

**ERISA AND EMPLOYEE BENEFITS PRACTICE TEAM WHITE PAPER****The Pension Protection Act of 2006: ERISA Undergoes the Knife (Again)**

After two years of study, debate, and above all, politics, Congress gave birth late last summer to a statutory tome modifying—in some cases radically modifying—the Federal tax and labor laws governing pension and profit-sharing plans. The Pension Protection Act, known of course by its initials PPA, is the most voluminous (907 pages), if not the most comprehensive, pension legislation since Congress enacted ERISA one score and twelve years before.

The birth process for the PPA was fitful and painful and the next several years are likely to be fitful and painful for pension plans as they, their sponsors, and the governmental agencies adjust to the new bill. It is perhaps time for some initial post-partum analysis of the legislation, or a PPA of the PPA.

This article will first reflect generally on the PPA's themes and issues, then describe the PPA's most significant provisions, then reflect on what the PPA will mean to businesses in the long and short run, and finally engage in some arm-chair prophesizing about what the political reordering of Congress might bring in legislative adjustments to the PPA.

**I. Some Early Reflections on the PPA**

Some have likened the PPA to ERISA itself, in part because of its size and in part because of the breadth of issues it addresses. But the analogy is probably not apt. ERISA was a statute with a unifying theme: employees could not rely on their private pension plans to pay the benefits promised to them, and this had to be corrected. Thus, ERISA introduced funding standards for pension plans, vesting standards and spousal protections for pension and profit-sharing plans, and fiduciary, disclosure, and reporting rules for all employee benefit plans. ERISA also created a Federal insurance agency for defined benefit plans

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(the Pension Benefit Guaranty Corporation, or PBGC) and federalized jurisdiction over most of what the statute governed. It also included a broad preemption provision, ousting the states from regulation of employee benefit plans.

Some commentators have suggested that after the civil rights legislation of the 1960s, ERISA was the most significant piece of economic and social legislation enacted in the last half of the 20<sup>th</sup> Century. That might be an inflated claim, but ERISA has spawned dozens of books, hundreds of articles, thousands of judicial opinions, and a new category of legal practice, employee benefits law.

It is doubtful that the PPA, thirty years hence, will loom nearly as large as ERISA in our understanding of how employee benefits law evolved. Unlike ERISA, with its overriding theme, the PPA is essentially a collection of unrelated statutory provisions addressing unrelated employee benefits issues. So why have so many likened the PPA to ERISA in importance?

There are probably two reasons. One reason is its sheer size, although there has been other voluminous pension legislation in the 32 years since ERISA was enacted. The second and more important reason is that both the ERISA and the PPA made substantial changes to the way employers will fund defined benefit plans and in the way the federal government, through the PBGC, will protect benefits accrued in defined benefit plans from the risk of plan insolvency.

Indeed, the issues of defined benefit plan funding and PBGC capacity to ensure defined benefit payments, were the issues that, ironically, both pushed this legislation and retarded its progress. The Bush Administration, and many in Congress, believed that the funding rules had to be radically stiffened, PBGC premium payments increased, and PBGC guarantees scaled back, to address the problem of substantially underfunded plans

Many in the business community, however, believed that the plan underfunding problems in the first part of the new millennia were cyclical rather than systemic, and that the real problems were (1) that the statutory discount rate for valuing liabilities was too low, artificially magnifying the problems of plan underfunding, and (2) that the funding rules resulted in an unpredictable see-sawing of contribution obligations, from years in which an employer *could not* contribute to the plan, to years when the employer would unpredictably be called upon to make a gigantic and cash-flow shattering contribution. Moreover,

the years when employers could not contribute were often years in the upside of the business cycle, and years when the employer was required to contribute significant amounts were often years in the downside of the business cycle.

Thus, although everyone wanted to do something about plan funding rules, various participants in the debate wanted to accomplish radically different ends. It was difficult to locate middle ground in this debate (the middle ground was probably doing nothing), so the political wrangling over what to do about funding was long and drawn out, and passage of the legislation was delayed. And the final legislation, with special provisions for certain industries and a substantially increased discount rate, may not have solved the underfunding problem or rescued the PBGC at all; and the legislation certainly did not fix the contribution volatility problem about which many employer groups complained.

As a result, some now predict that the legislation will push those employers who have continued to sponsor defined benefit plans away from those plans, replacing them with enhanced 401(k) plans. Thus, some have predicted that the statutory tome that is the PPA might become the tomb of the defined benefit plan. May it rest in peace. Or perhaps in pieces.

What else did the PPA do other than rewrite defined benefit plan funding rules? Lots of unrelated, and sometimes contradictory, things.

It legalized cash balance plans going forward, but didn't do much to end the controversy about the legality of cash balance plans before the PPA's enactment.

It accelerated vesting in employer contributions to defined contribution plans and benefits in cash balance plans, but not to benefits in traditional defined benefit plans.

It adopted new rules for valuing lump sum distributions, which will reduce the value of such distributions and thus encourage employees to take annuities. But the new funding rules will discourage employers from adopting plans that provide benefits in annuity form.

It allowed mutual fund providers and other financial service providers to give investment advice to participants (despite potential conflicts of interest), but under circumstances that might discourage many of them from doing so.

It forces certain underfunded plans to reduce benefits and benefit options, and allows some underfunded multi-employer plans to reduce already earned benefits.

It increases reporting and disclosure requirements, presumably on the theory that participants need more information about their plans and plan benefits, but it liberalizes certain fiduciary rules in ways that may result in higher plans costs and exempt certain investment managers from regulatory oversight.

It makes it easier for employers to adopt “automatic enrollment” 401(k) plans, in the expectation that this will result in more employee participation in 401(k) plans.

It makes permanent tax benefits for affluent participants, which were adopted in 2001, but which would have expired in 2011, and also makes permanent the saver’s credit for low-paid employees.

It adopts some additional protections for spouses of participants in employee plans.

It permits pension plans to make payments to employees before retirement in certain circumstances, purportedly to facilitate “phased retirement” programs. However, the new rule does not require a phased retirement program but simply permits payments to people who are still working if they are at least age 62.

It makes some changes to the rules governing the PBGC.

It allows small employers to combine a defined benefit plan with a 401(k) feature.

It requires plans to permit employees to diversify out of company stock more quickly than under prior law.

As can be seen, the PPA does a lot of things, most of which are related only by their inclusion in a single statutory vehicle.

The next section of this Article considers the PPA provisions in more detail.

## **II. Significant PPA Provisions.**

### **A. Plan Funding and Benefit Restriction Rules**

The PPA adjusted the funding rules and imposed restrictions on benefit payments for both single- and multi-employer plans. We will first summarize the changes affecting single-employer plans, then move to those affecting multi-employer plans.

#### 1. Single-Employer Plan Funding and Benefit Restriction Changes

Under pre-PPA law, defined benefit plans are subject to two parallel funding regimes, one of which provides a great amount of flexibility in determining how plans are funded and applies unless a plan falls below certain “current liability” funding targets. If a plan falls under the current liability funding targets, it is subject to a deficit reduction contribution, which can be considerably higher than the plan’s contribution under the regular funding rules. Both funding regimes permit smoothing of assets over a five-year period and the regular funding regime permits lengthy periods to amortize certain items, such as past-service liabilities. Under the alternative funding regime, benefit liabilities are measured using an interest rate equal to the rate on 30-year Treasury obligations. (Temporary legislation has for the last several years used the rate on corporate bonds, which was higher and thus resulted in lower plan liabilities.)

In addition, employers could build up credit balances by contributing more than the required contribution. These credit balances could be applied to contribution obligations in later years, even if the plan is then underfunded.

Beginning in 2008, the PPA replaces the existing two-track funding system with a single set of rules, although some plans considered to be “at risk” will be subject to some variations in the rules that will result in larger contributions.

The basic funding regime under the PPA will require the employer to fully fund the benefits accrued in the immediate plan year, and to amortize over no longer than seven years the difference between plan liabilities and plan assets. In other words, the funding target is 100% and shortfalls will be amortized over a relatively brief period of time. (The 100% funding target will be phased in over a four-year period.)

The plan does not have to value assets at fair market value, but may average asset values over a two-year period. The averaged value, however, must be between 90% and 110% of the actual fair market value of the assets.

The PPA also changes the way a plan values its liabilities. As noted, under pre-PPA law, the assets are valued using a discount rate equal to the interest rate on 30-year Treasury obligations. Under the PPA, the plan uses a modified yield curve, based on corporate bond rates averaged over a two-year period. The yield curve will have three segments, with different interest rates applying to each segment. The first segment, which will generally use the lowest discount rate, will apply to liabilities payable within the next five years; the second segment will apply to liabilities payable between five and 20 years; and the final segment will apply to liabilities payable more than 30 years after the valuation date. Most people expect that the impact of the modified yield curve will be to increase the valuation of liabilities for plans with older workers and with a heavy ratio of retired to active employees.

The PPA allows a plan to continue to use credit balances to reduce required contributions, so long as the plan is at least 80% funded. But there is now a cost to credit balances: they are subtracted from plan asset values. Plan sponsors may, however, elect to permanently waive their credit balances (to improve their funding ratio).

The funding rules become more draconian for plans with over 500 participants if the plans become at risk. To be at risk, a plan must fall below an 80% funding ratio, and also fall below a 70% ratio after recalculating the plan liabilities in accordance with revised actuarial assumptions (which assume that employees during the plan year and the succeeding 10 years will select the most valuable form of benefit). If a plan is at risk, its funding shortfall will be calculated with respect to the at-risk liability valuation.

The 80% trigger for the at-risk rules is phased in between 2008 and 2011. In 2008 the trigger is 65%, which increases by 5% per year until 2011, when it reaches 80%.

The PPA adds new restrictions on the benefits that can be accrued or paid by a severely underfunded defined benefit plan. There are two trigger points for the restrictions: a plan that falls below an 80% funding ratio and a plan that falls below a 60% funding ratio. When a plan pulls the first trigger, it is prohibited from adopting an amendment increasing benefits and generally may not pay benefits entirely in lump sum form. When the plan's funding ratio hits the second trigger, it must also freeze benefit accruals, cannot pay shutdown benefits, and may not pay benefits in a lump sum or other accelerated form.

## 2. Multi-Employer Plan Funding and Benefit Restrictions

Congress made some important changes to the rules for funding multi-employer plans, but these changes are far less encompassing than the parallel rules for funding single employer plans.

On the funding side, the PPA changed the amortization period for benefit improvements and initial liability from 30 years to 15 years. In addition, the PPA creates new rules for plans in the yellow zone, *i.e.*, that are less than 80% funded, and plans in the red zone, *i.e.*, that are less than 65% funded. Plans in either color-coded zone must develop plans to improve their funding status.

Plans in the yellow zone—referred to as “endangered” plans—must develop “funding improvement plans.” A funding improvement plan must improve the plan’s funding level over a decade or more. This can be done by reducing future benefit accruals and/or by increasing funding.

Plans in the red zone—referred to as “critical” plans, must develop rehabilitation plans. These plans must cut back future benefit accruals, and may have to increase funding and reduce already-earned “non-core” benefits, which can include early retirement benefits. Many labor and pension advocacy groups especially opposed the provisions that would allow a plan to cut back on such already-earned benefits. In addition, employers will be required to pay a surcharge on their funding obligations if a plan enters the red zone.

The PPA also raises the ceiling on the maximum deductible contributions that can be made to a multi-employer plan.

### B. Perpetual Sunshine on EGTRRA Tax Benefits

In 2001 Congress enacted EGTRRA, which made a number of important changes to the Internal Revenue Code’s provisions, and which permitted employers to design plans that increased the maximum benefits that can be provided to highly-paid employees. These provisions were subject to sunset in 2011. The PPA makes them permanent.

Among the dozens of formerly temporary provisions that the PPA now makes permanent are the following:

1. The increase in the maximum additions to accounts in defined contribution plans.
2. The increase in the maximum benefit that can be paid in a defined benefit plan.
3. Catch-up contributions for individuals age 50 and older, to both 401(k) plans and IRAs.
4. The increase in the maximum amount of compensation that a plan can use in calculating benefits or contributions.
5. The saver's credit for relatively low-income individuals.

### C. Cash-Balance and Other Hybrid Plans

Beginning in the late 1980s, many sponsors of what are now referred to as “traditional” defined benefit plans amended such plans to convert them to “cash-balance” or other forms of so-called hybrid plans, in which the benefits were formally expressed as an account balance rather than as a retirement age-annuity. Hybrid plans could reduce a plan sponsor’s future costs, but they generally resulted in lower future benefits for older employees. In addition, older employees sometimes experienced a “wear-away period” in conversions, in which they did not accrue any additional benefits for a period of time.

Because hybrid plans did not fall neatly into the defined benefit regulatory mold, they existed in a swirl of legal controversy and there have been several dozen lawsuits challenging the legality of wear-away, the formula used by some wear-away plans to calculate lump sum payments, and the overall legality of hybrid plans under ERISA.

The PPA resolves most legal questions involving cash balance plans, but only on a going-forward basis. (The Supreme Court is currently deciding whether to review the decision of a federal appeals court upholding the legality of IBM’s cash balance plan. The Court should decide whether to hear the case in early 2007.)

Here is what the PPA does with respect to cash balance and other hybrid plans:

1. It provides that such plans will be considered legal if they meet certain requirements. These requirements include accelerated vesting and a prohibition against wear-away following a conversion. (For existing plans, the accelerated vesting requirement begins in 2008.) In addition, the plans must provide the same pay and interest credits to similarly situated older and younger employees.

2. It generally allows plans to pay employees a lump sum equal to the employee's account balance in the plan. Prior to the PPA, the IRS ruled, and a number of courts held, that the plan had to engage in a complex set of calculations to determine a lump sum payout. (The calculation had required plans to first project interest credits through normal retirement age under the plan; then to convert the resulting projected account balance to an annuity benefit under plan rules; and finally to determine an equivalent lump sum using statutory mortality and interest assumptions. In some cases, this could lead to required lump sum payouts that exceeded a participant's account balance.)

3. It generally prohibits plans from providing interest credits that exceed market rates. Some people have questioned why Congress adopted this requirement, since it seems to prevent employers from adopting generous plans for their employees.

There are two explanations for this provision. First, above-market rate interest rates would favor younger employees, since they would earn them over a longer period of time. Second, above-market interest rates might favor higher-paid employees, who are on average likely to have longer-job tenures than rank-and-file employees and thus might enjoy the above-market rate of returns for longer periods than rank-and-file employees. If an employer wants to design a generous cash balance plan, it will have to use generous pay credits rather than generous interest credits.

The Department of Treasury is currently developing guidance on market-interest rate issues and other hybrid questions. Treasury issued limited guidance in late 2006, which, among other things, provided a safe harbor definition of market interest rate to include the interest rate on long-term investment-grade corporate bonds, the rate on 30-year Treasury securities, and the permissible equivalent indexes to 30-year Treasury securities described in IRS Notice 96-8.

Some analysts of the PPA believe that hybrid plans can be a particularly attractive type of plan for small and midsize employers.

#### D. Miscellaneous Defined Benefit Plan Provisions

The PPA includes several miscellaneous provisions aimed at defined benefit plans. These include:

1. *Surviving spouse rules.* Under pre-PPA law, a plan must provide that the normal form of benefit for a married participant is a joint-and-survivor annuity, with a survivor benefit for a participant's spouse equal to at least 50% of the annuity while the participant is living. A number of consumer and women's groups have long felt that plans should be required to offer an option with a larger survivor annuity. The PPA will, beginning in 2007, require plans to offer an optional form of benefit with a spousal survivor annuity equal to at least 75% of the annuity payable during the life of the participant. (This requirement will apply to all pension plans, including money-purchase pension plans.)

2. *Combined 401(k)/defined benefit plans for "small" employers.* The PPA will allow an employer with no more than 500 employees to sponsor a combined defined-benefit/401(k) plan, with a single document. If the defined benefit portion of the plan uses a cash-balance formula, pay credits must increase as the employee ages, in accordance with new statutory rules.

3. *In-service benefit payments to employees at age 62.* Prior to the PPA, a pension plan could not make distributions to workers before they separated from service or reached normal retirement age. Some commentators argue that this makes it difficult for employers to provide "phased retirement" programs, in which employees begin to draw a portion of their benefits even though they continue to work part-time. Supposedly to aid employers who want a phased-retirement program, Congress included in the PPA a provision that will allow plans to start paying full benefits to active employees once they reach age 62.

In fact, this provision of the PPA does not seem to do much to facilitate phased retirement, which generally is described as a plan under which an employee cuts back on hours and makes up the difference, or part of the difference, in lost pay by partly drawing retirement benefits. The PPA permits participants after age 62 to begin drawing full pension benefits even if they continue to work full-time.

The actual impact of the in-service distribution requirement would appear to make it easier to design defined benefit plans that maximize benefits. Under IRC § 415, a defined benefit plan may pay in 2007 a maximum benefit of 100% of pay or \$180,000, whichever is smaller. If an employee begins receiving benefits before age 62, the \$180,000 amount must be reduced to reflect the early starting date. The PPA, in effect, will enable high-paid employees to begin receiving the maximum benefit even though they continue to work.

4. *Reduced lump sum payments.* The normal form of benefit in a defined benefit plan is an annuity beginning at retirement age. A plan is permitted, however, to offer optional forms of benefits, the most popular of which is a lump sum payment of equivalent actuarial value to the normal annuity benefit.

IRC § 417(e) specifies the maximum interest rate assumption that can be used to calculate the lump sum equivalent of the annuity. For more than a decade, the IRC § 417(e) interest rate has been the interest rate on 30-year Treasury bonds. This interest rate is typically quite low. Because a low interest rate yields a high lump sum value, lump sum distributions calculated under IRC § 417(e) were quite high. Some commentators argued that this was unfair to plans, which ended up having to pay extra when an employee elected to forego the annuity and take a lump sum. It also encouraged participants to select lump sums rather than to receive their benefits in the more socially desirable annuity form.

The PPA thus changes the methodology used to determine lump sum benefits. Phased in over a five-year period beginning in 2008, the PPA will ultimately cause lump sums to be valued using the modified yield curve used for funding (see page 6). This will have the effect of decreasing the value of lump sums from current values, with the differences probably negatively impacting younger employees more than those close to retirement, although this will depend on what financial analysts call “the shape of the yield curve.”

5. *Expansion of Right to Use Excess Plan Assets to Pay for Retiree Health Benefits.* Defined benefit plans are permitted to use excess assets to pay for retiree health benefits. Before the PPA, this could be accomplished annually, but only to the extent a plan’s funding ratio exceeded 125% of current liabilities. The amount that could be transferred to an account for this purpose was limited to the amount needed to pay the retiree health benefits for a year.

The PPA will permit a plan to transfer assets to pay for up to ten years of projected retiree health benefits. The plan must have a funding ratio of at least 120% and if the plan's funding level falls below that level during the health-transfer period, the employer must make additional contributions or return assets to the plan.

#### E. Automatic Enrollment in 401(k) Plans

Innovative plan designers, taking a lesson from a school of economics that looks at people's actual behavior and quirks, have created a new model for 401(k) plans, a model that recognizes that employees will often put off making decisions, such as electing to participate in 401(k) plans. The new model 401(k) plan automatically enrolls participants in the 401(k) plan unless they affirmatively opt out. Thus, an employee participates in the 401(k) plan by doing nothing.

Most people believe that this type of plan, sometimes referred to as an "automatic enrollment," "opt out," or "reverse election" plan, is a positive development that will result in more people saving more money for retirement. But this type of plan has faced legal obstacles, both at the state and federal level, which have made some employers reluctant to use the opt-out approach. The PPA addresses such concerns. Here are the things that the PPA does with respect to such plans:

1. It expressly preempts any state payroll laws that require express authorization by the employee to have monies withheld from his or her paycheck.

2. It creates a non-discrimination safe harbor for automatic enrollment plans. Under the safe harbor, a plan must initially provide for at least a 3% elective deferral in the first year of plan participation, with the default deferral level increasing by 1% per year until it reaches 6% in the fourth year. The safe harbor also requires that the employer provide a dollar-for-dollar match of the first 1% of an employee's deferral, and 50% of the next 5% of deferral.

Example: E earns \$100,000 and defers \$6,000. The employer will have to provide a matching contribution of \$3,500 (a \$1,000 match on the first \$1,000 deferral and a \$2,500 match on the next \$5,000

of deferral). Note that the employer would not make a further match on deferral above 6% of compensation.

Reflection: Why does the default deferral percentage increase from 3% to 6% over the first 4 years? The idea is that the initial 3% default deferral rate is sufficiently low that people will not bother to opt out. But a 3% deferral rate is not optimal and most financial planners argue that a higher rate is needed. Thus, the deferral rate must rise to 6% by the fourth year of plan participation. Congress apparently anticipates that most employees would receive annual raises of at least 1%, so they will not feel their take-home pay decline as their savings rate increases.

3. The plan must provide each person automatically enrolled with a notice that includes information about how to opt out, about the plan's default investment vehicle, and about how to alter either the deferral rate or the investment vehicle.

4. The PPA charges the Department of Labor with creating default investment guidelines for individuals who do not give express investment directions. Plans that provide employees with the notice described in 3. above and invest in an investment vehicle approved by DOL guidance, will qualify as self-directed plans under ERISA.

5. The PPA gives an employee 90 days to opt out of a plan and withdraw contributions without them being subject to the 10% excise tax on premature distributions, *i.e.*, generally distributions before age 59.5.

The PPA provisions are generally effective for years beginning 2008, except that the state-law preemption provision is immediately effective.

#### F. Miscellaneous Defined Contribution Provisions

##### 1. *Diversification Rights in Plans with Employer Stock.*

Except for some ESOPs, a plan that permits or requires investment in publicly- traded employer stock must provide participants with the right to diversify into other investment options. An employee is entitled to exercise this right immediately with respect to stock purchased with the employee's

contributions and elective deferrals. An employee with at least three years of service is also entitled to exercise diversification rights with respect to other stock.

The diversification rights become effective for plan years beginning in 2007 and thereafter. The right is ratably phased in over three years for employer stock acquired before the effective date, except that employees who are 55 and have three years of service may exercise the right with respect to all stock on the effective date.

An employer must give employees notice of their diversification rights. The IRS has thus far taken the position that this must be done even with respect to plans in which such rights existed before Congress enacted the PPA, even if a form of notice (for example, in a summary plan description) had already been given. The IRS indicated that the initial notice for calendar year plans would not be required before January 1, 2007, and the Department of Labor has suggested that the notice should be given as soon as possible after January 1, 2007. In addition, the Department of Labor guidance also gives plans whose diversification rights were already equal to or greater than that required by the PPA until the time the first benefit statement has to be provided in self-directed plans. See Section H. below for a discussion of the timing of benefit statements.

### *2. Quicker Vesting in Defined Contribution Plans.*

Under pre-PPA law, full vesting in employer contributions could be delayed for five years (or for seven years if a graded vesting schedule were used). Generally for plan years beginning in 2007 and thereafter, vesting in defined contribution plans must occur after three years (or after six years if a graded vesting schedule is used).

### *3. Slight Loosening of Hardship Rules.*

Nonqualified deferred compensation plans, 401(k) plans, 403(b) plans, and 457 plans are allowed to permit employees to make withdrawals of their plan contributions on account of hardship or unforeseeable emergencies. The PPA directs the Department of Treasury to modify these rules to permit

withdrawals for hardships or unforeseen financial emergencies of the employee's beneficiaries under the plan.

#### *4. Investment Mapping on Change of Investment Options*

ERISA § 404(c) provides some fiduciary liability limitations for participant investment decisions in self-directed plans. A question that sometimes arises is whether such protection is lost when a participant fails to indicate new investment choices when a plan replaces one or more investment options held by the employee. In such cases, it is typical for a plan to “map” the investment to a similar type of investment. (The statutory question is whether the participant is exercising control when the participant fails to give instructions and the investment is mapped.)

The PPA provides that ERISA § 404(c) protection is not lost if a participant fails to give directions on how his account should be invested when the plan changes investment options, so long as the participant exercised control over his investments before the change; the plan provides a written timely notice before the change, which compares the old and new investment vehicles and indicates how the participant’s investments will be mapped if the participant fails to give instructions.

#### *5. Clarification of Safest Available Annuity Rule.*

The Department of Labor has long taken the position that plan fiduciaries must select the safest available annuity when transferring plan liabilities to an insurer. The Department of Labor’s position evolved during the era of plan terminations for surplus, when some plans increased recoverable plan surplus by purchasing low-priced annuity contracts. The Department’s position, however, was not limited to terminating defined benefit plans, but also arguably applied to defined contribution plans in which the annuity is an optional form of benefit. Some have argued that in such circumstances, a plan might plausibly sacrifice the highest degree of safety for a still high degree of safety but higher annuity payments.

The PPA directs the Department to issue regulations that will clarify that the safest annuity provider rule does not apply to optional forms of benefits in a defined contribution plan. Rather, fiduciary deliberation about the appropriate insurer for annuities in such circumstances should take account of all relevant factors in the context of the plan and its participants.

#### 6. *Missing Participant Program*

The PPA directs the PBGC to issue regulations to allow terminating defined contribution plans to transfer benefits for missing participants to the PBGC. This should relieve one of the more difficult fiduciary and administrative problems for defined contribution plans, particularly orphaned plans.

#### G. Fiduciary Provisions

The PPA revises a number of fiduciary rules, generally loosening the reins on what fiduciary conduct is prohibited.

##### 1. *Investment Advice.*

Long a controversial issue, the question of who may give investment advice to participants in participant-directed plans, and under what circumstances, has now been resolved. In particular, the PPA provides an exemption from the prohibited transaction rules for certain investment advice given by registered investment companies, banks, insurance companies, and registered broker-dealers. To guard against potential conflicts, the prohibited transaction exemption only applies if the adviser's own fees are unrelated to the choices made by the participant receiving the advice or if the advice is based on a computer model certified by an independent third party.

In addition, the arrangement under which investment advice is rendered must be authorized by another plan fiduciary, and specific information about the arrangement and fees must be provided to the participant. While exempt from the prohibited transaction rules, the investment adviser is a fiduciary under the plan and liable under the general rules applicable to fiduciary conduct.

The PPA also indicates that the plan sponsor (or the appropriate plan fiduciary) decision to permit the provision of investment advice must be prudent. However, there is no responsibility on the part of the plan sponsor to monitor the specific advice provided by the adviser to each participant.

##### 2. *Service Providers and Adequate Consideration.*

The PPA includes a provision that exempts from the prohibited transaction rules transactions with non-fiduciary service providers, so long as the plan receives "adequate consideration." This is a major departure from the approach taken by Congress in 1974, which was to treat the second service by a service

provider as automatically prohibited unless a statutory or class exemption applied (or if the Department of Labor granted an individual exemption).

3. *Plan Asset Rules Liberalized for Hedge Funds.*

The Department of Labor's plan asset rules have long provided that the underlying assets of an investment fund are plan assets subject to ERISA's fiduciary and prohibited transaction rules if 25% or more of the fund's assets are held by certain investors, including some plans that are not subject to ERISA. The PPA modifies that regulation by limiting the 25% threshold to plans that are subject to ERISA and by only treating as plan assets an amount that is proportionate to ERISA plan ownership of the fund. The effect of this PPA provision will be to make it somewhat easier for so-called hedge funds to avoid ERISA regulation of their assets.

4. *Maximum Amount of Fiduciary Bond Increased for Plans Investing in Employer Securities.*

ERISA requires plan fiduciaries and other individuals who handle funds or other plan property to be bonded. The bond must be equal to the smaller of 10% or \$500,000 (although the Secretary of Labor may require a bond larger than \$500,000 in certain circumstances). The PPA increases the dollar maximum to \$1,000,000 for a plan holding employer securities.

5. *Other New Statutory Prohibited Transaction Exemptions.*

The PPA also introduces other new statutory exemptions from the prohibited transaction rules, including exemptions for some block trading, some cross trading, and some trading transacted under an electronic communication network. In addition, the PPA creates a new statutory exemption for certain foreign exchange transactions connected with the sale, purchase, or holding of securities and other investment assets. Finally, the PPA provides an exemption for innocent transactions corrected within 14 days of the time the party-in-interest or other person participating in the transaction discovers that the transaction was prohibited.

## H. More Disclosure

One theme running through the PPA is that disclosure is good, and that more disclosure is better. The PPA requires that annual reports give more information about funding methodology and assumptions and will require that plans give more plan-specific information than is currently the case when more than one plan is sponsored. Single employer plans that are less than 80% funded will have to provide additional information to participants, labor organizations, and the PBGC. Multi-employer plans will also have to provide more information than they currently are required to provide.

The showpiece, though, is the revised and expanded set of rules for benefit statements to employees, especially in defined contribution plans. Quarterly notices must be given to participants in defined contribution plans with participant-directed accounts and annual notices to participants in non-participant-directed plans. Statements in defined benefit plans must be provided every three years, unless the plan administrator provides an annual notice to participants that such a statement is available on request.

The Department of Labor has indicated that until further guidance, defined-contribution benefit statements must be provided within 45 days of the close of the applicable period; thus, the first notice due under the PPA—for calendar year plans that permit participant direction of investments—must be distributed no later than May 15, 2007 (45 days after the end of the first quarter).

The Department of Labor has also indicated that the first benefit statements for defined benefit plans would not be due until the 2009 calendar year. A defined benefit plan that chooses to use the alternative means of compliance—plans that annually provide notice to participants that benefit statements are due on request—must give the initial such notice within the 2007 plan year.

The PPA also will require additional and revised disclosures to participants eligible to receive distribution of benefits. Disclosures will now generally have to be made earlier than under prior law.

## I. Changes to the PBGC

The PPA makes numerous changes to Title IV of ERISA, which regulates the PBGC. Among the changes are the following:

### 1. *Premiums*

The PPA will change the methodology used to calculate variable-rate premiums, beginning in 2008. The new methodology will use a modified yield-curve in assessing liabilities. The PPA will also place a \$5 ceiling on variable rate premiums for businesses with 25 or fewer employees.

### 2. *Plant Shutdown Benefits.*

Contingent-event benefits, such as plant shutdown benefits, are no longer automatically guaranteed. Instead, the guarantees for such benefits will be phased in over five years *following* the occurrence of the contingent event.

### 3. *PBGC Guarantees in Bankruptcy*

Benefit guarantees will be frozen when an employer enters bankruptcy or similar proceedings.

### 4. *Expansion of Missing Participant Program.*

The PPA directs the PBGC to expand its missing participant program to include terminating multi-employer defined benefit plans, defined benefit plans of small professional organizations, and defined contribution plans.

## J. Miscellaneous PPA Provisions

There are numerous “small” provisions in PPA that have not received much public attention, such as a provision that requires the Secretary of Labor to issue regulations to clarify that a domestic relations order can be a QDRO notwithstanding the timing of the order or the fact that it modifies an earlier order.

One of the reasons for this provision is to make clear that a domestic relations order that otherwise qualifies as a QDRO will not fail to be a QDRO when a state court reopens a prior divorce order to reconsider, or initially consider, how to divide benefits from a qualified plan.

Like any large bill emerging from recent Congresses, the PPA includes numerous provisions that apply outside the area of qualified plans. These include some tweaking to the new stricter rules on the tax treatment of nonqualified deferred compensation; some liberalization of the rules for Individual Retirement Accounts (including a rule permitting non-spouse beneficiaries of a deceased IRA owner to roll over inherited IRAs or employer plan benefits to be rolled over to an IRA); the tax treatment of company-owned life insurance (“COLI” contracts); and rules permitting “association health plans” to establish tax-deductible reserves.

### **III. The PPA: The Short Run and the Long Run**

What will the PPA mean in the short run and in the long run?

In the short run, employers will have to make numerous changes in administrative practices, particularly disclosure, and this will begin in 2007. Plans with employer stock investments will have to provide participants with notices of diversification rights. Defined contribution plans with participant-directed accounts will have to begin providing quarterly benefit statements, and other defined contribution and defined benefit plans will also have to make adjustments to the new benefit statement requirements. Plans will also have to change both their procedures and disclosure statements for participants prior to receiving benefits. Formal plan amendments to conform with the PPA do not have to be made until after 2008.

The administrative burdens on small plans are, in fact, moderate in the short run, but once plans get geared up the new burdens should not be much harder to cope with than pre-PPA provisions. The PPA does do some nice things for small employers: it makes permanent the increases in various limits applicable

to higher paid employees and it will make, in our view, cash balance plans the vehicle of choice for many small and medium-size businesses.

Large plans will, of course, face the same administrative burdens as small plans—both initial implementation of the PPA's provisions and ongoing compliance. But given the greater administrative resources of large plans and the number of participants over which compliance costs can be spread, the PPA will probably be no more burdensome than past pension legislation.

Except for one area: the funding of defined benefit pension plans. Here, the changes in the funding rules signal finally and definitively that the death spiral for large defined benefit plans is irrevocably under way. According to some observers, the new funding rules will combine potentially massive contribution volatility—perhaps the main complaint from the employer community about such plans—without assuring adequate funding of the system as a whole. It is likely that the only large defined benefit systems that will survive the next decade are those in the public sector and perhaps in the small corner of healthy negotiated defined benefit plans. And some people predict that though they may be last to fall, fall they eventually will.

But defined benefit plans, and particularly cash balance plans, will continue to offer important planning possibilities for small and medium-sized businesses, particularly those businesses whose compensation goals include maximizing sheltering opportunities for older owners and key employees.

With the defined benefit plan in decline, workers will have to fend more and more for themselves with respect to their retirement security. Here there are two concerns: employees may not participate or contribute enough to their 401(k) plans, and employees have not proven to be particularly wise investors.

There are provisions in the PPA that may help employees invest more sagaciously, at least at the margins. For example, mutual fund vendors may now decide to give investment advice (although they may be concerned about the fiduciary responsibility that will attach to those who give investment advice). And the employer stock diversification notice might at least cause some workers to avoid concentrating large portions of their retirement assets in employer securities.

What about employees who today are not utilizing savings plans that their employers make available to them? The PPA's many provisions designed to jump-start automatic-enrollment 401(k) plans

will certainly have some effect here, but the new automatic-enrollment safe harbor has a costly match feature that might discourage some employers from adopting opt-out plans. We do suspect that there is a group of employers concerned with ensuring their employees a supplement to Social Security—and generally we think these will be small and medium-sized businesses with relatively stable workforces—who will look seriously at automatic enrollment plans. But we have doubts that there will be an employer rush toward these plans. Because these plans are a promising way of almost, but not quite, forcing workers to save—a popular approach with most workers who would rather be induced than required to save—we hope that we are wrong and that many employers will consider these plans now that there is a relatively clean design template available for them.

In general, then, pension practice and pension law seem to continue on a path toward fewer large defined benefit plans and more individual savings programs. Whether this is good or bad, whether the individual responsibility paradigm of the 401(k) plan is preferable to the more paternalistic defined benefit approach to private retirement plans, can be debated endlessly. But the challenge remains ever the same: using qualified plans to help firms shape a rational compensation policy that fits each firm's individual needs to attract and retain employees, and at the same time help the nation's workers save for retirement.

#### **IV. Gazing Into the Retirement Crystal Ball**

Certainty in pension law is a virtue and one might hope that the PPA will be the last major piece of pension legislation for the next five or so years. But that is unlikely, for two interlocking reasons: first, the PPA is far from well-crafted legislation, and will almost certainly require an extensive technical corrections bill; and second, with Congress changing hands, the new majority may want a crack at shifting policy a few degrees toward a more paternalistic system. The coming technical corrections bill may thus try to do more than merely technically correct.

What are some of the areas in which the new Congress might have an interest? There was Democratic opposition to the investment adviser provision in PPA because it permits entities with conflicts of interest to give investment advice. But the provision was sufficiently watered down by its sponsors to

appease opponents and it is not likely to be revisited. On the other hand, the PPA provision exempting transactions between plans and non-fiduciary service providers from the prohibited transaction rules may be subject to some “technical corrections” that limit it, perhaps by defining a term such as “reasonable compensation.”\_ A technical corrections bill may also almost certainly have to address numerous questions about the new defined benefit funding rules and perhaps about some of the cash balance rules (particularly what is meant by limiting interest credits to market rates of return).

And we would not be surprised to see some interest in providing further protections for women. Here we would look to see some further spousal consent requirements for 401(k) and other profit-sharing plans, and for individual retirement accounts, which because of rollovers are where much of the nation’s retirement savings is currently stored. There may also be some interest in improving coverage for women, which might mean some tinkering in the minimum coverage rules, particularly dealing with permanent part-time workers. And although this is not likely, we think there will at least be further discussion about creating a default rule for dividing pensions at divorce, which would apply in the absence of a QDRO.

There may also be some discussion of expanding ERISA’s remedial provisions, particularly in permitting money damages in situations where only equitable relief is currently available. But we doubt that interest here will move much beyond the discussion stage, particularly given that such an expansion would likely be strongly resisted by the White House.

We would be surprised to see any cutbacks in the various dollar limits that currently apply to qualified plans, given that these provisions were bipartisan in origin and have proved popular. But to say we would be surprised is not to say we would be flabbergasted, particularly if budget-balancing becomes the call of the day. It would at least be easy for Congress to suspend indexation of the limits for a period of time.

In the longer run, we expect to see some proposals on ways to address the decline of defined benefit plans. It is possible, for example, that Congress will create new forms of career-average defined benefit plans, with relatively simple funding rules, reduced PBGC premiums, generous past-service provisions, and easy safe-harbors for non-discrimination testing. But it is also possible that Congress will explore approaches to make defined contribution plans more like defined benefit plans, particularly in the

payout stages. We have already seen proposals to give tax incentives for annuity payouts and we think this and other proposals to reduce the cost of and increase the attractiveness of annuity payouts from qualified plans will attract legislative attention in the coming years.

We are also likely to see legislative proposals addressing the problems of those who currently lack any, or adequate, pension coverage. There has been some interest in expanding the savers' credit, perhaps making it at least partly refundable. There is also some interest in mandating that employers provide an IRA-payroll deduction program for employers that do not sponsor their own qualified plan.

Of course, predictions about what Congress will, and will not, do, are fraught with likely error. Who, a year ago, would have confidently predicted passage of the largest pension legislative package since ERISA?

*Article created long with Professor Norman Stein at the University of Alabama Law School:*

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