may reasonably be expected to increase unreasonably if the plan is not terminated”).

48. See *Solvency of the Pension Benefit Guaranty Corp. • Current Financial Condition and Potential Risks: Hearing Before the S. Comm. on Budget, 109th Cong. 9* (2005) (statement of Bradley D. Belt, Executive Director, Pension Benefit Guar. Corp.), http://www.budget.senate.gov/democratic/testimony/2005/belt_pbgc061505.pdf [hereinafter “*Belt Budget*”] (expressing that the “PBGC strives to achieve the appropriate balance” between protecting participants of the pension plan and protecting the insurance fund).

49. See 29 U.S.C.A. § 1362(a) (West Supp. 2007) (noting that the plan sponsor will incur joint and several liability).

50. 29 U.S.C.A. § 1368(a) (West Supp. 2007).

51. See 29 U.S.C.A. § 1362(d)(1) (West Supp. 2007) (explaining determination of net worth).

158, requiring unfunded pension liability or surplus to be placed on the balance sheet as an asset or liability.⁵² Prior to SFAS No. 158, firms disclosed unfunded pension liability only in the footnotes of their financial statements.⁵³ To illustrate the problem, General Motors had \$11 billion in total owner's equity as of Sept. 30, 2006, but calculated its after-tax unfunded pension liability at between \$18 billion and \$25 billion.⁵⁴ Once that liability shows up on the balance sheet, GM will have owner's equity of, at most, negative \$7 billion. In the event of a GM plan termination, the statute would seem to grant a 30% interest in a negative amount of owner's equity.⁵⁵ Practically, the amount can go no lower than zero.⁵⁶

Even if a plan sponsor does have positive net worth, the PBGC must perfect (file with the appropriate government agency) the lien before it becomes effective.⁵⁷ If the sponsor terminates the plan after entering bankruptcy, the statutory protections built into ERISA dissolve. The bankruptcy court grants an automatic stay blocking any new liens from taking effect.⁵⁸ This prevents the above-described PBGC lien, on 30% of owner's equity, from becoming effective.

Current bankruptcy law creates a classic "race to the bottom"⁵⁹ scenario among firms with legacy costs in the same industry, especially those with strong competition from other jurisdictions with differing work rules.⁶⁰ Once one firm emerges from bankruptcy with a reduced cost structure, other firms must also take steps to lower costs, often through bankruptcy

52. See *supra* note 3 (discussing SFAS No. 158 and its effect on how companies account for pension obligations on their balance sheets).

53. See Gen. Motors Corp., *supra* note 3, at 10 (providing an example of the current accounting treatment of pension obligations); SFAS No. 158, *supra* note 3, at 55 (arguing that footnote disclosure is inadequate).

54. Gen. Motors Corp., *supra* note 3, at 5, 10.

55. See 29 U.S.C.A. § 1368(a) (West Supp. 2007).

56. See 29 U.S.C.A. § 1362(d)(1) (West Supp. 2007) (limiting net worth to positive net worth).

57. See Brannick, *supra* note 33, at 1605 n.169 (explaining procedures for perfecting the lien).

58. See 11 U.S.C.A. § 362(a)(4) (West Supp. 2007) (granting an automatic stay of "any act to create, perfect, or enforce any lien against property of the estate" once a petition is filed). For an example of this process, see *Pension Benefit Guaranty Corp. v. Belfance (In re CSC Indus., Inc.)*, 232 F.3d 505, 510 (6th Cir. 2000).

59. U.S. Supreme Court Justice Louis Brandeis first coined the phrase "race to the bottom" in the case *Louis K. Liggett Co. v. Lee* in reference to the escalating competition between states to attract corporations by offering lax regulatory schemes. SANFORD F. SCHRAM, *AFTER WELFARE: THE CULTURE OF POSTINDUSTRIAL SOCIAL POLICY* 91 (2000) (discussing *Louis K. Liggett Co. v. Lee*, 288 U.S. 517, 558–59 (1933) ("The race was one not of diligence but of laxity.")).

60. See Walsh, *supra* note 4, at 9 (discussing Bethlehem's legacy costs).

proceedings of their own.⁶¹ This competition plays out not only internationally, but also between largely non-unionized right-to-work states and more heavily unionized rust-belt states.⁶²

Additionally, because the PBGC funds all operations out of insurance premiums, it ultimately must pay for any underwriting loss incurred by increasing premiums.⁶³ This results in “healthy companies that are responsibly meeting their benefit obligations . . . making transfer payments to weak companies with chronically underfunded pension plans.”⁶⁴ Therefore, allowing firms to shed their pension obligations in bankruptcy creates perverse incentives to underfund. It frees up cash before entering bankruptcy—cash that the plan sponsor need never repay to the pensioners after entering bankruptcy.⁶⁵ The formerly bankrupt company emerges with a cost structure superior to its competitors.⁶⁶ To top it all off, the firm that responsibly funded its pension plan now must pay higher premiums to compensate for the past indiscretions of its competitor.⁶⁷ By blocking the PBGC’s lien on sponsor assets, the bankruptcy code allows struggling firms to underfund with impunity.⁶⁸ They do so secure in the knowledge that if business never turns around, the law will not require them to make up the shortfall. The following section explains how pensions were allowed to become underfunded in the first place.

III. HOW STRUCTURAL FLAWS IN ERISA HAVE CONTRIBUTED TO PENSION LOSSES AND THE PBGC’S CURRENT \$18 BILLION UNDERFUNDING

Failure of the bankruptcy code alone has not caused millions of people to lose retirement income. Structural flaws in the regulatory scheme created by Congress allowed firms in financial

61. See *Belt Budget*, *supra* note 48, at 12 (noting that “healthy companies” have to compete with their competitors that have unloaded most of their labor costs onto the government).

62. See SCHRAM, *supra* note 59, at 100–01 (detailing states’ responses to growing unemployment by themselves “racing to the bottom” of available assistance for those laid off).

63. *Belt Budget*, *supra* note 48, at 12.

64. *Id.*

65. See *infra* notes 91–92 and accompanying text (discussing possible uses for this freed up cash).

66. See *Belt Budget*, *supra* note 48, at 29 (discussing bankruptcy protection offered for companies in default).

67. *Id.* at 4.

68. See 11 U.S.C. § 362 (2000) (authorizing stays against certain methods of collection from a debtor).

distress to willfully disregard the promises workers exchanged for current compensation.⁶⁹ The problems preventing the PBGC from fulfilling its statutory mandate⁷⁰ include: ineffective plan funding rules;⁷¹ lack of control over insurance premiums;⁷² the potential for underfunding firms to gain substantial advantages over their competitors;⁷³ and overly cautious investment policy.⁷⁴

A. *The Old Rules Allowed Chronic Funding Shortfalls*

Funding refers to the amount of assets a plan has to satisfy its pension liabilities. Under the old rules, plans could often legally remain below 100% funded.⁷⁵ Of the ninety-four pension plans taken over by the PBGC in 2006, the average plan had a 50% funding ratio, meaning the plans actually had only fifty cents of assets for every dollar of payments promised to retirees.⁷⁶ No more compelling proof of the need to reform the PBGC exists. Symptomatic of the health of the plans it has taken over, the PBGC itself has a funding ratio of only 76%, a shortfall of \$18 billion dollars.⁷⁷ In a September 2005 study, the Congressional Budget Office estimated the PBGC's deficit would reach \$86.7 billion by 2015, and could grow as large as \$141.9 billion by 2025.⁷⁸

69. See Barlett & Steele, *supra* note 2, at 38 (describing Congress's "pivotal" role in creating a dysfunctional system).

70. See 29 U.S.C.A. § 1302(a)(1)–(3) (West Supp. 2007) (listing the statutory mandates of the PBGC); *supra* note 7 and accompanying text (discussing same).

71. See *infra* notes 75–104 and accompanying text (criticizing the old plan funding requirements and describing the abuse of credit balances and asset smoothing).

72. See *infra* notes 105–08 and accompanying text (pointing to the PBGC's inability to charge high-risk companies higher premiums than those charged to the lower-risk companies).

73. See *infra* notes 91–93 and accompanying text (explaining how plan sponsors can retain cash by underfunding pensions).

74. See *infra* notes 148–60 and accompanying text (examining the costs of an overly-cautious investment strategy).

75. See *Belt Budget*, *supra* note 48, at 36 (stating that when United Airlines filed for bankruptcy, it claimed to have done "everything required by law" to fund its pension plans, yet the plans were underfunded by almost \$10 billion); *infra* note 79 (providing ERISA's statutory funding requirements).

76. PENSION BENEFIT GUAR. CORP., *supra* note 23, at 3.

77. See *id.* at 5 (containing the PBGC's "Financial Statement Highlights"). The PBGC has \$61.1 billion in assets versus \$80 billion in liabilities. *Id.* While Congress intended the PBGC to sustain itself without backing from the Federal government, the agency does in fact have the option to place up to \$100 million in notes with the Treasury to cover funding shortfalls. See 29 U.S.C.A. § 1305(c) (West Supp. 2007). However, even this amount would not materially improve the solvency of the PBGC given the recent funding gap.

78. CONG. BUDGET OFFICE, THE RISK EXPOSURE OF THE PENSION BENEFIT GUARANTY CORPORATION 7 (2005), available at <http://www.cbo.gov/ftpdocs/66xx/doc6646/09-15-PBGC.pdf>.

It should come as no surprise that pension plans were underfunded prior to the enactment of PPA 2006, given that ERISA only required a plan to maintain a 90% funding ratio to reach its full funding target and avoid paying additional premiums.⁷⁹ The PBGC's Executive Director, Bradley D. Belt, repeatedly highlighted this flaw in his testimony to Congress during the run-up to the passage of PPA 2006.⁸⁰ Belt commented, "Some companies that have complied with all of the statutory funding requirements [of ERISA and the Internal Revenue Code] have still ended up with plans that are less than [fifty] percent funded when they [are] terminated."⁸¹

Exacerbating the problem, the old funding rules set maximum deductible contributions too low. This prevented companies from setting aside money in good years to offset funding shortfalls when the company did not perform as well.⁸² The old rules provide an example of competing policy interests between the Internal Revenue Service (IRS) and the PBGC. Congress set the maximum deductible level at the "full funding limitation"⁸³ to prevent companies from sheltering an inappropriate amount of net income as pension contributions during good years, but in the process hampered firms' flexibility in long-term planning.⁸⁴

The process of granting funding waivers provides an additional example of the administrative disconnect between the PBGC and the IRS. The tax code determines eligibility for preferential treatment of pension contributions for tax write-off

79. See 29 U.S.C. § 1306(a)(3)(E)(iv) (2000) (following the 90% minimum funding requirement found in 26 U.S.C. § 412(c)(7)(i) (2000)).

80. See *Belt Budget*, *supra* note 48, at 16 ("The first structural flaw is a set of funding rules that are needlessly complex and fail to ensure that pension plans are adequately funded."). For additional criticism of this flaw in pension accounting, see Barlett & Steele, *supra* note 2 (comparing pension accounting to Enron accounting, and noting that the only difference is that pension accounting is "perfectly legal").

81. *Belt Budget*, *supra* note 48, at 16.

82. See GAO FUNDING REPORT, *supra* note 8, at 23–24 (stating firms must pay an excise tax on contributions above the full funding limitation).

83. See 26 U.S.C.A. § 404(a)(1)(A)(iii) (West Supp. 2007). The full funding limit is defined as:

[T]he excess (if any) of—(i) the accrued liability (including normal cost) under the plan (determined under the entry age normal funding method if such accrued liability cannot be directly calculated under the funding method used for the plan), over (ii) the lesser of—(I) the fair market value of the plan's assets, or (II) the value of such assets determined under paragraph (2).

26 U.S.C.A. § 431(c)(6)(A) (West Supp. 2007).

84. See GAO FUNDING REPORT, *supra* note 8, at 23–24 ("The annual maximum contribution can act as a real constraint on cash contributions.").

purposes,⁸⁵ while ERISA regulates the administrative aspects of plan regulation.⁸⁶ The latter includes eligibility of participants, vesting, plan administration standards, and the PBGC's insurance and reporting requirements.⁸⁷ The IRS currently has the authority to grant waivers of required plan funding to alleviate business hardship.⁸⁸ Authority should instead lie with the PBGC, as it has the more compelling interest in determining whether a plan should have to contribute to its pension fund in a given year.⁸⁹ Though firms can receive waivers in only three of fifteen plan years,⁹⁰ the PBGC, not the IRS, has to make good on defaulted pension promises. Therefore, the PBGC should have the authority to determine eligibility for funding waivers.

Underfunding pensions allows a plan sponsor to keep more cash in the business for other purposes.⁹¹ A firm could raise dividends to shareholders, increase capital investment, or simply meet its debt service obligations by not contributing adequately to its pension plan.⁹² Pensions give employers a cost-effective way of providing benefits to employees. The amount of money the sponsor puts into even an adequately funded pension plan likely never exceeds the amount of cash the employee chose to forgo in exchange for a promise of pension.⁹³ Even when ERISA did require payments, it allowed sponsors to make them using projected, not actual, returns on certain assets, as discussed in the following section.

85. See 26 U.S.C.A. § 401 (West Supp. 2007).

86. See 29 U.S.C.A. §§ 1021–1031, 1051–1086 (West Supp. 2007).

87. 29 U.S.C.A. §§ 1021–1031, 1051–1086 (West Supp. 2007).

88. See 26 U.S.C.A. § 412(d) (West Supp. 2007) (providing rules for “[v]ariance from minimum funding standard”). In determining business hardship, the IRS considers whether:

(A) the employer is operating at an economic loss, (B) there is substantial unemployment or underemployment in the trade or business and in the industry concerned, (C) the sales and profits of the industry concerned are depressed or declining, and (D) it is reasonable to expect that the plan will be continued only if the waiver is granted.

26 U.S.C.A. § 412(d)(2)(A)–(D) (West Supp. 2007).

89. See Brannick, *supra* note 33, at 1625 (arguing the PBGC should have control over funding waivers).

90. 26 U.S.C.A. § 412(c)(1)(A) (West Supp. 2007).

91. See Daniel Keating, *Pension Insurance, Bankruptcy and Moral Hazard*, 1991 WIS. L. REV. 65, 76–77 (noting limited liability gives firm managers an incentive to divert cash to risky projects in hopes of rehabilitating a struggling firm, secure in the knowledge the PBGC, not management, will have to pay benefits if the firm fails).

92. See Brannick, *supra* note 33, at 1592 (“Pension insurance allows employers to reallocate resources away from labor costs and toward capital spending or shareholders.”).

93. *Id.* at 1592–93 (noting the time value of money reduced the cash requirement of pension contributions below the level required by wages in the current period).

B. Abuse of Credit Balances

A credit balance occurs when a plan sponsor carries over an excess payment from a previous year, which can earn interest as long as the plan sponsor does not use it.⁹⁴ The utilization of credit balances provides one of the clearest examples of disconnect between pension accounting and economic reality. If a plan makes contributions in excess of requirements in one year, it can use a projected, rather than actual, rate of return on the excess contribution when calculating the necessary funding contribution in subsequent years.⁹⁵ This permits companies to avoid contributions in years when *actual* returns on plan assets would otherwise require contributions to the plan.⁹⁶ Because of this rule, Bethlehem Steel and US Airways, two of the largest defaulters in PBGC history, made no cash contributions to their plans for three and four years, respectively, prior to plan termination.⁹⁷ Not only did ERISA permit plan sponsors to make plan contributions using projected credit balance returns, it also allowed the sponsor to use a predicted, rather than actual, rate of return when calculating normal plan assets.⁹⁸ This practice, known as “smoothing,”⁹⁹ is the subject of the next section.

C. Smoothing of Plan Assets

Smoothing of plan returns presents a problem related to the abuse of credit balances. To reduce net income volatility created by fluctuations in plan assets, pension accounting rules permit

94. See *Belt Budget*, *supra* note 48, at 19 (explaining how companies can use credit balances to take a “contribution holiday”).

95. See 26 U.S.C. § 412(b) (2000), amended by Pension Protection Act of 2006, Pub. L. No. 109-280, § 412, 120 Stat. 780, 820.

96. See *id.* (“For a plan year, the funding standard account shall be credited with the sum of . . . the excess (if any) of any debit balance in the funding standard account . . . over any debit balance in the alternative minimum funding standard account.”); 29 U.S.C. § 1083(b) (2000), repealed by Pension Protection Act of 2006, Pub. L. No. 109-280, § 101, 120 Stat. 780, 784 (setting out the general requirements to obtain a waiver of minimum funding requirements). Under the old rules, plan assets were not reduced by any credit balances for the purpose of determining the deficit reduction contribution. 26 U.S.C. § 412(b)(1) (2000), amended by Pension Protection Act of 2006, Pub. L. No. 109-280, § 412, 120 Stat. 780, 820; 29 U.S.C. § 1082(d) (2000), repealed by Pension Protection Act of 2006, Pub. L. No. 109-280, § 101, 120 Stat. 780, 784.

97. See *Belt Budget*, *supra* note 48, at 19.

98. See 26 U.S.C. §§ 412(b)–(c) (2000), amended by Pension Protection Act of 2006, Pub. L. No. 109-280, § 412, 120 Stat. 780, 820 (providing that plan assets are to be valued “taking into account the experience of the plan and reasonable expectations”).

99. See *Belt Budget*, *supra* note 48, at 18 (noting that plan assets are determined by a formula that “smooths” figures by averaging the assets’ market value over a number of years).

plan sponsors to use average, rather than actual, rates of return to calculate plan assets.¹⁰⁰ This causes a somewhat counterintuitive result. Plans appear less funded than they are in good years, but more funded than they are in bad years. In other words, smoothing allows plans to under-report both overfunding and underfunding.¹⁰¹ The accounting rules permitting smoothing of pension expenses are an anomaly—accounting rules do not permit smoothing of other volatile expenses such as fuel or steel prices.¹⁰² Pension expenses are actual expenses incurred by the company that may vary depending on the rate of return of assets already in the plan.¹⁰³ Yet smoothing does not eliminate volatility, it only masks it—keeping workers and retirees in the dark on an issue vital to the security of their retirement.¹⁰⁴ Further, the plan must pay retirees in real money. A pensioner cannot cash a best estimate at the bank. The employment of asset smoothing and credit balances would prove less problematic if the PBGC could tailor funding requirements to the financial position of individual firms. Unfortunately, as discussed in the next section, the PBGC did not have authority to do so.

D. Inability to Tailor Funding Requirements to Firm Risk

Pension smoothing allows plan sponsors to reduce the income statement volatility resulting from corresponding stock market volatility. However, allowing struggling firms to use these same smoothing techniques increases the risk that those firms will have a funding problem if they file for bankruptcy. The ERISA funding rules prior to PPA 2006 ignored the financial

100. See 26 U.S.C. § 412(c) (2000), amended by Pension Protection Act of 2006, Pub. L. No. 109-280, § 412, 120 Stat. 780, 820 (allowing the use of “any reasonable actuarial method of valuation” to calculate the value of plan assets).

101. See GAO FUNDING REPORT, *supra* note 8, at 15–16 (examining the difference in the volatility of reported funding levels when using the actuarial value of assets rather than market asset values).

102. See Marianne M. Jennings, *Fraud is the Moving Target, Not Corporate Securities Attorneys: The Market Relevance of Firing Before Being Fired Upon and Not Being “Shocked, Shocked” that Fraud is Going On*, 46 WASHBURN L.J. 27, 66–67 (2006) (indicating capitalization of ordinary business expenses in an effort to smooth their occurrence is neither proper nor ethical).

103. See GAO FUNDING REPORT, *supra* note 8, at 15–16 (noting that actual value of assets may range from 80%–120% of market asset level).

104. *Hearing Before the H. Subcomm. on Aviation, Comm. on Transp. & Infrastructure*, 109th Cong. (2005) [hereinafter “*Belt Aviation*”] (statement of Bradley D. Belt, Executive Director, Pension Benefit Guar. Corp.), available at <http://www.pbgc.gov/media/news-archive/testimony/tm13159.html>.

condition of a firm.¹⁰⁵ The PBGC's own analysis revealed that 90% of companies with large claims against PBGC had junk bond credit ratings for ten years prior to termination.¹⁰⁶ Nevertheless, these firms paid the same insurance rates as firms with investment-grade credit ratings.¹⁰⁷ Equal treatment for risky firms is akin to an insurance company not having the ability to charge a smoker a higher health insurance premium for the increased health risk. Accordingly, both scenarios lead to the same predictable result—an insurer that government regulators would have already closed down if it operated in the private sector.¹⁰⁸

Broadly speaking, when Congress enacted ERISA, it failed to construct a regulatory framework that would align plan sponsor behavior with its policy goals of ensuring sustainable pensions. As discussed in the next section, these problems, often referred to collectively as “moral hazard,” have manifested themselves in a variety of ways.

*E. The PBGC Had Insufficient Means to Combat Moral Hazard*¹⁰⁹

Economists define moral hazard as the change in an individual's behavior when someone other than the actor bears responsibility for the outcome of a particular action.¹¹⁰ In the specific context of pension insurance, the problems of moral hazard meant that, prior to PPA 2006, “there [was] little to prevent financially weak employers from creating unfunded pension costs that they [could] shift to the insurance system if the company fail[ed].”¹¹¹ In the pension context, moral hazard

105. See *Belt Budget*, *supra* note 48, at 18 (discussing the challenges of running a pension insurance company that cannot charge firms in dire financial condition higher premiums to compensate for its increased risk of default).

106. *Id.* at 18.

107. See *infra* notes 115–16 (discussing the PBGC's flat-rate premium structure).

108. See DOUGLAS J. ELLIOT, *CTR. ON FED. FIN. INST., PBGC: WHEN WILL THE CASH RUN OUT?* 1 (2004), <http://www.coffi.org/pubs/Summary%20v8.pdf> (noting the PBGC is insolvent as measured by Generally Accepted Accounting Principles (GAAP)).

109. Merriam Webster defines moral hazard as “the possibility of loss to an insurance company arising from the character or circumstances of the insured.” MERRIAM-WEBSTER'S COLLEGIATE DICTIONARY 807 (11th ed. 2003). Generally, moral hazard means one party's incentives have not been properly aligned with another party's, giving party one incentive to act in a way detrimental to party two. For example, having automobile liability insurance would make a person more likely to drive recklessly, since the insurance company, not the driver, would pay for any damage caused.

110. See Tom Baker, *On the Genealogy of Moral Hazard*, 75 *Tex. L. Rev.* 237, 238 (1996) (“[T]he conventional lesson taken from the economics of moral hazard is that ‘less is more’ . . .”).

111. See *Belt Budget*, *supra* note 48, at 21–22 (defining moral hazard within the

manifested itself in a variety of ways, including the disconnect between risk and the PBGC's premiums,¹¹² the ability of financially distressed plan sponsors to assuage stakeholders by substituting increased pension benefits for wage hikes,¹¹³ and the ability of plan sponsors to conceal information on plan health from stakeholders.¹¹⁴

1. *The PBGC Could Not Charge Risk-Based Premiums.* The PBGC's statutorily mandated premium remained at \$19 per plan participant per year from 1991 until 2005,¹¹⁵ when Congress raised it to \$30.¹¹⁶ During that same period, the maximum insured benefit purchased by those premiums increased by 69%.¹¹⁷ Unlike the premium increase, ERISA mandated the benefit increase at the same rate as the Social Security Wage Base.¹¹⁸ Academic studies varied in their estimations of the adequacy of the premiums received in proportion to the risk undertaken by the PBGC. Estimates concluded the PBGC premiums could cover only one-sixth to one-half the value of the insurance the PBGC provided.¹¹⁹ The statutorily-imposed inability to set risk-based premiums or raise flat-rate premiums hampered the PBGC in several ways. First, it denied the PBGC the ability to consider any changing actuarial factors for which premiums may need to increase.¹²⁰ For example, as life expectancy in America increased, the PBGC could not increase premiums to compensate for the increased duration of pension payments to retirees.

context of pension insurance).

112. See *infra* Part III.E.1.

113. See *infra* Part III.E.2.

114. See *infra* Part III.E.3.

115. See 29 U.S.C. § 1306(a)(3)(A)(i) (2000), *amended by* Deficit Reduction Act of 2005, Pub. L. No. 109-171, § 8101(a)(1)(A), 120 Stat. 4, 180 (indicating price of premium prior to the Deficit Reduction Act of 2005); DOUGLAS J. ELLIOT, CTR. ON FED. FIN. INST., PBGC: POLICY OPTIONS 8 (2005), <http://www.coffi.org/pubs/PBGC%20Policy%20Options%20%20January%206%202005.pdf> (discussing the implications of flat rate premiums). A plan must also pay \$9 per \$1000 of unfunded vested benefits. 29 U.S.C. § 1306(a)(3)(E)(ii) (2000). However, under the old scheme plans often were able to evade paying the variable-rate premium. As long as a plan was 90% funded on a current liability basis, it did not have to pay the variable-rate premium. 29 U.S.C. § 1306(a)(3)(E)(iv) (2000).

116. Deficit Reduction Act of 2005, Pub. L. No. 109-171, § 8101(a)(1)(A), 120 Stat. 4, 180 (2006) (to be codified at 29 U.S.C. § 1306(a)(3)(A)).

117. See ELLIOT, *supra* note 115, at 8 (noting that employee raises have also contributed to the increase in the PBGC's guaranteed pensions).

118. *Id.*

119. *Id.* at 3 (stating no academic study found the PBGC premiums able to cover more than half the value of the insurance provided).

120. See 29 U.S.C.A. § 1306(a)(3) (West Supp. 2007) (setting the annual premium rate payable to corporations); Brannick, *supra* note 33, at 1594-95 (noting that the PBGC premiums "do not reflect the risk assumed by the PBGC or displaced by employers").

Second, premiums bore little relation to the size of potential payouts.¹²¹ Even though Congress capped the PBGC's maximum annual benefit exposure for a single pensioner at \$49,500,¹²² there still exists a substantial variation in the gravity of harm suffered by the PBGC by the default of a given pension plan. Defaults at two equally underfunded plans of the same asset size will cause differing degrees of loss to the PBGC depending on the ratio of assets to participants. If 1,000 pensioners are to receive \$10,000 a year, the PBGC must pay the full amount to each party. On the other hand, if the plan paid \$100,000 a year to each of the plan's 100 participants, the PBGC would have to pay at most \$49,500 per participant.¹²³ A congress full of lawyers has forgotten Judge Learned Hand's insight noting the importance of weighing both the probability of harm *and* the gravity of that harm.¹²⁴

Finally, flat-rate premiums prevented the PBGC from charging more to firms in poor financial condition.¹²⁵ This represents the "probability of harm" portion of Judge Hand's framework.¹²⁶ The amount of underfunding represents the "gravity of the resulting injury."¹²⁷ For example, ratings agencies assigned United Airlines debt junk bond ratings since 2000,¹²⁸ and the ratings agencies proved correct when the company

121. See Brannick, *supra* note 33, at 1594–95, 1595 n.92 (noting, as an example of the discrepancy, that, while United only paid \$50 million in premiums over 30 years to the PBGC, the PBGC would be responsible for a \$6.4 billion payout).

122. See Press Release, Pension Benefit Guar. Corp., PBGC Announces Maximum Insurance Benefit for 2007 (Dec. 5, 2006), <http://www.pbgc.gov/media/news-archive/news-releases/2006/pr07-07.html> (noting the maximum insured benefit is higher for those who retire after age 65 than for those who retire before 65 because "younger retirees receive more monthly pension checks over a longer remaining lifespan").

123. The PBGC would likely, in fact, pay some amount below \$49,500, as it takes over the assets of the plan at the same time it takes over the plan itself. The same logic holds true for the \$10,000 pension as well. The PBGC notes more than 90% of pensioners in plans it has taken over experience no decrease in benefit. See Press Release, *supra* note 122 (summarizing the PBGC's research of the effects of legal coverage limits on benefits). While beneficial to pensioners, this does nothing to alleviate the almost \$20 billion of underfunding the PBGC itself faces. See PENSION BENEFIT GUAR. CORP., *supra* note 23, at 3, 5 (discussing deficit faced by PBGC).

124. See *United States v. Carroll Towing Co.*, 159 F.2d 169, 173 (1947) (proposing the famous "Hand Formula," which requires a balancing of the probability of the harm that could result and the gravity of the harm that did result to determine the reasonable burden of alternative precautionary action a tortfeasor should bear).

125. See Deficit Reduction Act of 2005, Pub. L. No. 109-171, §8101(b), 120 Stat. 4, 181–82 (2006) (to be codified at 29 U.S.C. § 1306) (setting premium rate at \$1,250 multiplied by the number of employees).

126. See *Carroll Towing Co.*, 159 F.2d at 173.

127. See *id.*

128. See *Belt Budget*, *supra* note 48, at 22 (explaining the predicament the PBGC faced when it had to offer insurance to United and Bethlehem Steel as their financial conditions deteriorated and their pension underfundings grew).

recently caused the PBGC a net loss of \$6 billion.¹²⁹ Yet United paid only \$75 million in premiums in the ten year period prior to its termination.¹³⁰ This means United paid premiums equal to 2.5% of the total amount the PBGC will pay United's retirees. Statutes preventing the PBGC from charging plan sponsors risk-based premiums eliminated a key insurance underwriting tool. Because sponsors suffered virtually no premium increases based on the risk they represented to the PBGC,¹³¹ they often chose to increase benefits when they could not afford to increase wages, as detailed in the subsequent section.

2. *Plan Sponsors Could Irresponsibly Increase Benefits.*

Industrial companies used pensions as a way to improve their competitiveness, both before and after going through the bankruptcy process.¹³² Plan participants effectively made loans to sponsors, exchanging work performed for the often illusory promise of a secure retirement.¹³³ Under the previous law, companies could increase benefits as long as they had assets covering 60% of liabilities.¹³⁴ This allowed a non-investment grade firm on the brink of bankruptcy to negotiate wage concessions from employees in return for promises of more generous pensions in the future, without paying any additional insurance premiums.¹³⁵ Companies that underfunded their plans often did so to avoid current wage increases, knowing they might not be able to honor the pension promises in the future.¹³⁶ The

129. See Press Release, Pension Benefit Guar. Corp., PBGC Reaches Pension Settlement with United Airlines (Apr. 22, 2005), <http://www.pbgc.gov/media/news-archive/news-releases/2005/pr05-36.html> (announcing PBGC's settlement liability for the termination of United Airlines pension plans).

130. *Belt Budget*, *supra* note 48, at 22.

131. See *infra* Part V.C (analyzing how PPA 2006 better ties premium rates to risk).

132. See *supra* notes 62–65 and accompanying text (describing the competitive advantage gained through bankruptcy); see also *Belt Aviation*, *supra* note 104, at ¶ 5 (pointing out that airlines accounted for 38% of failed plans and had paid only 2.6% of their premiums as of June 2005). The steel industry followed in second place with 33% of defaults. *Id.*

133. See IPPOLITO, *supra* note 35, at 18–19 (discussing employees' acceptance of higher pension benefits instead of wage increases).

134. See 26 U.S.C § 401(a)(29) (2000), *repealed by* Pension Protection Act of 2006, Pub. L. No. 109-280, § 114, 120 Stat. 780, 853 (allowing firms 40% below fully funded to increase their pension obligations). United Airlines asserted in its bankruptcy court filing that “the Company has done everything required by law” to fund its pension plans, which were underfunded by almost \$10 billion. *Belt Budget*, *supra* note 48, at 36.

135. See *Belt Budget*, *supra* note 48, at 4–5 (identifying plan sponsors' ability to promise benefits they cannot afford to pay as one impetus for reform).

136. See Adriel Bettelheim, *Moving to Close the Pension Gap*, 63 CQ WEEKLY 2624, 2626 (2005) (“The threat of pension defaults would not be as ominous had companies been less generous with their benefits.”).

firm's cash flow and income statements both improved because the cost of increasing wages showed up immediately, while the cost of increasing pension benefits could be amortized over thirty years.¹³⁷ Lack of authority to prohibit benefit increases based on a plan's funding status prevented the PBGC from combating firms irresponsibly raising benefits they likely could never repay.¹³⁸ As discussed in the following section, plan participants did not receive adequate information regarding the solvency of their plans.¹³⁹ Without this information they could not understand that the pension benefit increases offered to them by struggling plan sponsors often amounted to illusory promises at best.

3. *ERISA Did Not Require Adequate Disclosure to Plan Participants.* Previously under ERISA, the PBGC received information from most companies on a two-and-a-half-year time lag.¹⁴⁰ Here, PPA 2006 makes significant improvement. Starting in 2008, single employer plans must send out annual notices to the PBGC, plan beneficiaries, and participants within 120 days of the end of the plan year.¹⁴¹ The notices must disclose the value of plan assets and liabilities, funding status, investment allocation, summary of rules governing termination, and an explanation of the benefits insured by the PBGC.¹⁴²

Even though the PBGC received more current information for distressed companies, it could not disseminate the data to the public.¹⁴³ Therefore, plan participants often did not understand the risk exposure their plans presented.¹⁴⁴ Prior to 1994, the PBGC published a list of the top fifty most underfunded plans.¹⁴⁵ However, corporations disliked seeing their names on the list and

137. *Id.*; see also *Belt Budget*, *supra* note 48, at 21–22 (highlighting the differing accounting treatments for pension versus wage expenses, which only exacerbated the problem).

138. See *Belt Budget*, *supra* note 48, at 27–28 (outlining the difficulties of keeping the PBGC solvent when it can not price for risk).

139. See *infra* notes 140, 143–46 and accompanying text.

140. See *Belt Budget*, *supra* note 48, at 30 (discussing improving the timeliness of reporting to the PBGC).

141. See Pension Protection Act of 2006, Pub. L. No. 109-280, §§ 501(a), 501(c), 120 Stat. 780, 936–39.

142. See *id.* (defining the requirements of a plan funding notice).

143. See 29 U.S.C. § 1310 (2000) (limiting public disclosure to administrative or judicial proceedings).

144. Plan sponsors with a \$50 million or greater unfunded vested liability had to disclose the plan's assets and liabilities and certain confidential corporate information to the PBGC, but the information could not be made public and is not subject to the Freedom of Information Act. *Id.*; see also *Belt Budget*, *supra* note 48, at 22–23 (explaining how the old reporting rules kept retirees and investors in the dark regarding plan funding status).

145. Barlett & Steele, *supra* note 2, at 42.

convinced Congress to keep the information secret.¹⁴⁶ Reversing this change, PPA 2006 requires any company whose plan is less than 80% funded to share the information provided to the PBGC with plan participants.¹⁴⁷

F. The PBGC Follows a Needless Conservative Investment Policy

The PBGC receives an unnecessarily low rate of return on its assets under management. Because many of its liabilities will not mature for thirty years or more, the PBGC should increase its exposure to stocks and real estate while concurrently decreasing its exposure to government bonds. During a plan year when the major stock market indices increased by over 10%,¹⁴⁸ the PBGC's portfolio returned 4.2%.¹⁴⁹ However, the equity portion of the PBGC's portfolio matched the returns of the stock market.¹⁵⁰ Unfortunately, the PBGC allocates 77% of the assets it manages to cash and fixed-income securities, with only 23% in equities, and a "very small portion . . . in real estate and other financial instruments."¹⁵¹ The stated rationale of the PBGC's bond-heavy asset allocation policy is "to reduce balance sheet volatility."¹⁵² In 2006, the PBGC decided to include international investments in its portfolio, but still maintains a policy of investing primarily in long-duration fixed-income securities.¹⁵³ The PBGC does not explain why it believes a portfolio with an asset allocation tilted heavily toward bonds best reduces balance sheet volatility.¹⁵⁴ In fact, having the majority of the PBGC's assets in bonds actually exposes it to substantially increased balance sheet volatility in both rising and falling interest rate

146. *See id.* (discussing lobbying efforts by plan sponsors to drop the list, thus allowing them to conceal severe shortcomings in plan funding).

147. 29 U.S.C.A. § 1310 (West Supp. 2007). The plan sponsor must provide information on the fund's liabilities under both the at-risk and general funding rules. *Id.*

148. *See* PENSION BENEFIT GUAR. CORP., *supra* note 23, at 18 (listing a 10.4% return for the Wilshire 5000 and a 10.8% return for the S&P 500). The PBGC's plan year ends Sept. 30, so investment returns for the major indices are calculated for the previous twelve months and therefore do not match those normally given for calendar year 2006. *See id.*

149. *See id.* at 12 (reporting the overall rate of return on the PBGC's investments in 2006).

150. *See id.* at 18 (showing a 10.7% return for the PBGC's equity portfolio).

151. *Id.* at 16 (discussing the PBGC's asset allocation).

152. *Id.* at 17.

153. *See id.* (discussing the PBGC's investment policy enhancements).

154. *See id.* (noting that the PBGC invests in long-duration fixed-income securities to reduce its exposure to financial risk).

environments.¹⁵⁵ Alternatively, spreading assets over multiple asset classes that respond differently to changes in interest rates and economic conditions effectively reduces portfolio volatility.¹⁵⁶ All else equal, broadly diversified portfolios can produce equivalent returns with less risk or greater returns without any additional risk.¹⁵⁷ The PBGC currently invests the \$15.2 billion in premium-derived assets (“revolving funds”) it manages entirely in Treasury securities, though it has statutory permission to invest certain portions of these funds in higher-yielding corporate bonds.¹⁵⁸

The PBGC’s overly-cautious investment policy comes at a cost. To illustrate, although it comprised only 23% of the PBGC portfolio, the PBGC’s equity securities accounted for 82% of the \$2.2 billion of investment income in 2006.¹⁵⁹ In contrast to its assets, which rose 4.2%, the PBGC’s actuarially determined liabilities increased by 9%, resulting in organic liability growth outpacing asset growth by \$3.11 billion.¹⁶⁰ Given the large number of substantial losses the PBGC has faced over the last several years, the risk of America’s pension insurance system running out of cash under its current structure exceeds the risk presented by increasing the allocation of stocks in the portfolio. Further, because broad asset allocation reduces volatility, an

155. See Morningstar Investing Classroom, Course 101: Bond Market Interest Rates, <http://news.morningstar.com/classroom2/printlesson.asp?docId=5375&CN=COM> (last visited Apr. 11, 2008) (discussing the inverse relationship between bond prices and interest rates).

156. See Richard Jenkins, *Start Investing with Just \$100*, MSN MONEY.COM, <http://articles.moneycentral.msn.com/Investing/StartInvesting/StartInvestingWithJust100.aspx> (last visited Apr. 11, 2008) (demonstrating a portfolio prudently spread across a variety of asset classes reduces risk and volatility without sacrificing performance, citing the thirty-year research project of ROGER C. GIBSON, *ASSET ALLOCATION: BALANCING FINANCIAL RISK* (3d ed. 2000), and finding the performance of a variety of diversified portfolios superior to portfolios concentrated in one asset category).

157. See Morningstar Investing Classroom, Course 301: Why Diversify?, <http://news.morningstar.com/classroom2/printlesson.asp?docId=2938&CN=com> (last visited Apr. 11, 2008) (“Adding bonds and cash to a stock-heavy portfolio lowers your overall risk. Adding stocks to a bond- or cash-heavy portfolio increases your growth potential. For most investors, it is wise to own a mix of all three.”).

158. See PENSION BENEFIT GUAR. CORP., *supra* note 23, at 16 (discussing the PBGC’s investment activities).

159. *Id.* at 16, 18. Bonds provided especially low returns because market interest rates rose during the 2006 plan year, resulting in the PBGC reporting a financial loss of \$3.1 billion. See *id.* at 18 (crediting the PBGC’s “strong equity returns in 2006” with mitigating the PBGC’s 2006 losses); see also Morningstar Investing Classroom, *supra* note 155 (explaining the relationship between bond prices and interest rates).

160. PENSION BENEFIT GUAR. CORP., *supra* note 23, at 12, 17.

enlarged stock position would further the PBGC's stated goal of reducing balance sheet volatility.¹⁶¹

The structural flaws in ERISA discussed in this Part presented plan sponsors with a "heads I win, tails you lose" coin toss. Prior to the enactment of PPA 2006, plan sponsors could make pension promises they might or might not have the financial resources to honor with few or no consequences. If plan assets appreciated in value, or the business operations of the sponsor prospered, the plan would keep its promises. In any event, the sponsor lost nothing by making the promise because inadequate funding rules permitted sponsors to promise benefits without actually setting aside sufficient assets to fund them.

IV. PAST PROPOSALS FOR REFORM OF PENSION UNDERFUNDING AND BANKRUPTCY ABUSE

Proposals to improve America's pension system tend to focus on increasing funding and reducing the PBGC's losses through bankruptcy. Any comprehensive reform proposal must accomplish both of these goals.

A. *Grant a Higher Priority Status to PBGC Claims in Bankruptcy*

This idea proposes passing legislation granting the PBGC claims superpriority status in bankruptcy.¹⁶² This proposal would give the PBGC "the power to have a court enjoin the transfer of a company's assets until the agency's reimbursement claim was satisfied in full."¹⁶³ In order to avoid compromising the reliance interests of secured creditors whose loans predate the proposed law, the proposed lien would only affect the security interest of debts collateralized by firm assets after the passage of superpriority legislation.¹⁶⁴ Also, the proposed statute would not apply to purchase-money loans.¹⁶⁵ The proposal excludes

161. PBGC calculated that adopting this investment strategy would result in superior returns in 98% of the rolling twenty-year investment periods they simulated. Press Release, Pension Benefit Guar. Corp., PBGC Announces New Investment Policy (Feb. 18, 2008), <http://www.pbgc.gov/media/news-archive/news-releases/2008/pr08-19.html>.

162. See Keating, *supra* note 91, at 100–07 (outlining advantages, criticisms, and mechanics of this theory of enhanced priority of claim).

163. *Id.* at 100.

164. See *id.* ("[T]he statute should apply only prospectively, in order to protect the reliance interests of already-existing secured creditors.")

165. See *id.* ("[T]he PBGC's superpriority should be subordinate to any purchase-money security interest."). A purchase-money loan is an individual loan made specifically for the purchase of a given asset. *Id.* For example, if a company signed a separate lease

purchase-money loans because they occur only in conjunction with the acquisition of a given asset and do not reduce the existing collateral pool from which pension obligations could be satisfied.¹⁶⁶

Superpriority status would change the underwriting metrics a financial institution would consider before lending money to a corporation.¹⁶⁷ Instead of being able to lend money and secure unencumbered assets as collateral up to the day a company declares bankruptcy, a lender would have to consider the possibility that fulfilling the superior claims of the underfunded pension plan would exhaust its relied upon collateral. Banks have superior skills to perform this function compared to the PBGC,¹⁶⁸ which faces the constraint of statutorily limited maximum premiums.¹⁶⁹ Superpriority also favorably resolves the inequitable competitive advantage gained by firms who defer a portion of their employees' compensation through the guise of unrealistic pension promises.¹⁷⁰

Though the proposal would only apply prospectively, it suffers several disadvantages. Within the context of bankruptcy, the superpriority lien would greatly increase the difficulty for the debtor-in-possession (DIP) to obtain financing to continue operations.¹⁷¹ Under the bankruptcy code, if a DIP is otherwise

agreement to acquire a company car, this debt would likely qualify as a purchase-money loan. *See* U.C.C. § 9-103(a) (2005) (defining "purchase-money collateral" and "purchase-money obligation").

166. *See* Keating, *supra* note 91, at 100 ("The PBGC . . . would not really be losing its position with respect to such collateral, the acquisition of which never would have occurred without the loan of the purchase-money secured lender.").

167. *See id.* at 102.

168. *See id.* at 102–03 (listing the unique expertise of lenders, experience and information available to trade creditors, and ability to insist on realistic pension funding as reasons why creditors are better suited than the PBGC to police pension funding levels).

169. *See* 29 U.S.C. § 1306(a)(3) (2000), *amended by* Deficit Reduction Act of 2005, Pub. L. No. 109-171, § 8101(a)–(c), 120 Stat. 4, 180–83 (2006) (setting rules for annual premiums payable to PBGC); Brannick, *supra* note 33, at 1594–96 & n.92 (discussing a study concluding premiums are roughly 20% of what a private insurer would charge for similar exposure); DOUGLAS J. ELLIOT, CTR. ON FED. FIN. INSTS., PENSION REFORM: SUMMARY OF FINAL 2006 BILL 5 (2006), <http://www.coffi.org/pubs/Pension%20Reform%20Summary%20of%20Final%20Bill.pdf> (stating that pension reform legislation subjects all underfunded plans to a variable premium).

170. *See* Keating, *supra* note 91, at 101–02 (claiming that "enacting such a statute would prevent firms that underfunded their pension plans from operating at a strategic advantage over those which adequately funded their pension obligations"); *see also supra* notes 63–67, 132–38 and accompanying text (discussing firms' competitive positioning and irresponsible benefit increases).

171. *See* Brannick, *supra* note 33, at 1615–16 (describing the effect superpriority status will have on the estate, noting that "the pool of potential assets from which priority creditors might collect is diminished, thereby eliminating the possibility for unsecured lending").

unsuccessful in obtaining unsecured financing, it may pledge assets already used to secure other debts.¹⁷² Because all the firm's assets would be used first to satisfy pension obligations, lenders would likely charge elevated rates to lend money to the DIP.¹⁷³

Criticisms of this proposal's implications within the mechanics of bankruptcy miss the point.¹⁷⁴ The superpriority solution attempts to assure companies have adequately funded pension plans or do not make pension promises they cannot honor, before they ever get to bankruptcy.¹⁷⁵ Shifting the burden away from employees is beneficial because employees likely do not have sufficient time or expertise to determine their pension plan's solvency. Under this proposal, creditors would perform the calculations. Further, creditors already perform monitoring tasks as part of their business and have greater expertise in evaluating the solvency of a debtor's pension fund.¹⁷⁶

A similar proposal would grant the PBGC a floating lien for pension underfunding.¹⁷⁷ This mechanism would allow the PBGC to place a lien on plan sponsor assets in the amount of the accumulated funding deficiency at the end of every year.¹⁷⁸ Firms might find this less burdensome than a blanket lien because it would encumber only those assets needed in the event of a plan termination, rather than all sponsor assets.¹⁷⁹ This idea might prove difficult to implement, however, because it changes the amount of assets available to the company's other creditors annually. This would create uncertainty not only about the asset pool against which creditors could lend, but also about the asset pool against which they previously lent. For example, what would happen if underfunding increased in a year when a

172. See 11 U.S.C. § 364(d)(1) (2000) ("The court, after notice and a hearing, may authorize the obtaining of credit or the incurring of debt secured by a senior or equal lien on property of the estate that is subject to a lien . . ."); see also Brannick, *supra* note 33, at 1616 (noting the ability of the DIP to re-pledge already collateralized assets).

173. See Brannick, *supra* note 33, at 1616 ("Keating's super-priority would increase the DIP's cost of borrowing.").

174. See *id.* (arguing that Keating's superpriority would "strip the DIP of the ability to sell the property" of the bankrupt estate—an ability specifically granted in the bankruptcy code).

175. See Keating, *supra* note 91, at 102–03 (describing how to assure a pension fund has adequate resources by using the existing credit monitoring skills of creditors as a market-based litmus test for sufficient funding).

176. See *supra* note 168 and accompanying text (explaining the advantages of putting more responsibility for determining the adequacy of pension funding on lenders and trade creditors).

177. See Brannick, *supra* note 33, at 1621 (proposing the floating lien model as a remedy).

178. *Id.*

179. *Id.* at 1621–22.

sponsor took on new debt? Would the creditor's lien take priority, or could the PBGC subsequently come in and supersede the banker's position?

This proposal has a similar functional affect to a superpriority blanket lien on all assets. It reduces the collateral pool available to lenders, but does not provide as much security to pensioners because it collateralizes only the "funding gap." Further, because asset valuation would occur only periodically (likely annually), the potential exists for a company to have a substantial funding gap at the time it terminates its plan. Similarly, a company could pledge assets for collateral to lenders between recalculations of the floating lien, while simultaneously making inadequate contributions to the pension plan in the year before plan termination.¹⁸⁰

Improving the PBGC's position in bankruptcy provides the most elegant solution to the problems facing the pension industry. However, as discussed in Part III.F and Part V below, neither the Bush administration proposal nor PPA 2006 address the PBGC's lien position in bankruptcy. Through this omission, those proposals focus on only half of the pension problem: improved funding. PPA 2006 enacts preventative measures, but does nothing to stop firms from abandoning pension liabilities through bankruptcy.

B. *Private Pension Insurance*

Several commentators have considered the feasibility of allowing private firms to take on the insurance of the pension "diaspora".¹⁸¹ Of these, the most articulate proponent of private insurance advocates shoring up the existing PBGC system and subsequently using a private governing board to set premiums and policy levels in a self-insuring pool.¹⁸² After a transitional period, firms could seek private insurance if they believed they could do so at a less expensive rate, reducing the potential free-

180. Brannick also proposes moving waiver granting power from the IRS to the PBGC, a very practical and likely not overly complex reform that would transfer waiver granting authority to the party that could prospectively have to make good on the funding shortfall permitted by the waiver. Brannick, *supra* note 33, at 1621, 1625.

181. See RICHARD A. IPPOLITO, HOW TO REDUCE THE COST OF FEDERAL PENSION INSURANCE 13–15 (2004), available at <http://www.cato.org/pubs/pas/pa523.pdf> (advocating private firm insurance and simulating the economic effects of private firm insurance on the pension system); see also Brannick, *supra* note 33, at 1617–19 (analyzing Ippolito's private risk pooling plan); Keating, *supra* note 91, at 103–05 (arguing pension insurance is too new and uncertain for private insurers to join the fray).

182. IPPOLITO, *supra* note 181, at 13.

rider weakness of the transitional self-insurance pool.¹⁸³ Such a plan has the advantage of allowing for true risk-based premiums, instead of the statutory maxima set by the PBGC.¹⁸⁴ On the other hand, this proposal does little to prevent the continued use of bankruptcy as a tool for getting rid of unwanted pension obligations.¹⁸⁵ Also, the proposal makes no provision for the possible insolvency of the insurance pool itself. Someone must insure the insurer or else the pensioner still faces the prospect of losing his retirement funding.¹⁸⁶ Private sector providers may find pension insurance too new and unpredictable to offer it,¹⁸⁷ but more recent academic research indicates such risks may be quantifiable and, therefore, appropriate for private insurance.¹⁸⁸ By sidestepping the bankruptcy issue, this proposal could prove easier to implement. However, because private insurance would cost more than government insurance,¹⁸⁹ it would likely cause some sponsors to cease offering pension insurance.¹⁹⁰

C. *The Bush Administration Proposal*¹⁹¹

Though it did not address the bankruptcy issue, the Bush administration proposal targeted three important ERISA shortcomings in the pension system: funding, plan transparency, and premium levels.¹⁹² The plan based funding targets on the financial health of the sponsor, with separate measurements of liabilities for healthy plans and those deemed “at-risk.”¹⁹³ For at-risk plans, the proposal added the additional costs incurred in

183. See *id.* at 14 (stating that allowing sponsors of under-funded plans to find private coverage would eliminate the drain on well funded plans).

184. See *supra* note 169 and accompanying text (detailing the great bargain companies receive by purchasing pension insurance from the PBGC for one-fifth the price they might pay in the private marketplace).

185. See Brannick, *supra* note 33, at 1619 (“[N]othing prevents . . . plan sponsors from filing Chapter 11, terminating their plans, and throwing those plans into the pension pool while remaining in business to the benefit of other creditors.”).

186. See *id.* (arguing that private-risk pooling allows companies to gamble on pension programs and pass off “staggering” losses to the insurance pool).

187. See *supra* note 181 and accompanying text.

188. See Steven Boyce & Richard A. Ippolito, *The Cost of Pension Insurance*, 69 J. RISK & INS. 121, 131 n.28 (2002) (noting there are several models that can be used to predict bankruptcies). Inferentially, this would help insurance firms quantify the risk they would be forced to pay a claim on a plan’s unfunded premiums.

189. See *supra* note 119 and accompanying text (discussing under-priced government pension insurance).

190. GAO FUNDING REPORT, *supra* note 8, at 39.

191. DEPT OF LABOR, STRENGTHEN FUNDING FOR SINGLE-EMPLOYER PENSION PLANS (2005), available at <http://www.dol.gov/ebsa/pdf/sepproposal2.pdf>.

192. *Id.* at 1–2.

193. *Belt Budget*, *supra* note 48, at 24.

plan termination to the present value of accrued benefits under an ongoing plan.¹⁹⁴ When the rules deemed a plan at-risk, the calculations assumed more early retirements, more lump sum payouts of benefits upon retirement if offered by the plan, and included the administrative costs of plan termination.¹⁹⁵ The administration proposal considered a company weak if it had no senior unsecured debt rated investment grade by one of the three major credit rating agencies.¹⁹⁶ This could have proven an unfair definition for companies that carried no debt or were too small to receive ratings from the major credit ratings agencies, but the proposal also contained a provision exempting plans with 500 or fewer participants so long as they had no junk bond debt.¹⁹⁷ An at-risk designation would have increased the cost of pension insurance to high legacy-cost industrial firms with poor credit ratings. Tellingly, General Motors and the United Auto Workers Union required the administration remove this proposal to gain their support for the bill.¹⁹⁸

For healthy plans measured using the “ongoing” plan metrics, the funding target equals the present value of all the benefits the sponsor has to pay to retirees in the future.¹⁹⁹ To calculate present value, the plan could use the long-term corporate bond rate.²⁰⁰ This would have decreased required funding levels, all else being equal, because corporate bond rates exceed the previously utilized government bond rate.²⁰¹ The higher the interest rate used in the calculations, the lower the plan’s liabilities will appear.²⁰²

194. See DEPT OF LABOR, *supra* note 191, at 15–16 (delineating the differences in liability calculation assumptions for ongoing and at-risk plans).

195. *Belt Budget*, *supra* note 48, at 25.

196. DEPT OF LABOR, *supra* note 191, at 14–15.

197. See *id.* at 15 (“[A] plan sponsor is automatically treated as not being financially weak if it has neither senior unsecured debt that is rated nor an issuer credit rating and the employer does not maintain defined benefit plans covering at least 500 participants.”).

198. See Jim Abrams, *Taxpayers and Wall Street are Winners in Pension-Rescue Effort*, MORNINGSUN.NET, Aug. 5, 2006, http://www.morningsun.net/stories/080506/usw_20060805004.shtml (noting GM and the UAW only came out in support of the bill after the House removed a provision linking funding to credit ratings from an earlier Senate version).

199. *Belt Budget*, *supra* note 48, at 24.

200. *Id.*

201. DEPT OF TREASURY, CREATING A CORPORATE BOND SPOT YIELD CURVE FOR PENSION DISCOUNTING 6 (2005), available at http://www.dol.gov/ebsa/pdf/treasury_whitepaper.pdf.

202. See GAO FUNDING REPORT, *supra* note 8, at 14–15 (noting the inverse relationship between interest rate assumptions and reported liabilities). The Administration believed the present value determined through the corporate bond rate more accurately reflected liabilities. *Belt Budget*, *supra* note 48, at 25.

Under the proposal, the plan sponsor would have had to pay the amount accrued during the plan year plus one-seventh of any accumulated shortfall if plan liabilities exceeded the market value, *not* the smoothed value, of plan assets.²⁰³ This would eliminate the sponsor's ability to misuse credit balances to avoid making cash funding contributions.²⁰⁴ The plan sponsor would have had to amortize any shortfall over seven years until the shortfall no longer existed.²⁰⁵ If, in subsequent years, the amortization base established in the current year would not eliminate the shortfall over seven years, the plan would have had to amortize any subsequent gap between the market value of the assets, plus the then-present value of amortization payments, minus the plan liabilities over the subsequent seven years.²⁰⁶

The Bush proposal also increased the annual funding cap to roughly 130% of current liability,²⁰⁷ which would have allowed firms to build up a larger rainy day fund in good years so they could contribute less in years in which they experience business downturns.²⁰⁸ The administration proposal also eliminated at-risk plans' ability to offer lump-sum payouts or increase benefits when funded at 80% or less.²⁰⁹

The administration proposal mandated an immediate increase in premiums to \$30 per plan participant per year to offset inflation since the \$19 premium went into place in 1991.²¹⁰ It also proposed raising the "full funding target" from 90 to 100% of plan liabilities.²¹¹ Further, the Bush administration proposal allowed the PBGC to perfect its lien on assets to recover premiums missed while a plan sponsor navigated through the bankruptcy process, but did nothing to secure pension benefits vis-à-vis other creditors.²¹² The proposal also improved disclosure

203. *Belt Budget*, *supra* note 48, at 26.

204. *See id.* at 19 (describing how companies could take advantage of credit balances to underfund pension plans).

205. *Id.* at 26.

206. *Id.*

207. *See* DEP'T OF LABOR, *supra* note 191, at 18 (stating "[t]he cushion amount is defined as . . . 30 percent of the plan's funding target" plus an allowance for future benefit increases).

208. *See supra* notes 82–84 and accompanying text (describing how statutory restraints on maximum annual funding prevented firms from contributing extra cash in profitable years).

209. *Belt Budget*, *supra* note 48, at 27.

210. *Id.* at 28.

211. ELLIOT, *supra* note 169, at 2; *see also* DEP'T OF LABOR, *supra* note 191, at 29 (highlighting the potential for moral hazard in the then-existing premium rate structure).

212. *See Belt Budget*, *supra* note 48, at 29 (stating the administration proposal would freeze the PBGC guarantee limit while the plan went through bankruptcy and allow the PBGC to circumvent the automatic bankruptcy stay in perfecting a lien on sponsor assets).

and transparency to plan participants by requiring plan sponsors to make public the information shared with the PBGC under ERISA.²¹³

Overall, the Bush administration proposal effectively addressed many of the structural flaws in ERISA that damaged the security of private pensions over the last forty years. However, in doing so, it likely would have hastened employers' exit from the area.²¹⁴ As discussed in the next section, PPA 2006 incorporates several facets of the Bush proposal, but does not fully embrace its free-market reforms.²¹⁵ It instead takes a more middle-of-the-road position that may not cause employers to exit the pension area as rapidly. Unfortunately, it does so at the expense of security to existing pensioners.²¹⁶

V. DISCUSSION AND ANALYSIS OF THE PENSION PROTECTION ACT OF 2006²¹⁷

If a doctor told a patient suffering from severe heart disease to eat right and exercise, the advice would have an effect similar to that of PPA 2006 on the pension industry—helpful forty years ago, but entirely inadequate to address the situation at hand.²¹⁸ The Act fails to resolve the paradox facing pension policy makers: the desire to promote the continuation of the defined benefit pension system while at the same time ensuring those pensions will exist for the employees who depend upon them.²¹⁹ PPA 2006 does more to protect pensions as such than to protect pensions as the third leg of retirement savings.²²⁰

for funding payments missed during bankruptcy).

213. The Bush administration proposal sought to require “broader dissemination of plan information” and proposed rules to assure plan sponsors gave “meaningful and timely” data when providing information. *Id.* at 30. The proposal intended to build on the disclosure requirements in ERISA. *See* Employee Retirement Income Security Act of 1974 § 4010, 29 U.S.C. § 1310 (2000).

214. *See* GAO FUNDING REPORT, *supra* note 8, at 39 (recognizing that any meaningful reform of pension regulations would likely cause plan sponsors to stop offering pensions).

215. *See, e.g., infra* note 227 and accompanying text (describing how Congress did not adopt the proposed abolition of credit balances).

216. *See* Cocco, *supra* note 14 (arguing that the act will likely “shrink traditional pension coverage” and “hasten the shift of the retirement burden to workers”).

217. Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat. 780.

218. *See* Abrams, *supra* note 198 (“Young workers, Wall Street, a couple of airlines[,] and U.S. taxpayers could come out as winners in the pension changes made by Congress.”). Note that retirees and long-time employees of mature U.S. industries do not appear on the list. *Id.*

219. *See* GAO FUNDING REPORT, *supra* note 8, at 37–39 (discussing the challenge in balancing the desire for funding flexibility with the need for pension security).

220. *See* Mark Trumbull, *Reform Erodes Future of Pensions*, CHRISTIAN SCI.

Most disappointingly, PPA 2006 does nothing to prohibit companies from terminating their pension plans in bankruptcy—thereby passing responsibility to the PBGC for payment of the pensions.²²¹ Congress’s failure to address the bankruptcy loophole could prove especially problematic given the current state of the U.S. automobile manufacturing industry. There, high legacy-costs²²² and decreasing market share²²³ combine with poor pension funding rules²²⁴ and the ability to shed pension in bankruptcy to create the necessary conditions for a repeat of the “perfect storm” airline industry pensioners recently experienced. If U.S. automobile manufacturers do go through a round of bankruptcies, the industry’s pensioners face a decidedly bleak outlook.²²⁵ Based on historical experience, pension promises above the PBGC statutory maximum-insured level likely will not survive any future bankruptcy proceedings.²²⁶

Though the PBGC generally endorsed the changes to the system, this is not the first time the PBGC has been a cheerleader for changes in pension funding. In fact, after the 1994 changes to the pension law, the PBGC officials asserted, “[T]he act nearly guarantees that large underfunded plans will strengthen and the chronic deficits suffered by the pension guaranty organization will be eliminated within 10 years.”²²⁷ One

MONITOR, Aug. 18, 2006, at 2 (describing the tradeoff between offering fully funded pensions and shifting the retirement burden onto the workers); see also Cocco, *supra* note 14 (advising pensioners to skip reading the 900 page PPA 2006 and “[k]eep worrying” whether their pension plan will still exist when they retire).

221. See Cocco, *supra* note 14 (lamenting the bill still allows plan sponsors the “obnoxious corporate strategy” of terminating their pensions in bankruptcy).

222. Similar to the Social Security system, the proportion of retirees to workers in pension plans has been growing. In 1985, inactive participants comprised 28% of single employer defined contribution plans, compared to 50% in 2005. *Belt Budget*, *supra* note 48, at 7; see also Walsh, *supra* note 4, at 9 (discussing the legacy costs facing mature U.S. industries).

223. See Christine Tierney, *Tough End to a Tough Year*, DETROIT NEWS, Jan. 4, 2007, at 1C (noting U.S. manufacturers have never had a lower domestic market share than they did in 2006). Sales at GM, Ford, and DaimlerChrysler fell by 8.7%, 8%, and 5.5% in a year when the U.S. market overall shrank by 2.6%. *Id.* In contrast, sales by Toyota climbed 12.5%, passing DaimlerChrysler for the first time. *Id.*

224. See *infra* part III.A and accompanying notes (discussing how the old pension rules led to chronic underfunding).

225. As of June 15, 2005, the liabilities of pension plans sponsored by auto industry firms exceeded assets by an estimated \$55–\$60 billion. *Belt Budget*, *supra* note 48, at 3.

226. See, e.g., Press Release, *supra* note 122 (stating pensioners in underfunded pension plans terminating in 2007 who retire at age 65 will receive no more than \$49,500 per year, regardless of the amount promised under the company’s pension plan); see also *supra* notes 27–31 and accompanying text (stating that Delta pilots will never recover their full pensions after Delta unloaded the pensions onto the PBGC).

227. Barlett & Steele, *supra* note 2, at 42 (demonstrating the PBGC overestimated the effectiveness of prior reforms). These predictions proved incorrect, as total

can only hope the remedies of PPA 2006 prove more effective than those put in place twelve years ago.

The Act makes four major changes: (1) stricter funding requirements; (2) restrictions on benefit increases for troubled plans; (3) increased inflation-indexed premiums; and (4) changes to calculations of asset and liability values.²²⁸

A. *Stricter Funding Requirements*²²⁹

The Act strengthens funding requirements in three main ways: (1) it increases the funding target from 90 to 100% of plan assets;²³⁰ (2) it restricts the use of credit balances;²³¹ and (3) it uses tougher actuarial assumptions for at-risk plans.²³² The Act also makes special funding provisions for certain airline plans which are discussed in this section, though they protect the existence, rather than the solvency, of the affected plans.²³³

1. *Increased Funding Target.* The new law increases the funding target from 90 to 100% of plan assets,²³⁴ but gives plans

underfunding in the PBGC plans totaled \$31 billion in 1994, but reached as high as \$450 billion in 2005. *Id.*

228. ELLIOT, *supra* note 169, at 2.

229. Funding requirements are addressed in two separate PPA 2006 sections. *See* Pension Protection Act of 2006, Pub. L. No. 109-280, § 102(a), 120 Stat. 780, 789 (to be codified at 29 U.S.C. § 1083) (updating labor law); Pension Protection Act of 2006, Pub. L. No. 109-280, § 112(a), 120 Stat. 780, 789 (to be codified at 26 U.S.C. § 430) (updating the tax code). The PBGC attributes the \$100 billion decrease in nationwide underfunding of single-employer plans during 2006 from \$450 to \$350 to improved economic conditions and higher interest rates, not the act. PENSION BENEFIT GUAR. CORP., *supra* note 23, at 8. The effects of PPA 2006, positive or negative, likely will not become apparent for several years.

230. *See* 26 U.S.C.A. § 430(d)(1) (West Supp. 2007) (setting the funding target at the present value of *all* benefits accrued); 29 U.S.C.A. § 1083(d)(1) (West Supp. 2007) (same); *see also* ELLIOT, *supra* note 169, at 2 (calculating this measure will result in \$200 billion in additional funding, given a system with roughly \$2 trillion in total liabilities).

231. *See* ELLIOT, *supra* note 169, at 3 (acknowledging that the Bush administration wanted to abolish credit balances, but Congress only restricted them significantly); *see also supra* notes 95–97 and accompanying text (explaining past abuses of credit balances).

232. *See* 26 U.S.C.A. § 430(i)(1)(B) (West Supp. 2007) (including assuming that retirees will retire at the earliest retirement date of the plan); 29 U.S.C.A. § 1083(i)(1)(B) (West Supp. 2007) (same); *see also* ELLIOT, *supra* note 169, at 4 (discussing the implications of more stringent metrics for at-risk plans).

233. *See* Pension Protection Act of 2006, Pub. L. No. 109-280, § 402, 120 Stat. 780, 922, 925 (allowing a seventeen-year amortization period to qualified airlines); *see also* ELLIOT, *supra* note 169, at 4–5 (explaining the differing treatment for firms even within the airline industry).

234. *Supra* note 229 and accompanying text. The Deficit Reduction Contribution (DRC) requirements previously set required funding levels. ELLIOT, *supra* note 169, at 2–3. They applied to pensions that were under 80% funded or were less than 90% funded in two of the last three years. *Id.* Because no penalty existed as long as a plan had assets equal to 90% of liabilities, the previous rules functionally had a 90% funding requirement (at that level a firm can avoid the DRC measures). *Id.* at 3.

seven years from the effective date of the Act to amortize any shortfall below the funding target.²³⁵ The Act uses a phased step-up in the funding target over four years,²³⁶ culminating with a target of 100% funding by 2011.²³⁷ Previously, the law allowed for the amortization of many types of funding shortfalls over periods as long as thirty years.²³⁸ In contrast, PPA 2006 requires that a plan amortize all funding shortfalls over seven years from the date the shortfall occurred. This represents a substantial improvement over previous law.²³⁹ As a result, increasing benefits instead of wages will become less attractive to plan sponsors due to the reduction in the amount of time over which the sponsor may amortize the increase.²⁴⁰

Though it will make offering pension benefits less cost effective, experts do not believe the new funding law itself will cause existing plan sponsors to terminate their defined benefit plans.²⁴¹ In fact, the Congressional Budget Office estimates companies will actually make lower contributions over the next five years as the funding requirements go into place, with higher contributions thereafter.²⁴² This results from the Act allowing firms to discount liabilities using the more favorable corporate bond rate, rather than the more conservative Treasury rate.²⁴³

235. 26 U.S.C.A. § 430(c)(2)(A) (West Supp. 2007); 29 U.S.C.A. § 1083(c)(2)(A) (West Supp. 2007).

236. Only plans that (1) were in existence prior to 2007, (2) were not subject to the DRC in 2007, and (3) met the funding threshold in the previous plan year can take advantage of the phase-in. 26 U.S.C.A. § 430(c)(5)(B) (West Supp. 2007); 29 U.S.C.A. § 1083(c)(5)(B) (West Supp. 2007).

237. See 26 U.S.C.A. § 430(c)(5)(B)(ii) (West Supp. 2007) (mandating 92% funding in 2008, 94% in 2009, 96% in 2010, and 100% thereafter to avoid a new “shortfall amortization base”); 29 U.S.C.A. § 1083(c)(5)(B)(ii) (West Supp. 2007) (same). If a plan does not meet the specified level in any year during the phase-in period, the act uses the difference between its liabilities and its assets, *not* between the prescribed percentage in a given year and its assets, to calculate its shortfall amortization base. See 26 U.S.C.A. § 430(c)(3)–(4) (West Supp. 2007); 29 U.S.C.A. § 1083(c)(3)–(4) (West Supp. 2007).

238. See 26 U.S.C. § 412(b) (2000) (mandating amortization of past service liability and unfunded liability from plan amendment over thirty years, and allowing ten years to amortize changes in actuarial assumptions), *amended by* Pension Protection Act of 2006, Pub. L. No. 109-280, § 412, 120 Stat. 780, 820; 29 U.S.C. § 1082(b) (2000) (same), *repealed by* Pension Protection Act of 2006, Pub. L. No. 109-280, § 101, 120 Stat. 780, 784.

239. See *supra* notes 132–38 and accompanying text (detailing the problem of firms granting overly generous benefit increases to plan participants instead of wage raises, due in part to the sponsor’s ability to amortize benefits expense over thirty years).

240. *Id.*

241. See Abrams, *supra* note 198 (quoting Frank McArdle, manager of the Washington office of Hewitt Associates, a human resources consulting firm, as opining, “We think in the end companies will figure out a way to work with [the new funding requirements].”).

242. *Id.*

243. 26 U.S.C.A. § 430(h)(2) (West Supp. 2007) (describing applicable interest rates

In fact, threats of voluntary termination by firms in financial distress due to higher funding requirements likely represent more of a lobbying tactic than economic reality.²⁴⁴ Most plan sponsors in financial distress will not choose to perform a standard termination, even given funding rules or other measures by Congress to strengthen the pension insurance system.²⁴⁵ Doing so would require the sponsor to purchase annuities from a private insurer that will use more conservative actuarial assumptions than those used by the plan sponsor, resulting in a greater expense to the sponsor than simply freezing the plan and keeping it under sponsor administration.²⁴⁶ However, the above analysis applies only to firms outside of bankruptcy. Even after the passage of PPA 2006, firms can still terminate their plans through bankruptcy with only nominal penalties for underfunding.

2. *Restrictions on the Use of Credit Balances.*²⁴⁷ A credit balance occurs when a plan sponsor carries over an excess payment from a previous year, which can earn interest as long as the plan sponsor does not use it.²⁴⁸ Many of the largest defaults foisted onto the PBGC came from firms that had not made cash contributions in several years due to their use of credit balances.²⁴⁹ Crucial to the reforms of PPA 2006, plan sponsors must now adjust credit balances based on *actual* returns, rather than the imaginary “smoothed” (i.e., averaged) interest rate used in other plan calculations.²⁵⁰

In the past, even if the credit balance assets lost value, the plan could add to its asset account as if the credit balance assets had increased in value by the projected interest rate when

as determined through the corporate bond yield curve); *see also infra* note 292 and accompanying text (explaining how to calculate the corporate bond rate under PPA 2006).

244. *See* ELLIOT, *supra* note 115, at 6 (discussing the economic disincentive to voluntarily terminate a pension plan).

245. *See id.* (arguing that companies are more likely to freeze future benefits instead of terminating the plan outright to avoid the costs of passing the plan on to insurers).

246. *See id.* (estimating such a transition would cost roughly \$51 billion, or 3% of the \$1.7 trillion of pension assets currently in the defined benefit pension system as of 2004). In comparison, the PBGC took in only \$1.5 billion in premiums that year. *Id.*

247. For a discussion of the past abuses of credit balances, *see supra* Part III.B.

248. *See generally* 26 U.S.C. § 412(b) (2000) (setting forth rules for crediting and charging the “funding standard account”), *amended by* Pension Protection Act of 2006, Pub. L. No. 109-280, § 412, 120 Stat. 780, 820; 29 U.S.C. § 1082(b) (2000) (same), *repealed by* Pension Protection Act of 2006, Pub. L. No. 109-280, § 101, 120 Stat. 780, 784.

249. ELLIOT, *supra* note 169, at 3.

250. 26 U.S.C.A. § 430(f)(8) (West Supp. 2007); 29 U.S.C.A. § 1083(f)(8) (West Supp. 2007).

calculating the required funding contributions.²⁵¹ The Act calls existing credit balances “carryover,”²⁵² and new credit balances “prefunding balances.”²⁵³ Sponsors must mark assets in both categories to *market value*, rather than report the assets as having increased at the previously utilized projected rate.²⁵⁴ However, if total plan assets minus prefunding balances, including “carryover” balances, equal at least 80% of the target funding level, up to 100% of the contributions for the year may be made from non-cash credit balances.²⁵⁵ Also, if total plan assets including credit balances exceed the funding target of the plan, the sponsor can use credit balances as all or part of current year contributions.²⁵⁶

3. *Tougher Assumptions for “At Risk” Plan Liabilities.* PPA 2006 considers a plan “at risk” if it has a funding target attainment percentage for the preceding year below 80% based on the standard calculation or if the plan has an attainment percentage below 70% based on certain at-risk metrics.²⁵⁷ If a plan falls into the “at risk” category, it must use worst-case actuarial assumptions for participants eligible to receive benefits in the current year and the next ten plan years.²⁵⁸ For example, the sponsor must assume plan participants will retire early and elect lump sum payments where available.²⁵⁹ While this appears

251. See generally 26 U.S.C. § 412(l) (2000) (addressing funding requirements for deficient pension plans), amended by Pension Protection Act of 2006, Pub. L. No. 109-280, § 412, 120 Stat. 780, 820; see also ELLIOT, *supra* note 169, at 3 (noting that this issue came to a head during the most recent bursting of the financial bubble). However, if a plan was subject to the DRC rules, the sponsor had to subtract credit balances from plan assets when determining the amount of contributions necessary under the DRC. 26 U.S.C. § 412(l)(1) (2000), amended by Pension Protection Act of 2006, Pub. L. No. 109-280, § 412, 120 Stat. 780, 820.

252. 29 U.S.C.A. § 1083(f)(1)(B) (West Supp. 2007).

253. 29 U.S.C.A. § 1083(f)(1)(A) (West Supp. 2007).

254. 26 U.S.C.A. § 430(f)(8) (West Supp. 2007); 29 U.S.C.A. § 1083(f)(8) (West Supp. 2007).

255. 26 U.S.C.A. § 430(f)(3) (West Supp. 2007); 29 U.S.C.A. § 1083(f)(3) (West Supp. 2007).

256. See ELLIOT, *supra* note 169, at 3.

257. See 26 U.S.C.A. § 430(i)(4)(A) (West Supp. 2007) (giving the funding targets). The target percentage will phase in at 5% increments from 65% in 2008 to 80% in 2011. 26 U.S.C.A. § 430(i)(4)(B) (West Supp. 2007).

258. 26 U.S.C.A. § 430(i)(1)(B) (West Supp. 2007); 29 U.S.C.A. § 1083(i)(1)(B) (West Supp. 2007).

259. See 26 U.S.C.A. § 430(i)(1)(B) (listing actuarial assumptions for at-risk plans); 29 U.S.C.A. § 1083(i)(1)(B) (same). Employees of GM, Ford, and Delphi who refused early retirement packages offered in 2006 would not count as likely to retire over the next ten years in the mandated ‘worst-case’ actuarial assumptions. See ELLIOT, *supra* note 169, at 4 (noting that these autoworkers do not count as potential retirees). For these firms, this exception virtually eliminates the cost of being categorized as “at risk.” *Id.*

to substantially improve the PBGC's ability to force underfunded firms to make catch-up contributions, one commentator argues that the combined effect of the transition period will permit a firm funded at 79% throughout the period to avoid making the full "at risk" funding payments until 2015.²⁶⁰ However, the Act provides additional incentive for "at risk" plans to fund, since those firms deemed "at risk" in both the current year and two of the previous four years must pay a PBGC load of 4% of plan assets plus \$700 per plan participant.²⁶¹

4. *Special Airline Provisions.* Though they represent the largest percentage of claims against the PBGC of any industry,²⁶² the airlines successfully lobbied for more lenient funding standards. If a commercial passenger airline accepts a "freeze" on the insured benefit levels of its pensions, the Act allows the airline an additional ten years from 2008, on top of the standard seven, to make up its funding deficits.²⁶³ This change will improve the airline's cash flow, but it does little to otherwise improve the retirement security of the participants in these plans. Additionally, airlines making the election to freeze their plans also get to use a discount rate of 8.85% when calculating the present value to plan liabilities, two to three percentage points higher than the rate the Act permits other firms to use.²⁶⁴ The provision ensures the Act at best protects the *existence* of airline industry pension plans, but it does very little to protect the solvency of these plans. This results because each 1% increase in the discount rate causes a 10%–15% decrease in calculated pension liability, which in turn greatly decreases the plan's funding requirements.²⁶⁵ The provision therefore effectively reduces airlines' calculated pension liability by between 20% and 45%. The PBGC believes these changes have at least delayed the failure of several airline pension plans, as it reported a \$4.2

260. See ELLIOT, *supra* note 169, at 4 (explaining potential effect of the phase-out period).

261. 26 U.S.C.A. § 430(i)(1)(A), (C) (West Supp. 2007).

262. See *supra* note 132 and accompanying text (examining number of failed plans by industry).

263. See Pension Protection Act of 2006, Pub. L. No. 109-280, § 402(e), 120 Stat. 780, 925 (authorizing seventeen-year amortization period). Additionally, if an airline still has a deficit at the end of the seventeen-year period in 2025, it will receive the standard seven years to make up the shortfall. See ELLIOT, *supra* note 169, at 4 (observing the Act grants airlines seven years to correct underfunding).

264. See Pension Protection Act of 2006, Pub. L. No. 109-280, § 402(e)(4), 120 Stat. 780, 925 (allowing use of 8.85% rate). The default interest rate is determined by averaging a range of corporate bond yields. See *infra* note 298 and accompanying text.

265. See ELLIOT, *supra* note 169, at 4 (estimating the reduction in calculated pension liability resulting from using these rates).

billion improvement in net position in 2006, largely due to the reclassification of \$5.6 billion of airline pension obligations from “probable” to “reasonably possible.”²⁶⁶

Ironically, the only two legacy carriers that continue to maintain active pension plans, American and Continental, opposed the special provisions for airlines.²⁶⁷ They opposed the bill because airlines with “frozen” plans get seventeen years to catch up, while airlines with ongoing plans receive only ten years.²⁶⁸ PPA 2006 therefore counterintuitively tilts the competitive landscape in favor of airlines that chose not to honor their employees’ pensions.

B. Restrictions on Benefits Increases by At-Risk Plans

Under the Act, a plan may not increase benefits if plan assets represent less than 80% of its “adjusted funding target attainment percentage”²⁶⁹ or would equal less than 80% after taking into account the contemplated plan amendment.²⁷⁰ However, an exception applies if the sponsor funds the increase in cash or brings the funding level up to 80%.²⁷¹ Prior to PPA 2006, ERISA prohibited plans with more than 100 participants from increasing benefits if plan assets equaled less than 60% of liabilities calculated on a current liability basis.²⁷² PPA 2006 further stipulates plans less than 60% funded after subtracting all credit balances must suspend benefit accruals.²⁷³ Additionally, employees cannot receive any increase in pension benefits for additional time worked or elect to take lump sum payouts, even if their labor contract calls for it.²⁷⁴ Similarly, plans funded between 60% and 80% can continue accruals but cannot make the accrual

266. See PENSION BENEFIT GUAR. CORP., *supra* note 23, at 3 (describing plan relief resulting from reclassification).

267. See Abrams, *supra* note 198 (noting fifteen of the sixteen House Republicans who voted against the bill represented Texas, where both American and Continental are headquartered).

268. See *id.* (noting that American and Continental both have active plans).

269. Basically defined as the ratio of the plan’s assets, not including credit balances, divided by its funding target. For the exact definition, see 26 U.S.C.A. 436(j)(2) (West Supp. 2007).

270. 26 U.S.C.A. § 436(c)(1) (West Supp. 2007); 29 U.S.C.A. § 1056(g)(2) (West Supp. 2007).

271. *Id.*

272. See 26 U.S.C. § 401(a)(29) (2000), *repealed by* Pension Protection Act of 2006, Pub. L. No. 109-280, 120 Stat. 780, 853 (requiring plan sponsor to provide security prior to plan amendment).

273. 26 U.S.C.A. § 436(e) (West Supp. 2007); 29 U.S.C.A. § 1056(g)(4) (West Supp. 2007).

274. See ELLIOT, *supra* note 169, at 5 (cataloguing restrictions created by the act).

formula more generous.²⁷⁵ Also, plans in this funding category can pay lump sums, but only at 50% of the amount to which the employee is entitled or the level guaranteed by the PBGC, whichever is lower.²⁷⁶ The employee receives the remaining benefit as an annuity with no guaranty of security.²⁷⁷ However, none of these restrictions apply if a plan is fully funded when credit balances are taken into account.²⁷⁸ These provisions effectively discourage sponsors from offering benefits they cannot afford to pay. Additionally, as discussed in the following section, PPA 2006 takes a small step toward charging underfunded firms risk-based premiums.²⁷⁹

C. Premium Increases

PBGC's premiums remained static at \$19 per participant per year from 1991 to 2005, while the maximum insured benefit increased 69% during that same period.²⁸⁰ The increase in premiums represents the simplest and perhaps most obvious reform of PPA 2006. The Act makes permanent the premium increase put in place by the Deficit Reduction Act of 2005,²⁸¹ raising rates from \$19 per plan participant per year to \$30.²⁸² PPA 2006 also eliminates exceptions that allowed firms to escape paying the additional variable premium of 0.9% of unfunded vested benefits.²⁸³ The Act makes permanent the provisions of the Deficit Reduction Act of 2005, charging successfully reorganized companies that dump their pension obligations on the PBGC during bankruptcy a "termination premium" of \$1,250 per formerly covered worker per year for three years.²⁸⁴ Because

275. See 26 U.S.C.A. § 436(d)(3) (West Supp. 2007) (limiting ability of plan to make certain payments); 29 U.S.C.A. § 1056(g)(3) (West Supp. 2007) (same).

276. 26 U.S.C.A. § 436(3)(A) (West Supp. 2007).

277. See ELLIOT, *supra* note 169, at 5 (describing distribution of remaining benefit).

278. See *id.* (commenting on significance of the lack of restrictions for those plans that are 100% funded).

279. See *infra* note 283 and accompanying text (discussing ability of PPA 2006 to effectively charge underfunded or unfunded benefits).

280. See *supra* notes 115–20 and accompanying text (discussing static premiums and resulting consequences).

281. See Deficit Reduction Act of 2005, Pub. L. No. 109-171, § 8101, 120 Stat. 4, 180 (2006) (raising the PBGC premiums).

282. See 29 U.S.C. § 1306(a)(3)(A)–(E) (2000), *amended by* Deficit Reduction Act of 2005, Pub. L. No. 109-171, § 8101(a)–(c), 120 Stat. 4, 180 (2006); see also *supra* notes 115–19 and accompanying text (discussing the role that the PBGC's flat rate premium structure played in creating moral hazard).

283. See Pension Protection Act of 2006, Pub. L. No. 109-280, § 401(a), 120 Stat. 780, 922 (amending 29 U.S.C. § 1306(a)(3)(E) (2000)); see also ELLIOT, *supra* note 169, at 5 (noting that the bill removes such exceptions).

284. See Pension Protection Act of 2006, Pub. L. No. 109-280, § 401(b), 120 Stat. 780,

underfunding per worker can vastly exceed this modest amount, this provision will not change the attractiveness of shedding pension obligations through bankruptcy.²⁸⁵

Plan sponsors may complain about higher premiums, but voluntary plan terminations due to higher rates likely will not occur. The same logic holds true as in the case of increasing stricter funding requirements.²⁸⁶ Increasing premiums likely will drive few firms in financial difficulty to terminate their pensions outside of bankruptcy because doing so would require them to purchase unfavorably priced private annuities for their employees.²⁸⁷

Even risk-based premiums are not an incentive to fund fully at the current levels because paying higher premiums is still much cheaper than voluntary termination or paying the money necessary to fund adequately. Aside from the high cost of voluntary termination,²⁸⁸ higher premiums resemble only the interest on the loan employees make to employers by allowing them to underfund their pension promises.²⁸⁹ This represents a very low-cost, attractive source of capital, especially for firms having financial difficulties, which may never repay the “loan” from their employees. Removing from PPA 2006 the Bush administration proposal to tie premiums to credit ratings means struggling plan sponsors can still, in effect, take out low interest loans from their employees’ pension funds. Also, as discussed in the following section, the Act permits the use of more favorable interest rate assumptions. This decreases the calculated unfunded pension liability upon which the plan must pay variable-rate premiums.

922 (amending 29 U.S.C. § 1306(a)(7) (2000)); *see also* ELLIOT, *supra* note 169, at 5 (explaining the “termination premium”).

285. *See supra* notes 27–32 and accompanying text (noting that Delta Airlines shed pension obligations equal to \$160,000 per pilot in bankruptcy).

286. *See* ELLIOT, *supra* note 115, at 8 (explaining concerns that stricter funding requirements may increase voluntary plan terminations will prove unfounded because voluntary plan termination requires the sponsor to purchase high priced private pensions for employees); *see also supra* notes 245–46 and accompanying text (same).

287. *See supra* notes 245–46 and accompanying text (describing consequences to firms that choose to terminate pension plans).

288. *Supra* notes 245–46 and accompanying text.

289. *See* IPPOLITO, *supra* note 35, at 18–19 (explaining the pension essentially represents current earnings an employer would pay the employee but are instead held by the employer until a later time of distribution).

D. Changes to Asset and Liability Value Calculations

PPA 2006 permanently changes the interest rate benchmark by which the present value of liabilities is calculated.²⁹⁰ The new law bases the yield curve for discounting liabilities on three categories: payments due in one to five years, payments due in six to twenty years, and payments due in twenty or more years.²⁹¹ One calculates the yield based on an equal blend of corporate bonds rated of the relevant maturities AAA, AA, and A.²⁹² Using a higher interest rate will yield a lower present value of liabilities, reducing the amount companies must contribute.²⁹³ It will also decrease the amount of underfunding reported to the PBGC, thereby decreasing sponsors' liability to pay the risk-based variable-rate premium (VRP).²⁹⁴

The Act also reduces the number of years a firm can use to "smooth"²⁹⁵ its reported rate of return. The new law reduces the period from which a firm can draw historical return data for smoothing purposes to twenty-four months for both assets and liabilities.²⁹⁶ Additionally, PPA 2006 allows smoothing only within a band of 90% to 110% of current fair market value.²⁹⁷ Firms may also choose to switch to a calculation using only current rates with no smoothing, but having done so may only revert to the twenty-four month smoothing model with the permission of the Secretary of the Treasury.²⁹⁸

290. See 26 U.S.C.A. § 430(h)(2) (West Supp. 2007) (mandating rates to be used). Before 2004, the rate was based on the thirty-year Treasury rate. See PENSION BENEFIT GUAR. CORP., *supra* note 23, at 10 (tracing recent history of applicable rates). In 2005 and 2006, Congress authorized plans to use long term investment grade corporate bond yields to calculate the rate. *Id.*

291. See 26 U.S.C.A. § 430(h)(2)(C)(i)–(iii) (West Supp. 2007) (defining the three portions of the rate curve).

292. See 26 U.S.C.A. § 430(h)(2) (West Supp. 2007) (calculating yield based on investment grade bonds); see also ELLIOT, *supra* note 169, at 6 (identifying top three bond ratings).

293. See *supra* note 265 and accompanying text (discussing the inverse relationship between interest rate assumptions and calculated plan liability).

294. See PENSION BENEFIT GUAR. CORP., *supra* note 23, at 10 (explaining interaction between interest rate and variable-rate premium).

295. For a discussion of the problems caused by smoothing under the prior regulations, see *supra* notes 100–04 and accompanying text.

296. See ELLIOT, *supra* note 169, at 6 (detailing smoothing options now available).

297. See Pension Protection Act of 2006, Pub. L. No. 109-280, § 102(a), 120 Stat. 780, 789–97 (to be codified at 29 U.S.C. § 1083(g)(3)) (restricting smoothing of assets); Pension Protection Act of 2006, Pub. L. No. 109-280, § 112(a), 120 Stat. 780, 826, 826, 833–34 (to be codified at 26 U.S.C. § 430(g)(3)) (same); see also ELLIOT, *supra* note 169, at 6 (reviewing limits of asset value smoothing).

298. See 26 U.S.C.A. § 430(h)(2)(D)(ii) (West Supp. 2007) (setting restrictions on ability to switch between different rates).

PPA 2006 provides much-needed reform in the areas of premiums, transparency, and funding. Unfortunately, because it largely ignores bankruptcy issues, the Act leaves pensioners in need of additional protection. As discussed in the subsequent section, mandatory private supplemental pension insurance for benefits above the PBGC statutory maximum would provide the needed protection. At the same time, it would provide sponsors with additional incentive to adequately fund their plans.

VI. PROPOSALS FOR FURTHER REFORM

Given that Congress has repeatedly proven either unwilling or unable to address the statutory loophole allowing firms to discard their pensions in bankruptcy, further suggestions to reform that portion of the pension problem likely would fall on deaf ears. Therefore, Congress should require firms to carry private supplemental insurance for any amount promised to workers above the statutory maximum the PBGC will pay. This insurance would guarantee the pensioner retained rights to receive the full amount promised at the time specified by the pension plan.

Enacting such a proposal would likely cause some firms to freeze plans at the statutory maximum²⁹⁹ because insurers would not offer insurance, or would charge prohibitively expensive rates to firms in bad financial condition with underfunded plans.³⁰⁰ However, the proposal at least would stop firms from irresponsibly using pension benefit increases they likely will never honor as a substitute for current wage increases.³⁰¹ A firm's inability to secure supplemental insurance would serve as a warning to pensioners that their retirement income was not secure above the PBGC level.

Additionally, this proposal would transfer a portion of the underwriting onus from plan participants to more financially savvy experts in insurance, actuarial assumptions, and credit.³⁰² The entrance of private insurance underwriting discipline would provide incentive to fund more fully to reduce the cost of the

299. GAO FUNDING REPORT, *supra* note 8, at 39 (admitting even carefully crafted reform may cause some sponsors to freeze their plans).

300. IPPOLITO, *supra* note 35, at 89–90; *see also* Keating, *supra* note 91, at 103–04 (arguing pension insurance is too new and uncertain for private insurers to join the fray).

301. *Cf. supra* notes 132–38 and accompanying text (describing how firms shift employment expense from the present to the future to free up cash).

302. *See* Keating, *supra* note 91, at 101–03 (discussing the benefits of market monitoring of plan solvency).

insurance.³⁰³ Supplemental insurance also would likely cost more per dollar of benefit insured due to the differing actuarial assumptions used by plan sponsors and private insurance companies,³⁰⁴ thereby reducing a firm's incentive to defer compensation in order to free up present-day liquidity. This proposal would eliminate the detriment to retirees in the event of sponsor bankruptcy.³⁰⁵ It might cause slower increases in pension benefit accrual, but at least the amount funded would be secure.³⁰⁶

Further, Congress should build on the progress it made in PPA 2006 regarding VRPs.³⁰⁷ While closing the loopholes that allowed firms to avoid paying the VRP will increase premium revenue going forward, charging a fixed percentage of assets as the VRP could leave pension underfunding as an attractive source of capital for a cash-strapped firm.³⁰⁸ Charging a low, fixed percentage of underfunding does not connect the VRP to the changing economic conditions reflected in interest rate fluctuations. Paradoxically, as it stands currently, the VRP rate is itself completely static at 4% of plan assets plus \$700 per plan participant.³⁰⁹ Congress should instead enact legislation charging underfunding firms a VRP based on the one-year Treasury note rate. To account for the disparate risks posed to the PBGC by firms of various credit ratings, the VRP rate would vary based on

303. See *supra* note 119 and accompanying text (stating academic studies find the PBGC insurance two to six times more valuable than the premium charged).

304. See ELLIOT, *supra* note 115, at 6 (noting private insurance companies generally use assumptions around 5% for rates of return, while pensions plans use assumptions around 8%). The more optimistic the anticipated rate of return, the less expensive promising to provide the benefit will appear on a current liability basis today. GAO FUNDING REPORT, *supra* note 8, at 14–15. This means pensions offer employers a lower-cost benefit than anticipated to give their workers when plan assets appreciate more rapidly than expected, but a high-cost benefit when assets appreciate more slowly than expected. All else equal, plan sponsors “win” in a strong investment environment, while conversely plan participants “win” in a poor investment environment, if one defines winning as receiving a deal better than that for which one bargained.

305. Losing a pension relied upon in retirement often profoundly affects a retiree's standard of living. Said one retiree when asked how she survived without her pension, “I save cans.” Barlett & Steele, *supra* note 2, at 35.

306. See GAO FUNDING REPORT, *supra* note 8, at 39 (asserting that ultimate goal of pension reform should be secure retirement benefits). Ironically, the security of the income stream has always ranked high on the list of advantages pension proponents tout in arguing their virtues versus the 401(k) plan. See Barlett & Steele, *supra* note 2, at 38 (arguing that 401(k) “contributions will never be enough to match the certain and long-term income from a defined-benefit plan”).

307. See *supra* note 282 and accompanying text (discussing Congress's steps towards imposing the VRP on firms that once may have avoided it).

308. See *supra* notes 91–93 and accompanying text (examining advantages firms may have in underfunding its pension plan).

309. See 26 U.S.C.A. 430(i)(1)(C) (West Supp. 2007) (setting VRP rate); 29 U.S.C.A. 1083(i)(1)(C) (West Supp. 2007) (same).

a percentage of the T-note rate. AAA-rated firms would pay a rate roughly equal to the T-note rate, while C-rated firms would pay a maximum rate equal to some multiple of the T-note rate.³¹⁰

Requiring underfunding firms to pay a variable-rate premium based on market interest rates would remove the potential attractiveness of pension plan underfunding as a source of capital. If Congress passed this proposal, plan sponsors could no longer use pension underfunding as a low-cost source of capital during a cash crunch because they would have to pay a market-based VRP approximating the interest on a loan to a firm in similar financial condition. Furthermore, the proposal negates the competitive advantage accruing to underfunding firms versus their competitors in an industry—the underfunding firm would no longer enjoy a relative cost advantage, gained by underfunding its pension plan.

These proposals would cause some firms to exit the pension arena,³¹¹ however, many firms were already doing so under the old rules.³¹² Pension reform should focus as much on plan security as on the continued existence of pensions as a benefit category.³¹³ The two proposals discussed above remedy shortcomings of PPA 2006 by securing the pension payments of retirees while simultaneously providing sponsors greater incentive to fund their plans.

Finally, the PBGC should invest a larger portion of its assets under management in non-Treasury securities.³¹⁴ By doing otherwise, the PBGC needlessly leaves money on the table at a time when it needs every advantage it can muster.³¹⁵

VII. CONCLUSION

Systemic flaws in the regulatory framework governing America's pension system led to chronic underfunding of pension

310. The Treasury Department would determine an appropriate VRP scale based on the model proposed. Determining the appropriate VRP scale multiples exceeds the scope of this Comment.

311. See GAO FUNDING REPORT, *supra* note 8, at 39 (recognizing that any meaningful reform of pension regulations will likely cause plan sponsors to stop offering pensions).

312. See *Belt Aviation*, *supra* note 104 (documenting the decline in pension coverage among American workers).

313. See GAO FUNDING REPORT, *supra* note 8, at 39 (noting the need to protect pensioners as well as the pension system).

314. See *supra* Part III.F (arguing that the PBGC uses an overly cautious investment policy for an asset manager with liabilities stretching out to a thirty-year-plus time horizon).

315. See *supra* Part III.F (urging the PBGC to reconsider investment strategy).

obligations by plan sponsors.³¹⁶ The inability of the bankruptcy code to adequately provide for pension obligations during reorganization permits plan sponsors to walk away from their pension obligations, yet emerge from bankruptcy as an ongoing company.³¹⁷ The burden of paying these obligations shifts to the PBGC. However, the PBGC does not receive sufficient premium revenue to pay the benefits it has taken on from defaulted pensions.

Congress took a step in the right direction with the passage of PPA 2006.³¹⁸ The measures it enacts bring pension funding rules closer to economic reality and should improve funding levels in the future. By failing to address bankruptcy issues, however, PPA 2006 left the job half done. Given the nation's current \$350 billion pension funding shortfall,³¹⁹ focusing only on preventative measures resembles telling a patient with advanced heart disease to eat right and exercise: the advice would have helped forty years ago, but does not adequately address the issue at hand.

Because Congress has repeatedly declined to address the bankruptcy issues affecting pension security, this Comment focuses its recommendations on alternate proposals assuring plan participants receive their full pension even if their plan sponsor enters bankruptcy. To that end, this Comment makes three proposals.

First, Congress should require plans to carry private supplemental insurance to cover any amount above the PBGC maximum. This would encourage full funding because the supplemental insurance would cost far less for fully funded plans, while simultaneously assuring pensioners receive the benefits they earn. Second, Congress should substantially increase the variable-rate premium paid by sponsors on unfunded liabilities. Currently, underfunding a pension plan represents a low-cost source of capital for plan sponsors. Only a premium rate that approximates the interest rate a plan sponsor would have to pay on debt will discourage plan sponsors from using pension underfunding as a source of capital. Finally, the PBGC should diversify its investment holdings. Using a strategy tilted so heavily towards bonds needlessly lowers returns and

316. See *supra* Part III.A (examining shortcomings in pension regulation).

317. See *supra* Part II (criticizing bankruptcy code's treatment of underfunded pension obligations).

318. See *supra* Part V (discussing positive aspects of PPA 2006).

319. PENSION BENEFIT GUAR. CORP., *supra* note 23, at 8.

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increases balance sheet volatility, in direct contravention of the PBGC's stated investment goals.³²⁰

Congress made progress by passing the provisions of PPA 2006. However, America's pensions remain far from protected. Consequently, Congress should extend the reforms made under PPA 2006 to ensure pensioners actually receive the benefits they earn.

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320. See *supra* notes 154–56 and accompanying text (disagreeing with the PBGC's investment strategy).