

Spring 2007

The Pension Protection Act of 2006: An Overview of Sweeping Changes in the Law Governing Retirement Plans, 40 J. Marshall L. Rev. 843 (2007)

Craig C. Martin

Joshua Rafsky

Follow this and additional works at: <https://repository.law.uic.edu/lawreview>



Part of the [Antitrust and Trade Regulation Commons](#), [Banking and Finance Law Commons](#), [Business Organizations Law Commons](#), [Consumer Protection Law Commons](#), [Insurance Law Commons](#), [Labor and Employment Law Commons](#), [Legislation Commons](#), [Retirement Security Law Commons](#), [Securities Law Commons](#), and the [Tax Law Commons](#)

Recommended Citation

Craig C. Martin & Joshua Rafsky, The Pension Protection Act of 2006: An Overview of Sweeping Changes in the Law Governing Retirement Plans, 40 J. Marshall L. Rev. 843 (2007)

<https://repository.law.uic.edu/lawreview/vol40/iss3/5>

This Symposium is brought to you for free and open access by UIC Law Open Access Repository. It has been accepted for inclusion in UIC Law Review by an authorized administrator of UIC Law Open Access Repository. For more information, please contact repository@jmls.edu.

THE PENSION PROTECTION ACT OF 2006: AN OVERVIEW OF SWEEPING CHANGES IN THE LAW GOVERNING RETIREMENT PLANS

CRAIG C. MARTIN* & JOSHUA RAFSKY**

I. INTRODUCTION

Issues surrounding the future of pensions are of paramount importance as the oldest baby boomers approach retirement. Congress recently enacted the comprehensive and cumbersome Pension Protection Act of 2006 (“PPA”) to combat the impairment of several major defined benefit plans. One of the PPA’s main purposes is to eliminate defined benefit plan underfunding by revamping the old rules governing defined benefit funding. Other major, and intended consequences of the PPA, however, are the encouragement and promotion of the use of defined contribution plans, as well as the legitimization of controversial cash balance plans.

This article provides an overview of some of the major provisions of the PPA. It also explores possible policy implications on the future of the defined benefit plan and considers the future of employer sponsored retirement plans. Part II of this article defines and provides key demographics about baby boomers. Part III describes and discusses the two major types of pension plans: defined benefit plans and defined contribution plans. Part IV overviews the decline of the defined benefit plan as the favored employer sponsored retirement plan. Part V highlights the current troubles facing the defined benefit system. Part VI discusses the importance of a properly functioning retirement system. Part VII provides an overview of the newly enacted PPA

* Craig C. Martin is a partner with Jenner & Block LLP. Mr. Martin is a member of the Firm’s Policy and Litigation Committees, the Co-Chair of its ERISA Litigation Practice and the Co-Chair of its Business Litigation Practice. Mr. Martin regularly represents and advises clients with respect to fiduciary and ERISA issues. Mr. Martin received his B.A. from the University of Notre Dame in 1985, and his J.D. from Harvard Law School in 1988.

** Joshua Rafsky is an associate with Jenner & Block LLP. He is a member of the Firm’s Litigation Department. Mr. Rafsky earned his B.B.A. from the University of Michigan-Dearborn in 2002, and his J.D. from the University of Michigan Law School in 2005.

by discussing both the genesis of the PPA and some of its key provisions. Finally, Part VIII considers the future of employer sponsored retirement plans.

II. "BABY BOOMERS," DEFINED

The end of World War II brought about a surge of elation and pride as American soldiers returned home victorious. World War II changed the economic fate of the United States by spurring manufacturing and inevitably bringing the country out of the Great Depression. As the soldiers returned home, childbirth rates increased dramatically. The result was a population explosion. Consequently, the term "baby boomers" commonly refers to the segment of our population that is the result of that explosion — those born after World War II from 1946 to 1964.¹

According to 2000 United States Census figures, the "baby boom" fueled the largest population percentage increase of any age group in the last decade.² The eldest segment of baby boomers generated a fifty-five percent increase in the 50 to 54 year-old age demographic.³ The number of 45 to 49 year-olds increased by forty-five percent.⁴ At the time of the 2000 Census, those born at the end of the baby boom (the 35 to 39 year-olds) comprised the largest five-year age group.⁵ The second largest five-year age group was the 40 to 44 year-old age group.⁶ In total, this ten-year age span of baby boomers comprises over sixteen percent of the population of the United States.⁷

As a group, baby boomers "have enjoyed higher income during their working years than any preceding generation, and they have been accumulating substantial savings, in part to provide for their retirement."⁸ Baby boomers will benefit from higher retirement income than previous generations;⁹ however, the retirement of such a large segment of the population challenges the ability of

1. Press Release, U.S. Census Bureau, U.S. Dep't of Commerce News, Baby Boom Brought Biggest Increases Among People 45-to-54 Years Old (2001), <http://www.census.gov/Press-Release/www/2001/cb01cn184.html>.

2. *Id.*

3. *Id.*

4. *Id.*

5. *Id.*

6. *Id.*

7. *Id.*

8. CONG. BUDGET OFFICE, THE RETIREMENT PROSPECTS OF THE BABY BOOMERS 1 (2004).

9. *Id.* Although the baby boomer generation is predicted to fare well as a whole during the retirement years, it is estimated that approximately twenty-five percent of baby boomer households are failing to accumulate sufficient retirement savings. *Id.* Government assistance and benefit programs are likely to be the only source of retirement income for this segment of the baby boomer population. *Id.*

government assistance and benefit programs to provide sufficient resources to our aging workforce. More specifically, a large influx of retirees threatens to overwhelm the already struggling Social Security and Medicare programs.¹⁰ Private retirement plans have therefore become a powerful tool in retirement planning.

III. DEFINED BENEFIT PLANS AND DEFINED CONTRIBUTION PLANS, DEFINED

Pension plans are retirement savings programs provided by employers to employees.¹¹ The two main categories of pension plans are defined benefit plans and defined contribution plans.¹² A defined benefit plan is an employer-sponsored pension where the employer has an obligation to contribute to the plan on behalf of the employee. Such plans calculate employer contributions based on the employee's salary and length of service.¹³ The traditional defined benefit plan promises participants retirement benefits to be paid periodically for the duration of the retiree's life.¹⁴ Assets are accumulated through employer contributions and profit from investment of the plan's assets.¹⁵ Defined benefit plans promise fixed periodic benefits to employees, so the obligation to fund the program rests with the employer.¹⁶ Generally, the employer is obligated to compensate for underfunding.¹⁷ Individual

10. See *id.* (“[T]he population of retirees will grow much more quickly than the taxpaying workforce, at a time when average benefits per retiree are expected to continue rising. Those developments will place severe and mounting budgetary pressures on the federal government.”); see also U.S. DEPT OF STATE, LABOR IN AMERICA: THE WORKER'S ROLE, <http://usinfo.state.gov/products/pubs/oecon/chap9.htm>. (“[W]ith the post-war baby-boom generation due to retire early in the 21st century, politicians grew concerned in the 1990s that the government would not be able to pay all of its Social Security obligations without either reducing benefits or raising payroll taxes.”).

11. Craig C. Martin, Matthew J. Renaud & Omar R. Akbar, *What's Up On Stock-Drops? Moench Revisited*, 39 J. MARSHALL L. REV. 605, 610 (2006).

12. *Id.*

13. *Id.*; see also Edward A. Zelinsky, *The Defined Contribution Paradigm*, 114 YALE L.J. 451, 455-56 (2004).

14. *Hughes Aircraft Co. v. Jacobson*, 525 U.S. 432, 439 (1999) (quoting *Comm'r v. Keystone Consol. Indus., Inc.*, 508 U.S. 152, 154 (1993)); Zelinsky, *supra* note 13, at 456.

15. Martin et al., *supra* note 11, at 610-11. In some cases, employees also contribute to the defined benefit plan. *Id.* at 611. However, the recipients of the pension fund generally have “no right to the assets of the plan.” *Bash v. Firstmark Standard Life Ins., Co.*, 861 F.2d 159, 163 (7th Cir. 1988). Instead, “[t]he essence of a defined-benefits plan is that the participants' pension benefits are a specified amount, rather than a proportional share of the pension fund's assets, as in a defined-contributions plan.” *Id.*

16. Martin et al., *supra* note 11, at 610-11.

17. *Id.* at 611 & n.27 (citing Daniel Fischel & John H. Langbein, *ERISA's Fundamental Contradiction: The Exclusive Benefit Rule*, 55 U. CHI. L. REV.

participants are not provided with their own separate accounts, nor do they have control over how the assets of the plan are invested.¹⁸

For some people, the defined benefit plan is the representative model of the "American Dream." The model represents an American workplace based on manufacturing and exporting and a workforce that remained loyal to its employers. Historically, employees did not conceive of working for several different companies throughout their careers. In other words, employees worked hard and devoted the bulk of their careers to one employer that provided a defined benefit plan and, in turn, received hefty pensions to cover retirement expenses.

In contrast, defined contribution programs are compatible with a younger, more mobile workforce. Defined contribution plans are portable because they can be "rolled-over" to another plan when a participant switches jobs. Furthermore, defined contribution plans allow for more uniform investment growth because salary and longevity do not dictate contributions; rather, contributions are based on whatever portion of the participant's salary the participant wants to contribute (up to the statutorily allowed maximum) coupled with the employer's matching contribution (provided to all participants).

Individual accounts are established for each participant in a defined contribution plan.¹⁹ Defined contribution programs generally pay out in lump sums, and employees have control over funding and investing in their own individual accounts.²⁰ While employers usually contribute to each defined contribution account at specified rates, employers do not guarantee accounts.²¹ Risk of decline in account assets is therefore borne by each individual employee based on the investment choices he or she makes.²² Defined contribution plans can never suffer from underfunding because "each beneficiary is [only] entitled to whatever assets are dedicated to his individual account."²³

IV. THE DECLINE OF THE DEFINED BENEFIT PLAN

It is no secret that health care and retirement costs make up a substantial portion of company overhead, especially in older

1105, 1113 (1988)); *Hughes*, 525 U.S. at 439; *Zelinsky*, *supra* note 13, at 456.

18. *Zelinsky*, *supra* note 13, at 456.

19. *Hughes*, 525 U.S. at 439; *Martin et al.*, *supra* note 11, at 611. This is in contrast to defined benefit plans which are "funded collectively" in that participants receive their benefits from contributions made by the employer to a pooled common trust fund. *Zelinsky*, *supra* note 13, at 456.

20. *Zelinsky*, *supra* note 13, at 456-57.

21. *Martin et al.*, *supra* note 11, at 611.

22. *Id.*

23. *Hughes*, 525 U.S. at 439.

industries like manufacturing.²⁴ The impending retirement of the baby boomer generation has prompted employers to investigate cost efficient alternatives to expensive defined benefit pensions because “legacy costs” place a major strain on the competitiveness of a company.²⁵ Since 1985, there has been a sharp decline in the number of private defined plans, but a significant increase in the number of defined contribution programs.²⁶

Several factors have contributed to the decline of the defined benefit program in favor of the defined contribution program. First, defined benefit plans are more costly to maintain than defined contribution plans.²⁷ Those costs are associated with the myriad of complicated provisions of the Employee Retirement Income Security Act (“ERISA”),²⁸ which has been a factor in the decline of defined benefit plans.²⁹ ERISA places heavy regulatory burdens on defined benefit plans, such as complex minimum funding requirements, high premium payments to the Pension Benefit Guaranty Corporation (“PBGC”),³⁰ and high administrative fees.³¹

24. See, e.g., JOSH BIVENS, ROBERT SCOTT & CHRISTIAN WELLEN, MENDING MANUFACTURING: REVERSING POOR POLICY DECISION IS THE ONLY WAY TO END CURRENT CRISIS 1 (2003), available at <http://epinet.org/briefingpapers/144/bp144.pdf>.

25. *Id.*; Angela Boothe Noel, *The Future of Cash Balance Plans: Inherently Illegal or a Viable Pension Option?*, 56 ALA. L. REV. 899, 900 (2005).

26. Craig C. Martin & Amanda S. Amert, *Cash Balance Plans Reassessed in Light of Discrimination and Funding Litigation*, 59 BUS. LAW 453, 454 (2004). The Pension Benefit Guaranty Corporation estimates that the number of defined benefit plans has decreased from 114,000 to 40,000. *Id.* In contrast, the United States Department of State estimates that the number of defined contribution plans has increased from 461,000 to 647,000 since 1965. U.S. DEP'T OF STATE, *supra* note 10; see also Zelinsky, *supra* note 13, at 470 (“[T]he defined benefit system today stagnates; both the number of such plans and the number of participants in them have declined.”).

27. Amy B. Monahan, *Addressing the Problem of Impatients, Impulsives and other Imperfect Actors in 401(k) Plans*, 23 VA. TAX REV. 471, 477 (2004).

28. Pub. L. No. 93-406, 88 Stat. 829 (codified in scattered sections of 29 U.S.C.).

29. Martin & Amert, *supra* note 26, at 454; Noel, *supra* note 25, at 901.

30. The PBGC is the federal agency established by ERISA, which is charged with insuring pensions. PENSION BENEFIT GUAR. CORP., ANNUAL PERFORMANCE AND ACCOUNTABILITY REPORT (2005), available at <http://www.pbgc.gov/docs/2005par.pdf>. Currently, the PBGC insures over 30,000 private defined benefit pension plans covering over forty-four million workers and retirees. *Id.* However, in the event that a pension defaults, the PBGC does not guarantee complete coverage of the amount of the affected participants' pensions. The current cap on benefits that the PBGC will pay is approximately \$46,000 annually per participant at age sixty-five. Charles J. Ford, Mark M. Glickman & Charles A. Jeszeck, *Weaknesses in Defined Benefit Funding Rules: A Look at the Largest Plans, 1995-2002*, 44 BRANDEIS L.J. 351, 357 (2006).

31. Zelinsky, *supra* note 13, at 455-56.

Second, employers are increasingly interested in eliminating the investment risks associated with retirement plans.³² In contrast to defined benefit plans, defined contribution plans provide an effective means of shifting investment risk to employees.³³

Furthermore, the changing nature of the workforce has contributed to the decline. Because defined benefit plans are “back-loaded,” the majority of the benefits earned by employees accrue in the years approaching retirement.³⁴ This back-loading feature matched “the working trends of the 1950s and 1960s, when workers typically spent most of their careers at a single company.”³⁵ In effect, defined benefit plans reward longevity and discourage mobility.³⁶ However, the American workforce has become increasingly mobile, and younger employees are attracted to the portability of defined contribution plans.³⁷ Similarly, the changing workplace, as demonstrated by the decline of the number of large unionized companies and traditional industries sponsoring defined benefit plans, has contributed to the erosion of the popularity of defined benefit plans.³⁸

Another factor leading to the decline is increased international and domestic competition in older, traditional industries. Manufacturing and exporting have been a backbone of the United States economy. Older mainstays in these industries struck deals with labor unions to provide generous pension and health benefits for employees and retirees. Although our economy is shifting away from industry to services, these older companies are still subject to high employee and legacy costs. These costs are deeply entrenched in these companies’ cost structures. In contrast, newer domestic manufacturers and international competitors do not face these same cost structures. Pension funding at these older companies has contributed to the disparate cost structures between traditional American companies and

32. Noel, *supra* note 25, at 902.

33. *Id.*

34. Martin & Amert, *supra* note 26, at 454.

35. *Id.*

36. Unlike 401(k) plans which employees can generally “roll-over” to another plan after they switch jobs, defined benefit plans are not portable. Monahan, *supra* note 27, at 477. “A worker who changes jobs cannot take his defined benefit plan benefit with him.” *Id.*

37. Noel, *supra* note 25, at 902.

38. Edward A. Zelinsky, *Deregulating Marriage: The Pro-Marriage Case for Abolishing Civil Marriage*, 27 CARDOZO L. REV. 1161, 1171 n.35 (2006); Noel, *supra* note 25, at 902; *see also* Monahan, *supra* note 27, at 477 (“The demographic shift in the United States away from manufacturing and other traditionally union jobs, which are strongly associated with defined benefit plan coverage, also contributed to the shift [from defined benefit to defined contribution plans].”).

newer domestic and international companies, particularly when those newer and foreign companies employ non-unionized labor.

This has forced companies to take cost-cutting measures, since pension expenses impose a major strain on corporate competitiveness.³⁹ Indeed, many believe that traditional pension plans and other legacy costs are major factors in the decline of the international and domestic competitive position of old-line manufacturing companies.⁴⁰ Transitioning away from defined benefit plans may provide a much needed hedge for these companies and enable them to secure their powerful positions in the global economy.

Consequently, major corporations, even those that are profitable, are freezing their pension programs and moving toward employer sponsored, defined contribution plans.⁴¹ For instance, IBM announced in January 2006 that it plans to freeze its pension plan in the United States in 2008.⁴² This “effective deactivation of one [of] the nation’s biggest pension plans marks a significant milestone in the gradual but persistent shift away from traditional, defined-benefit plans at major U.S. corporations.”⁴³ Other high profile companies that have frozen or reduced future defined benefit accruals in their defined benefit plans include Verizon, Lockheed Martin, Alcoa, Sears, Hewlett Packard and Motorola.⁴⁴ Employers are finding that traditional defined benefit plans are too costly and place them at a competitive disadvantage against peers who offer less costly 401(k) and other defined contribution programs, and that defined contribution plans

39. See John Burritt McArthur, *Private Pensions and the Justification for Social Security*, 48 S. TEX. L. REV. 1, 25-26 (2006) (“With international competition increasing pressure on old-line companies, many have forced employees to replace defined-benefit pensions with defined-contribution plans, in which the payout varies depending upon how well the invested funds fare.”); see also MARK M. GLICKMAN & CHARLES A. JESZEK, U.S. GOVERNMENT ACCOUNTABILITY OFFICE, PBGC AND THE CURRENT CHALLENGES FACING THE U.S. DEFINED BENEFIT PENSION SYSTEM 3 (2005), available at <http://www.socrates.berkeley.edu/~iir/events/spring05/seminars/glickman/glickman.pdf> (“Since PBGC’s insured plans lie disproportionately in industries that are facing intense global competition (or have already been decimated, as in the case of steel), PBGC’s balance sheet is likely to worsen drastically in the near term.”).

40. See BIVENS ET AL., *supra* note 24, at 1.

41. See, e.g., Stephanie Armour, Marilyn Adams & Kathy Chu, *Even Health Firms Freeze or Cut Loose Traditional Pensions*, U.S.A. TODAY, Dec. 7, 2005, at 1B.

42. Justin Cummins & Meg Luger Nikolai, *ERISA Reform in a Post-Enron World*, 39 J. MARSHALL L. REV. 563, 569 (2006); Ellen E. Schultz et al., *IBM to Freeze Pension Program in '08*, WALL ST. J. ONLINE, http://www.online.wsj.com/article/SB113649758562938958.html?mod=home_whats_news_us.

43. Schultz et al., *supra* note 42.

44. See 152 CONG. REC. S38 (2006), available at <http://www.govtrack.us/congress/record.xpd?id=109-h20060308-38&person=400267>.

provide more stability and predictability than defined benefit plans.⁴⁵

V. DEFINED BENEFIT PLAN TROUBLES

While the number of defined benefit plans has declined over the past several years, many plans are still in existence. Millions of employees and retirees are dependent on these plans. There is currently about 1.6 trillion dollars in assets accumulated in private-sector defined benefit plans.⁴⁶ These plans cover approximately one-fifth of all full-time private-sector employees.⁴⁷ Nearly seventy-five percent of S&P 500 companies sponsor defined benefit plans.⁴⁸

Recent studies have highlighted the funding problems surrounding defined benefit plans. The United States Government Accountability Office ("GAO") recently reported that between 1995 and 2002, thirty-nine percent of the 100 largest defined benefit plans were less than fully funded.⁴⁹ By 2002, over half of the 100 largest defined benefit plans were underfunded, with one quarter of the largest plans being less than ninety percent funded. Moreover, on average 62.5 percent of the largest plan sponsors per year made no cash contributions to their plans.⁵⁰

Consequently, an extremely troubling concern faced by the baby boomer generation is the well-documented problems of the defined pension programs of several major corporations, including Delta Air Lines, US Airways, United Airlines, Polaroid, Kaiser Aluminum, Bethlehem Steel, and others.⁵¹ These failures have been attributed to the popping of the 2000 stock market bubble, which reduced the asset values of many defined benefit plans, and historically low interest rates, which caused an increase in plan liabilities.⁵² Moreover, competition in industries, such as airline, steel, and automotive, which have traditionally provided defined

45. See Schultz et al., *supra* note 42 ("IBM has complained that its pension program, which offers workers benefits based on the number of years they work, is expensive and puts it at a disadvantage to its tech competitors"); see also Armour et al., *supra* note 41 ("Companies are freezing or ending [defined benefit] plans in part because pensions have become more costly, and the costs are also less predictable amid lowered investment returns from the stock market.").

46. Zelinsky, *supra* note 13, at 469.

47. *Id.*

48. *Id.* at 469-70.

49. U.S. GOV'T ACCOUNTABILITY OFFICE, PRIVATE PENSIONS: RECENT EXPERIENCE OF LARGE DEFINED BENEFIT PLANS ILLUSTRATE WEAKNESSES IN FUNDING RULES (2005), available at <http://www.gao.gov/new.items/d05294.pdf>.

50. *Id.*

51. See, e.g., Armour et al., *supra* note 41; Ford et al., *supra* note 30, at 351.

52. GLICKMAN & JESZECK, *supra* note 39, at 2.

benefit plans, has led to the bankruptcies of companies with severely underfunded plans.⁵³

Instability in the defined benefit world has taken a major toll on the PBGC, which reported a deficit of over 18.1 billion dollars in 2006.⁵⁴ The PBGC estimates that by the end of 2005 underfunding in pension plans “topped more than half a trillion dollars,” and the PBGC’s potential exposure from financially troubled plan sponsors reached 108 billion dollars.⁵⁵ Highlighting this troubling trend is the collapse of United Airlines’ pension program, the largest corporate pension default in United States’ history.⁵⁶ When United Airlines turned its pension over to the PBGC, the plan was more than ten billion dollars underfunded.⁵⁷ The workers and retirees affected by the default were forced to forfeit more than three billion dollars in pension benefits.⁵⁸

VI. WHY A PROPERLY FUNCTIONING RETIREMENT SYSTEM IS IMPORTANT

There are many reasons why a properly functioning retirement system is important in the United States. Moral and ethical concerns dictate in favor of a robust system. Indeed, the defining characteristic of a civilized society is the showing of benevolence toward its most vulnerable members – the youth, the elderly, and the poor.⁵⁹ A retirement system is integral to ensuring sufficient support for the nation’s elderly.

The retirement system is also of critical fiscal importance to the United States’ economy.⁶⁰ In 2005, the Department of Labor estimated the total value of United States pension assets, including both public sector and private sector plans, at twelve

53. *Id.*

54. PENSION BENEFIT GUAR. CORP., 2006 ANNUAL MANAGEMENT REPORT 16 (2006), available at <http://www.pbgc.gov/docs/PBGCAMR.pdf>.

The staggering deficit stands in stark contrast to the \$9.7 billion surplus the PBGC reported at the end of fiscal year 2000. Ford et al., *supra* note 30, at 351. Compounding the concern over the PBGC’s budget deficit is the fact that PBGC’s insurance payments are not backed by the full faith and credit of the federal government. GLICKMAN & JESZECK, *supra* note 39, at 1.

55. PENSION BENEFIT GUAR. CORP., 2005 ANNUAL REPORT 4 (2005), available at <http://www.pbgc.gov/docs/05annrpt.pdf>.

56. *Id.*

57. *Id.*

58. *Id.*

59. See, e.g., Peter Tompkins, *Essay: Immigration: Governments and Lawyers on a Collision Course*, 17 LOY. L.A. INT’L & COMP. L. REV. 891, 895 (1995) (“The measure of a civilized society must be the way it treats the vulnerable and the marginalized . . .”).

60. Aaron Klein, *Divorce, Death, and Posthumous Qdros: When Is It Too Late for a Divorcee to Claim Pension Benefits Under ERISA*, 26 CARDOZO L. REV. 1651, 1658 (2005).

trillion.⁶¹ Private employer pension plans hold around 4.3 trillion dollars of those assets, including both deferred benefit and deferred contribution plans.⁶² The staggering influx of capital into the system makes it among the largest (if not the largest) segment of the economy. Properly safeguarding and investing this capital is crucial to our economic stability.

Moreover, retirement spending is economically significant since “retirees spend lots of money and pay lots of taxes.”⁶³ Indeed, some argue that regions with larger elderly populations fare better economically because of the high spending rate among retirees.⁶⁴ Because spending by retirees can have such a beneficial effect on the economy, it is important to preserve retirees’ income streams by providing a properly functioning and stable retirement system.

VII. AN OVERVIEW OF THE PENSION PROTECTION ACT

A. *Genesis of the Pension Protection Act of 2006*

On the wake of many high-profile pension defaults and corporate scandals, increasing public pressure to fix the “pension crisis” forced politicians to take action. In 2005, the government began making proposals to “strengthen the retirement security of 34 million workers.”⁶⁵ Three main objectives emerged: (1) reforming defined benefit funding rules to ensure full funding; (2) reforming PBGC premium rules to better reflect risks and costs; and (3) increasing accountability and transparency through new disclosure rules.⁶⁶

In 2006, the PPA went into effect.⁶⁷ The PPA amends several portions of ERISA and the Internal Revenue Code (“Code”)⁶⁸ in order to strengthen the defined benefit system as baby boomers head toward retirement.⁶⁹ However, as will be discussed later, the

61. Elaine L. Chao, U.S. Sec’y of Labor, *Protecting the Retirement Security of America’s Workers: The President’s Plan for Reforming Private Defined Benefit Pension Plans* (Jan. 10, 2005), http://www.dol.gov/_sec/media/speeches/20050110_retirement.htm.

62. *Id.*

63. Patrick Barta, *Aging in Place Keeps Homes Off the Market*, REAL ESTATE JOURNAL.COM, <http://www.realestatejournal.com/buysell/relocation/20010503-barta.html>.

64. *Id.*

65. News Release, U.S. Dep’t of Labor, *Bush Administration Proposal to Strengthen the Retirement Security of 34 Million Workers Announced by Secretary of Labor* (Jan. 10, 2005), *available at* <http://www.dol.gov/opa/media/press/opa/opa20050041.htm>.

66. *Id.*

67. News Release, George W. Bush, Pres., White House, *President Bush Signs H.R. 4, the Pension Protection Act of 2006* (Aug. 17, 2006), *available at* <http://www.whitehouse.gov/news/releases/2006/08/print/20060817-1.html>.

68. 26 U.S.C. § 1 (2000).

69. *See* Bush, *supra* note 67 (“We must also prepare for the impact of the

PPA may provide further fuel for the migration away from defined benefit plans. Moreover, it is entirely uncertain how financially beleaguered corporations that sponsor defined benefit plans will be able to comply with the new rules imposed by the PPA.

B. Some Major Provisions of the PPA⁷⁰

1. New Funding Rules for Defined Benefit Plans

Addressing the underfunding and default problems of defined benefit plans, the PPA overhauled previous ERISA funding rules.⁷¹ The new funding rules are based on the funding status of the plan.⁷² Generally, these new funding rules are effective for the 2008 plan year.⁷³ For single-employer defined benefit plans, the PPA requires the plan to meet new minimum funding standards.⁷⁴ The new funding target under the PPA is 100 percent, which means that “the funding target of a plan for a plan year is the present value of all benefits accrued or earned under the plan as of the beginning of the plan year.”⁷⁵ A plan’s required contribution under the PPA equals the present value of benefits earned by participants for the current year, plus any amount needed to amortize funding shortfalls over a period of no longer than seven years.⁷⁶ This has the effect of requiring underfunded plans to make “catch-up” payments in order to get those plans up to proper funding levels. The Secretary of the Treasury is empowered to waive the minimum funding requirements for employers that are unable to satisfy the minimum funding standard for the plan year without “temporary substantial business hardship” if application of the minimum funding standard would be “adverse to the

baby boomer generation’s retirement, and what that impact will have on federal entitlement programs like Social Security and Medicare.”)

70. The intent of this discussion is to highlight some of the major provisions enacted by the PPA. It is certainly not an exhaustive discussion of all of the extensive changes imposed by the PPA.

71. Pension Protection Act of 2006, Pub. L. No. 109-280, §§ 102, 112, 120 Stat. 780 (2006) (hereinafter PPA) (amending 29 U.S.C. § 1083 and establishing 26 U.S.C. § 430, respectfully); CCH, LEGISLATION 2006, PENSION PROTECTION ACT OF 2006: LAW, EXPLANATION AND ANALYSIS 43 (2006).

72. Jenner & Block Client Alert, *Pension Protection Act of 2006* (2006), available at <http://www.jenner.com>.

73. *Id.*

74. Single-employer plans are plans to which only one employer is required to contribute. *Id.* In contrast, multiemployer plans are plans to which more than one employer is required to contribute. 26 U.S.C. § 414(f)(1). As single-employer plans comprise the majority of traditional defined benefit plans, this article focuses on the provisions applicable to these plans.

75. 29 U.S.C. § 1083(d)(1); 26 U.S.C. § 430(c)(4) (2000).

76. Jenner & Block Client Alert, *supra* note 72. However, there is a phase-in of the new 100% funding target. See 29 U.S.C. § 1083(c)(5); 26 U.S.C. § 430(c)(5).

interests of plan participants in the aggregate.”⁷⁷

Beginning in 2008, the PPA allows a plan sponsor to elect to maintain a credit balance, also known as a “pre-funding balance.”⁷⁸ Similarly, plans formed prior to 2008 that maintain existing credit balances may elect to maintain all or a portion of that balance as a “funding standard carryover balance.”⁷⁹ Credit balances, whether in the form of a “pre-funding balance” or a “funding standard carryover balance,” are available as a credit against the employer’s minimum funding contribution for the year in order to reduce the amount the employer must pay for the year.⁸⁰ If a plan maintains a pre-funding balance or a funding standard carryover balance, the value of the plan’s assets are reduced.⁸¹ Consequently, plan sponsors may choose to reduce or waive any credits in order to prevent the reduction of assets.⁸²

As an incentive for employers to “add more money [to their defined benefit plans] during good times and build up a cushion that can keep pensions solvent in lean times,”⁸³ the PPA amended the Code to provide increases in tax deductibility limits for defined benefit plans. Beginning in 2008, the PPA will allow employers that sponsor single-employer plans to contribute and deduct a “cushion” equal to fifty percent of the funding target for the year, plus amounts that reflect salary increase projections.⁸⁴ Companies will be able to use the money saved through tax deductions to offset the increased money they forward to their defined benefit plans. This will allow companies the possibility of beefing up defined benefit plan funding without suffering a long-term substantial shortage of available cash.

77. 29 U.S.C. § 1082(c)(1)(A); 26 U.S.C. § 412(c)(1)(A); CCH, *supra* note 71, at 86. The Internal Revenue Service administers Title II of ERISA. Susan B. Hutches, *Web Resources for Employee Benefit and Corporate Research*, in UNDERSTANDING ERISA 2006: AN INTRODUCTION TO BASIC EMPLOYEE RETIREMENT BENEFITS 191, 207 (2006). Title III of ERISA provides jurisdictional, enforcement and administration rules administered by the Department of Labor and Department of Treasury. Charles S. Crase & Richard A. Bales, *Why a Written Request for Plan Documents by an Attorney Representing a Plan Participant or Beneficiary Should Trigger a Plan Administrator’s Duty of Disclosure Under ERISA*, 29 U.S.C. § 1024(B)(4), 32 CAP. U. L. REV. 803, 808 (2004). Because the PPA operates in conjunction with ERISA and the I.R.C., and ERISA and I.R.C. rules govern the administration of the PPA, all of these agencies will have input into interpretation and enforcement of the PPA.

78. 29 U.S.C. § 1083(f)(1)(A); 26 U.S.C. § 430(f)(1)(A) (2000).

79. 29 U.S.C. § 1083(f)(1)(B); 26 U.S.C. § 430(f)(1)(B).

80. 29 U.S.C. § 1083(f)(2); 26 U.S.C. § 430(f)(2).

81. 29 U.S.C. § 1083(f)(4); 26 U.S.C. § 430(f)(4).

82. 29 U.S.C. § 1083(f)(5); 26 U.S.C. § 430(f)(5); CCH, *supra* note 71, at 100.

83. Bush, *supra* note 67.

84. See PPA § 801 (amending 26 U.S.C. § 404). Multiemployer plans are entitled to deduct up to 140 percent of their current unfunded liability, minus the value of the plan’s assets. See PPA § 802 (amending 26 U.S.C. § 404).

The PPA provides a new interest rate for calculating pension liabilities. Under pre-PPA rules, plans use interest rates based on the thirty-year Treasury bond interest rate. Industry leaders have sharply criticized this rate claiming that it “artificially inflates pension liabilities and funding obligations.”⁸⁵ Therefore, in order to ensure accurate calculations of the present value of plan obligations, the new PPA provides for an interest rate using a “corporate bond yield curve” based on a twenty-four-month average on the top three grades of corporate bonds.⁸⁶ There are three different interest rate assumptions, depending on the expected payment date of plan benefits: (1) zero to five years; (2) five to twenty years; and (3) after twenty years.⁸⁷ The PPA fully phases in the new modified yield curve by 2010.⁸⁸

In order to measure the value of plan assets, the PPA establishes a valuation date, which is generally the first day of the plan year.⁸⁹ The value of plan assets is the fair market value of the assets, but the PPA allows averaging.⁹⁰ The averaging period is limited to two years, and plan asset values are required to be between ninety and one-hundred percent of the fair market value of the assets.⁹¹

The PPA places even stricter funding rules on “at-risk” plans.⁹² At-risk plans are “subject to a higher funding target and to a higher target normal cost” than other plans.⁹³ These provisions aim to discourage and rectify underfunding by accurately determining the present value of funding obligations, and then requiring companies to fund accordingly. The funding target for an at-risk plan is “the present value of all benefits accrued or earned under the plan as of the beginning of the plan year” as determined by using specified at-risk actuarial assumptions.⁹⁴ Similarly, the target normal cost of at-risk plans is

85. See, e.g., *The Administration's Pension Reform Proposal, Committee on Education and the Workforce*, 109th Cong. 3 (2005) (Testimony of Kenneth W. Porter on Behalf of the American Benefits Council).

86. 29 U.S.C. § 1083(h)(12)(D)(i) and IRC; 26 U.S.C. § 430(h)(2); *H.R. 4 — Pension Protection Act of 2006, U.S. Senate Republican Policy Committee Legislative Notice*, 109th Cong. 5 (2006) (statement of Jon Kyl, Chairman).

87. 29 U.S.C. § 1083(h)(1)(B); 26 U.S.C. § 430(h)(2); Jenner & Block Client Alert, *supra* note 72.

88. *H.R. 4 - Pension Protection Act of 2006, supra* note 86, at 4.

89. 29 U.S.C. § 1083(g)(2); 26 U.S.C. § 430(g)(2). These provisions apply to plans with fewer than 100 participants. A plan with 100 or fewer participants may designate any day during the plan year as its valuation date. *Id.*

90. 29 U.S.C. § 1083(g)(3); 26 U.S.C. § 430(g)(3).

91. 29 U.S.C. § 1083(g)(3); 26 U.S.C. § 430(g)(3).

92. See 29 U.S.C. § 1083(i)(6) (discussing small plan exceptions to “at-risk” plans). Only defined benefit plans with more than 500 employees for the plan year can receive at-risk status. *Id.*; 26 U.S.C. § 430(i)(6).

93. CCH, *supra* note 71, at 111.

94. 29 U.S.C. § 1083(i)(1)(A)(i); 26 U.S.C. § 430(i)(1)(A)(i).

“the present value of all benefits which are expected to accrue or be earned under the plan during the plan year.”⁹⁵

The PPA uses a “funding target attainment percentage,” which is the “ratio of plan assets (reduced by credit balances) to the funding target for the preceding plan year,” in order to determine the plan’s financial health.⁹⁶ A plan is at-risk if: (1) “the funding target attainment percentage for the preceding plan year . . . is less than eighty percent,” and (2) the funding target attainment percentage for the preceding plan year including specified at-risk actuarial assumptions⁹⁷ is less than seventy percent.⁹⁸ The eighty percent prong of the at-risk test will be phased-in from 2008 to 2011.⁹⁹ The seventy percent prong of the at-risk test is effective beginning 2008, but the applicable at-risk actuarial assumptions will be phased in over a five-year period.¹⁰⁰ In effect, these new rules make the liabilities of an at-risk plan greater than they would be without the at-risk rules.¹⁰¹ An increase in plan liabilities means that companies will have to put more money into the plan in order to meet its funding targets. This provides incentive for companies to avoid underfunding, and it also provides incentive for at-risk plans to rectify underfunding as soon as possible.

Furthermore, the PPA imposes several new benefit restrictions on underfunded plans. Benefit restrictions serve to

95. 29 U.S.C. § 1083(i)(2)(A); 26 U.S.C. § 430(i)(2)(A). Plans which are at-risk for the current plan year, as well as for at least two of the four preceding plan years, are also subject to a “loading factor,” which is incorporated into the funding target and target normal cost. 29 U.S.C. § 1083(i)(2)(B); 26 U.S.C. § 430(i)(2)(B).

96. *H.R. 4 — Pension Protection Act of 2006*, *supra* note 86, at 5; CCH, *supra* note 71, at 109-10.

97. The actuarial assumptions are: (1) that all employees eligible to elect benefits during the plan year and in the ten succeeding plan years will retire at the earliest authorized retirement date (but not before the end of the plan year for which the at-risk determination is being made); and (2) that all employees will elect the retirement benefits available under the plan at the assumed retirement age which would result in the highest present value of benefits.

29 U.S.C. § 1083(i)(1)(B) and IRC); 26 U.S.C. § 430(i)(1)(B); CCH, *supra* note 71, at 110.

98. 29 U.S.C. § 1083(i)(4)(A); 26 U.S.C. § 430(i)(4)(A); CCH, *supra* note 71, at 109-10.

99. CCH, *supra* note 71, at 110. The funding target attainment percentage for the first prong of the at-risk test is phased in as follows:

(1) in 2008, the percentage is sixty-five percent;

(2) in 2009, the percentage is seventy percent; and

(3) in 2010, the percentage is seventy-five percent.

29 U.S.C. § 1083(i)(4)(B); 26 U.S.C. § 430(i)(4)(B); CCH, *supra* note 71, at 110.

100. CCH, *supra* note 71, at 110; *H.R. 4 — Pension Protection Act of 2006*, *supra* note 86, at 5.

101. See CCH, *supra* note 71, at 111.

limit liability growth when a plan is underfunded.¹⁰² They also prevent the “moral hazard” associated with underfunding, reducing employer incentive to increase benefits instead of wages during financially unstable times with the knowledge that the PBGC will pick up the slack.¹⁰³ If a defined benefit plan is less than sixty percent funded, then it is prohibited from paying “unpredictable contingent event benefits.”¹⁰⁴ A defined benefit plan that is less than eighty percent funded cannot adopt an amendment “which has the effect of increasing liabilities of the plan by reason of increases in benefits, establishment of new benefits, changing the rate of benefit accrual, or changing the rate at which benefits become nonforfeitable.”¹⁰⁵ The PPA also prohibits accelerated or lump-sum payments if the plan is under sixty percent funded, or when the plan is in federal or state bankruptcy proceedings.¹⁰⁶ A plan that is under sixty percent funded must cease all benefit accruals until the plan sponsor contributes enough to attain the sixty percent funding threshold.¹⁰⁷ Furthermore, plans cannot use credit balances to avoid these underfunding restrictions.¹⁰⁸

In order to provide relief to the financially-beleaguered airline industry, the PPA adopts special funding rules for defined benefit pension plans sponsored by commercial passenger airlines.¹⁰⁹ Airlines adopting a “hard freeze”¹¹⁰ on benefits receive an additional ten years to meet funding obligations and an interest rate of 8.85 percent to calculate pension contributions.¹¹¹ Those

102. *United States Senate Special Comm’n on Aging*, 109th Cong. 7 (2005) (Testimony of Mark J. Warshawsky, Assistant Sec’y of Treasury).

103. *Id.*

104. See PPA § 103 (amending 29 U.S.C. § 1056); PPA § 113 (amending 26 U.S.C. § 436). An example of an unpredictable contingent event would be the shutdown of an employer’s operations. CCH, *supra* note 71, at 118.

105. PPA §§ 103, 113 (amending 29 U.S.C. § 1056(g)(2)(A); 26 U.S.C. § 436(c)(1)). However, an employer subject to these provisions is allowed to amend an underfunded plan if the employer pays a contribution (in addition to its minimum required contribution for the plan year) equal to the amount of the increase in the funding target attributable to the amendment. See *id.* (amending 29 U.S.C. § 1056(g)(2)(B) and U.S.C. § 436(c)(2)).

106. See *id.* (amending 29 U.S.C. § 1056(g)(3) and U.S.C. § 436(d)); CCH, *supra* note 71, at 120.

107. See *id.* (amending 29 U.S.C. § 1056(g)(4) and U.S.C. § 436(e)). Alternatively, an employer can provide sufficient security to the plan to enable it to begin accruing benefits again. See *id.* (amending 29 U.S.C. § 1056(g)(5) and U.S.C. § 436(f)).

108. See *id.* (amending 29 U.S.C. § 1056(g)(5)(B) and U.S.C. § 436(f)(2)).

109. See PPA § 402.

110. A “hard freeze” means that no participant in the plan will accrue further benefits based on job tenure or compensation growth. PENSION BENEFIT GUAR. CORP., AN ANALYSIS OF FROZEN DEFINED BENEFIT PLANS (2005), available at http://www.pbgc.gov/docs/frozen_plans_1205.pdf.

111. *H.R. 4 – Pension Protection Act of 2006*, *supra* note 86, at 10.

that do not adopt a "hard freeze" are given three additional years to meet their funding obligations.¹¹²

One question that arises when analyzing these aggressive new funding rules is how to ensure compliance from financially troubled companies. While there are a variety of reasons why companies underfund their pensions, some companies simply do not have the financial resources to fully fund their plans. A financially unstable company may not be able to satisfy these new rules, especially since their minimum funding requirements will increase once the rules are effective. Indeed, the PPA takes great strides at preventing the pitfalls that lead to underfunding, but it may be less effective at curing the current underfunding problem.

The above discussion merely highlights some of the major funding changes imposed by the PPA. The funding changes appear to be aimed at ensuring that plans are adequately funded and avoid default. There have been criticisms, however, that the new funding requirements will further push companies away from defined benefit plans, especially those companies with healthy plans, because the rules require most companies to contribute more money to their plans per year.¹¹³ Moreover, some critics argue that the new rules are too volatile and do not add enough stability, further pushing the drive toward defined contribution plans.¹¹⁴ It is likely that it will take several years before the accuracy of these predictions can be measured and to decide whether the new funding rules are furthering the goal of eradicating the problems of underfunded pensions.

2. *Defined Benefit Plan Disclosure Statements*

The PPA also requires sponsors of defined benefit plans to provide periodic plan disclosure statements. Sponsors must provide the statements at least once every three years to each participant in the plan, and sponsors must provide them at anytime to a participant or beneficiary upon written request.¹¹⁵ The statement must indicate, on the basis of the latest available information, the participant's total accrued benefits and the total vested percentage, or the earliest date on which benefits become vested.¹¹⁶ The notice must be written in a manner calculated to be understood by the average plan participant, and it may be sent in

112. PPA § 402; *H.R. 4 - Pension Protection Act of 2006*, *supra* note 86, at 10.

113. *See, e.g.*, Chris Isidore, *Pension Problems 101*, CNN, May 17, 2005, available at http://www.money.cnn.com/2005/05/17/retirement/pension_problems/index.htm; Peter Baker, *Bush Signs Sweeping Revision of Pension Law*, WASH. POST, Aug. 18, 2006, at D01.

114. Sue Kirchoff, *Pension Act: Does it Add to Instability?*, U.S.A. TODAY, at 4B.

115. PPA § 508 (amending 29 U.S.C. § 1025(a)(1)(B)(i)).

116. *Id.* (amending 29 U.S.C. § 1025(a)(2)(A)).

written, electronic, or other appropriate form.¹¹⁷ Alternatively, the notice requirements can be met “if at least once each year the administrator provides to the participant notice of the availability of the pension benefit statement and the ways in which the participant may obtain such statement.”¹¹⁸

3. *Protection of the PBGC*

The PPA has taken steps to combat the severely high-budget deficit the PBGC is facing. Currently, plans covered by the PBGC pay a flat-rate premium of thirty dollars per participant per year.¹¹⁹ Furthermore, underfunded plans must pay a variable rate premium, which is based on the level of underfunding. The variable rate premium is nine dollars per one thousand dollars of unfunded vested benefits at the end of the preceding plan year.¹²⁰ Beginning in 2008, the PPA will change the way underfunded plan variable rate premiums are calculated. The determination of unfunded vested benefits will conform to the funding rules of the PPA discussed earlier.¹²¹ The variable rate premium calculations will be based on yield curve segment rates.¹²² Significantly, the PPA eliminates the “full funding limit” exception to variable rate premiums.¹²³ Under that exception, no variable rate premium is imposed if contributions made to the plan for the prior year were at least equal to the full funding limit for that year.¹²⁴

The elimination of the full funding limit was intended to combat the failure of the variable rate premium to raise sufficient revenue for the PBGC.¹²⁵ Because less than twenty percent of plans pay a variable rate premium due to the full funding limit exception,¹²⁶ the elimination of the exception may result in large increases of revenue for the PBGC. However, the changes in the premium structure may push more companies away from traditional pension plans. Many employers who were not subject to premiums due to the full funding limit exception will see sharp increases in their premium obligations once the exception is

117. *Id.*

118. *Id.*

119. 29 U.S.C. § 1306(a)(3)(A)(i); CCH, *supra* note 71, at 202.

120. 29 U.S.C. § 1306(a)(3)(E)(ii); CCH, *supra* note 71, at 202.

121. CCH, *supra* note 71, at 203.

122. Jenner & Block Client Alert, *supra* note 72.

123. PPA § 401 (amending 29 U.S.C. § 1306(a)(3)(E) to eliminate the reference to 26 U.S.C. § 412(c)(7), the full funding limit exception).

124. CCH, *supra* note 71, at 202. The full funding limit is not less than the excess, if any, of ninety percent of the plan’s liabilities over the actuarial value of its assets. 26 U.S.C. § 412.

125. See *United States Senate Budget Committee*, 109th Cong. 28 (2005) (Testimony of Bradley D. Belt, Executive Director, Pension Benefit Guaranty Corporation); CCH, *supra* note 71, at 204.

126. CCH, *supra* note 71, at 204.

eliminated in 2008.¹²⁷ Furthermore, because the new variable premium rates will be based on the new funding rules of the PPA, employers whose funding requirements increase will also see a rise in their PBGC premiums.¹²⁸ Consequently, these changes may not have the desired effect of significantly raising the PBGC's annual revenues.

4. *Executive Compensation*

In a further effort to prevent pension default, the PPA restricts "the use of deferred executive compensation arrangements for employers with severely underfunded plans."¹²⁹ The PPA prohibits employers from setting money aside to pay for nonqualified deferred compensation for top executives if the company is bankrupt, has an at-risk defined benefit plan or has a terminated plan with insufficient assets to pay benefits.¹³⁰ If amounts are set aside in violation of this proscription, the executive will be taxed and have to pay interest and a twenty percent penalty.¹³¹ This provision takes effect as of the enactment date of the PPA, but plans cannot be considered at-risk before the 2008 plan year.¹³²

5. *Defined Contribution Provisions*

The PPA imposes progressive new requirements intended to strengthen and grow defined contribution plans. One of the most significant changes provided by the PPA is the granting of diversification rights to participants in "applicable defined contribution plans."¹³³ The diversification rights will allow eligible participants to divest and reinvest those plan portions attributable to employee contributions and elective deferrals invested in publicly traded employer securities.¹³⁴ Regarding portions of an individual's plan account attributable to employer contributions (other than elective deferrals), which are invested in publicly traded employer securities, the PPA allows participants who have completed at least three years of service to divest and reinvest

127. *Id.* at 203.

128. *Id.*

129. *House Committee on Education & the Workforce, Bill Summary, The Pension Protection Act (H.R. 4)*, 109th Cong. (2006).

130. PPA § 116 (amending 26 U.S.C. § 409(A)).

131. *Id.*; Jenner & Block Client Alert, *supra* note 72.

132. *Id.*

133. "Applicable defined contribution plan" means any defined contribution plan holding publicly traded employer securities. PPA § 901 (amending 26 U.S.C. § 401(a)(35)(E)(i)). Depending on how they are structured, employee stock ownership plans (ESOP) may not be considered applicable defined contribution plans. 26 U.S.C. § 401(a)(35)(E)(ii).

134. PPA § 901 (amending 29 U.S.C. § 1054 and 26 U.S.C. § 401); Jenner & Block Client Alert, *supra* note 72.

that portion.¹³⁵ However, there is a phase-in approach for diversification of the employer contribution portions invested in employer securities acquired in any plan year prior to January 1, 2007.¹³⁶

Diversification minimizes the risks associated with holding too few and too risky investments. Consequently, the PPA requires plans that must allow diversification to offer at least three investment alternatives other than employer securities.¹³⁷ Diversified alternatives with materially different risk and return characteristics are required.¹³⁸ Plans may limit the time for divestment and reinvestment to “periodic, reasonable opportunities occurring no less frequently than quarterly.”¹³⁹ In order to prevent employer discouragement of diversification, employers cannot impose restrictions or conditions on investment of employer securities that they do not impose on investments of other assets of the plan, except as provided by application of securities laws.¹⁴⁰

Recent major corporate scandals such as Enron highlight the need for diversification in retirement planning. While investments in company stock are often a wise choice for employees, placing too much emphasis in retirement planning on employer securities creates the risk of catastrophe if the employer’s stock plummets in value. In order to encourage diversification, the PPA requires plans to provide notice to participants regarding their diversification rights.¹⁴¹ The notice must set forth the participants’ rights to diversify their accounts and describe “the importance of diversifying the investment of retirement account assets.”¹⁴² The notice must be “written in a manner calculated to be understood by the average plan participant and may be delivered in written, electronic, or other appropriate form.”¹⁴³ The notice requirements are effective as of January 1, 2007.¹⁴⁴

In a major nod toward strengthening defined contribution plan enrollment, the PPA allows for automatic enrollment of new employees into employer sponsored 401(k) plans.¹⁴⁵ Allowing

135. *Id.* This also applies to beneficiaries of a participant or a deceased participant.

136. *Id.*; CCH, *supra* note 71, at 225. The applicable percentages are 33% in year one, 66% percent in year two, and 100% in year three and beyond.

137. 26 U.S.C. § 401(a)(35)(D)(i); 29 U.S.C. § 1054(j)(4).

138. 26 U.S.C. § 401(a)(35)(D)(i); 29 U.S.C. § 1054(j)(4).

139. 26 U.S.C. § 401(a)(35)(D)(ii)(I); 29 U.S.C. § 1054(j)(4)(B)(i).

140. 26 U.S.C. § 401(a)(35)(D)(ii)(II); 29 U.S.C. § 1054(j)(4)(B)(ii).

141. PPA § 507 (amending 29 U.S.C. §§ 1021, 1132).

142. *Id.*

143. *Id.*

144. *Id.*

145. *See* PPA § 902 (amending 26 U.S.C. § 401(k) and 29 U.S.C. § 1144).

employers to automatically enroll employees in defined contribution plans reflects the trend away from socialized retirement programs in favor of private wealth providing for the bulk of retirement security. The PPA outlines several safe harbor requirements that employers who automatically enroll their employees must fulfill, including default contribution rates, match rates, vesting, notice, and opt-out requirements.¹⁴⁶ The PPA amends ERISA § 514 to add provisions preempting “any law of a State which would directly or indirectly prohibit or restrict the inclusion in any plan of an automatic contribution arrangement.”¹⁴⁷

6. Hybrid/Cash Plans

Hybrid plans are defined benefit plans that share characteristics of both defined benefit and defined contribution plans. A cash balance plan is a hybrid plan, and it is governed by the same rules governing traditional defined benefit plans under ERISA.¹⁴⁸ Cash balance plans more closely resemble defined contribution accounts because workers are provided with individual accounts.¹⁴⁹ In cash balance plans, however, the employees’ personal accounts are not separately funded.¹⁵⁰ Rather, a participant is given a hypothetical account that receives a semi-annual or annual credit comprised of a percentage of the participant’s compensation and an interest credit.¹⁵¹

Cash balance plans have been the source of major controversy in recent years. These plans appeal to younger workers because they are not back-loaded and therefore provide a more even benefit to workers regardless of the time spent working for their employer.¹⁵² These types of plans are also more attractive to employers because they are not as costly to maintain and the funding obligations are not as volatile.¹⁵³ On the flipside, these plans are disfavored by older, more experienced workers because it is a move away from traditional plans which reward longevity and experience. Unlike the traditional back-loaded pension plans, cash

146. Jenner & Block Client Alert, *supra* note 72. The Department of Labor recently issued a final regulation detailing conditions that must be satisfied in order to obtain safe harbor relief. See Default Investment Alternatives Under Participant Directed Individual Account Plans, 72 Fed. Reg. 60,452 (Oct. 24, 2007) (to be codified at 29 C.F.R. pt. 2550).

147. 29 U.S.C. § 1144(e)(1).

148. Martin & Amert, *supra* note 26, at 455 (citing Employment Benefit Research Institute, *New EBRI Backgrounder Cash Balance Pros and Cons Outlined*, PR NEWSWIRE, June 24, 1999).

149. *Id.*

150. *Cooper v. IBM Personal Pension Plan*, 457 F.3d 636, 637 (7th Cir. 2006).

151. *Id.*

152. Martin & Amert, *supra* note 26, at 455-56.

153. *Id.* at 458; CCH, *supra* note 71, at 334.

balance plans are front-loaded, which means that benefits accrue more rapidly during the early years of employment.¹⁵⁴ Due to the tension caused by these plans, litigation has ensued in which older plaintiffs are claiming age discrimination.¹⁵⁵

One of the most significant actions taken by the PPA is the legitimization of cash balance and hybrid pension plans. The PPA clarifies that a defined benefit plan is not considered age discriminatory “if a participant’s accrued benefit, as determined as of any date under the terms of the plan, would be equal to or greater than that of any similarly situated, younger individual who is or could be a participant.”¹⁵⁶ A cash balance plan does not violate the prohibition against ceasing or reducing the rate of an employee’s benefit accrual because of age¹⁵⁷ as long as a participant’s accrued benefit meets the similarly situated standard described above.¹⁵⁸ Consequently, there is no discriminatory violation being committed as long as similarly situated employees receive equal annual credits to their accounts. However, it is important to note that these age discrimination provisions are prospective and that “[n]othing in the amendments . . . shall be construed to create an inference” as to the legality of hybrid plans in effect before the amendments.¹⁵⁹

The legalization of hybrid plans simply reflects the shift away from traditional defined benefit plans. Furthermore, these provisions show the dichotomy and possible inconsistent objectives of the PPA. The PPA attempts to ensure adequate funding is present to meet the demands of defined benefit plan participants. However, another theme emerging is that the PPA creates incentives for employers to move away from offering traditional

154. Martin & Amert, *supra* note 26, at 459.

155. For instance, in *Cooper*, 457 F.3d at 638, the plaintiffs argued that IBM’s cash balance plan violated two anti-discrimination provisions in ERISA because “younger employees receive interest credits for more years.” The Seventh Circuit upheld the legality of IBM’s cash balance plan, finding that it was not age discriminatory because the plan was age-neutral. *Id.* at 642. According to Judge Easterbrook, in enacting the age discrimination provisions in ERISA, Congress did not “set out to legislate against the fact that younger workers have (statistically) more time left before retirement, and thus a greater opportunity to earn interest on each year’s retirement savings.” *Id.* at 639.

156. PPA § 701 (amending 29 U.S.C. § 1054, 26 U.S.C. § 411 and ADEA § 4); Jenner & Block Client Alert, *supra* note 72. “[A] participant is similarly situated to any other such individual if such participant is identical to such other individual in every respect (including period of service, compensation, position, date of hire, work history, and any other respect) except for age.” Jenner & Block Client Alert, *supra* note 72.

157. 29 U.S.C. § 1054(b)(1)(H); 26 U.S.C. § 411(b)(1)(H).

158. PPA § 701(d) (amending 29 U.S.C. § 204, I.R.C. § 411 and ADEA § 4); Jenner & Block Client Alert, *supra* note 72.

159. PPA § 701 (amending 29 U.S.C. § 1054, 26 U.S.C. § 411 and ADEA § 4).

pensions. The clarification of the age discrimination rules and their effect on hybrid plans is yet another example of Congress' push to minimize the importance of traditional pensions in our retirement system.

7. Solving Tricky ERISA Provisions

ERISA has been criticized as one of the most confusing and complex statutory schemes in existence. One of ERISA's "fundamental restrictions," the prohibition on transactions between a plan and a "party in interest," has been scrutinized as costly and burdensome.¹⁶⁰ Section 406(a) of ERISA codifies a list of several prohibited transactions between a plan fiduciary and a "party in interest."¹⁶¹ In order to alleviate some of the burden placed on plans to comply with the prohibited transactions statute, the PPA creates several new prohibited transaction exceptions for: (1) block trading; (2) transactions executed through approved electronic communications networks, alternative trading systems, or similar execution systems; (3) non-fiduciary service providers who receive "adequate consideration"; (4) foreign exchange securities transactions in which the broker does not have investment discretion; and (5) cross trading between plans which each have at least 100 million dollars in assets managed by the same investment manager.¹⁶² These exceptions have the dual purpose of permitting plans "to complete many transactions more freely, while still providing protection for plans and their participants and beneficiaries."¹⁶³

Another thorn in the side of plan administrators has been the "plan assets" restriction imposed by the Department of Labor.¹⁶⁴ Under both the PPA and the Department of Labor regulation, when a defined benefit plan invests in hedge funds, private equity funds, or other similar investments, the underlying assets of those funds may be considered "plan assets."¹⁶⁵ Fund managers attempt to avoid plan assets because those assets subject the managers to complicated ERISA rules, such as the fiduciary and prohibited transaction rules.¹⁶⁶ The "significant benefit plan investor"

160. Alson R. Martin, *Pension Protection Act of 2006*, SM047 ALI-ABA 1, 43 (2006).

161. Parties in interest include employers, fiduciaries, participants, and others. *Harris Trust Sav. Bank v. Solomon Smith Barney, Inc.*, 530 U.S. 238, 242 (2000).

162. PPA § 611 (amending 29 U.S.C. § 1108 and 26 U.S.C. § 4975).

163. Andrew L. Oringer, *Ancillary Provisions of the Pension Funding Bill May Contribute to the Evolution of ERISA*, BNA PENSION PROTECTION ACT CENTER, Aug. 18, 2006, available at <http://www.subscript.bna.com/pic2/ppa.nsf/id/BNAP-6SSLZL?OpenDocument>.

164. *Id.*

165. PPA § 611 (amending 29 U.S.C. § 1001a; 29 C.F.R. § 2510.3-101)

166. Jenner & Block Client Alert, *supra* note 72.

exception ameliorates this problem if immediately after the most recent acquisition of any equity interest in the fund less than twenty-five percent of each class of equity interests in the fund is held by benefit plan investors.¹⁶⁷ Under the Department of Labor regulation, “benefit plan investors” include any employee benefit plan regardless of whether it is subject to ERISA.¹⁶⁸ The PPA revises the “benefit plan investors” definition to limit it to cover only employee benefit plans that are subject to ERISA.¹⁶⁹ This new change will allow funds to foster and encourage investment from ERISA plans while providing more leeway in avoiding the plan asset restrictions.¹⁷⁰

8. *The Future*

Although the PPA aims to prevent defined benefit default, it clearly reflects the nation’s trend toward hybrid plans and defined contribution plans. Defined contribution plans already provide more security and less risk to employers, while being amenable to today’s mobile workforce. By requiring diversification of investment options in defined contribution plans, defined contribution plans become even more attractive to employees. Employers who want to gain a competitive advantage and retain the best possible workforce may find that offering defined contribution plans is the most feasible way to achieve that goal. Consequently, a likely consequence of the PPA is that the erosion of the defined benefit plan system will continue.

The enactment of the PPA is only the first step in the reform of the nation’s retirement system. The PPA is a highly technical and dense act, and substantial guidance from Congress, the Department of Labor, and the Internal Revenue Service will be necessary in parsing all of the new rules. However, employers now need to reassess their retirement plans in light of the new PPA. Employers who provide defined benefit plans should review their existing plans in order to ensure compliance with the new funding rules. The increase in yearly funding obligations may prove onerous for many employers, especially those who are in a financially shaky position. Those employers who decide that providing a defined benefit plan is no longer feasible or competitively advantageous ought to consider changing the type of retirement plan provided.

167. Martin, *supra* note 160, at 41; Oringer, *supra* note 163.

168. Oringer, *supra* note 163.

169. Martin, *supra* note 160, at 42.

170. Jenner & Block Client Alert, *supra* note 72.

VIII. CONCLUSION

The retirement system in the United States is at a crossroads. Government retirement plans such as Social Security are not sufficient to guarantee enough retirement funds for the current workforce. More than ever, employer sponsored retirement plans are integral to proper retirement planning, and they will continue to become more important in the future. The recent high-profile collapse of several major defined benefit programs, as well as major corporate scandals, have highlighted the need for changes to the legislation governing employee benefit plans. The PPA provides much needed reform to the law in an attempt to shore up the current funding crisis.

Remarkably, there is a duality to the PPA. While it does take steps to cure current defined benefit funding problems, it also creates incentives for alternative retirement plans. It makes defined contribution plans more attractive, and legalizes hybrid plans. Furthermore, the new defined benefit funding rules may prove onerous and costly, especially for those companies who need to catch up on funding. This provides further cause for companies to stop offering traditional defined benefit plans. In the end, the PPA fosters different goals in that it opens new retirement funding avenues and attempts to cure the problems that have arisen from the defined benefit plan system, while at the same time attempts to ensure the security of existing traditional defined benefit plans.