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Proposed Regulations May Affect Default Risk for Borrowers with Pension Plans

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The Pension Benefit Guaranty Corporation (PBGC) has proposed regulatory safe harbors waiving the obligation of financially sound defined benefit pension plans and the companies that maintain them from the duty to report certain events that signal an increase in a plan's financial risk. The regulations would also revise many existing reportable event waivers. In recognition of the significant effect that pension liabilities can have on creditworthiness, many credit agreements refer to unwaived reportable events when defining the events of default. Finalization of the PBGC's proposed changes could change the borrower's risk of default under existing agreements.

ERISA Reportable Events

The Employee Retirement Income Security Act (ERISA) requires sponsors of single-employer defined benefit retirement plans to report certain events to the PBGC that could herald an increase in a plan's financial liabilities or a decrease in the sponsor's financial health. This mechanism allows the PBGC to identify pension plans that may terminate in distress or otherwise require the PBGC's financial assistance. Reportable events vary widely in their scope. For instance, the statute includes as reportable events:

- the bankruptcy of a plan sponsor or another company in the sponsor's controlled group;
- a change in the identity of a plan sponsor or change in composition of the sponsor's controlled group;
- the transfer of plan liabilities to a plan sponsored by a company outside the transferring sponsor's controlled group; and
- a distribution to a 10% owner of the plan sponsor equaling 1% or more of plan assets.

The newly proposed regulations are intended to reduce the burden on a plan sponsor of determining when a reportable event occurs. In particular, the proposal includes less burdensome rules for testing when a sponsor must report a reduction in the plan's active participants or approval of a dividend or stock redemption by the plan sponsor. Less favorable to plan sponsors is a broadened obligation to report changes in the sponsor's controlled group. Under the proposal, a plan sponsor would experience a reportable event immediately upon entering into an agreement to divest an affiliate, even if completion of the divestiture is contingent on regulatory approval or financing.

Current Reportable Event Waivers

In many circumstances, the PBGC automatically waives reportable events, depending on the perceived likelihood that the PBGC may be required to provide guarantees to fund the plan's benefits. Under existing regulations, waivers may apply for well funded plans and small plans, reportable events that involve de minimis dollar amounts and reportable events triggered by a foreign affiliate of the plan sponsor. Currently, the most significant waivers are for well funded plans and de minimis dollar amounts because they apply to the broadest range of reportable events.

Proposed Liberalizations

Many credit agreements provide that an event of default occurs if the borrower or a member of the borrower's controlled group experiences an ERISA reportable event that is not subject to a PBGC waiver. Four years ago, the PBGC proposed regulations that would have eliminated most funding waivers. It withdrew those regulations in the face of criticism that the changes would have made it more likely that borrowers with defined benefit pension plans would trigger an event of default for relatively innocuous occurrences, such as normal employee attrition or a lump sum pension distribution.

The PBGC asserts that the proposed regulations address these concerns by focusing ERISA reportable events on the plans at greatest risk while easing reporting burdens on most companies. To this end, the regulations include a safe harbor for many events related to plan funding for sponsors that are "financially sound." Under the proposed regulations, financial soundness depends on the plan sponsor's: (i) commercial credit score from Dun & Bradstreet or a similar service; (ii) absence of secured debt other than property leases or equipment financing; and (iii) positive net income, absence of significant loan defaults and timely pension contributions for the prior two years. A financially sound sponsor would have an automatic waiver of the duty to report a reduction in a plan's active participants, a distribution to a substantial owner, a change in sponsor identity or composition of the sponsor's controlled group, a transfer of plan liabilities to an unrelated plan sponsor or an extraordinary dividend or stock redemption.

The proposed regulations also expand the small plan waiver for reporting significant reductions in active participants, making it also applicable to the reportable events for an extraordinary dividend or stock redemption, a controlled group change and a transfer of plan liabilities. Finally, the insolvency of, or loan default by, an entity in the sponsor's controlled group would no longer be a reportable event as long as the insolvent or defaulting entity was a de minimis element of the controlled group.

Proposed Restrictions

Although the majority of the proposed changes to the reportable event regulations would broaden the scope of existing waivers, certain changes would increase the risk of an unwaived reportable event. In particular, the well funded plan waiver, which is the most significant extant waiver, would be subject to a more stringent definition. Under the current regulations, a plan is generally deemed well funded if at least 80% of vested benefits are funded, calculated on an ongoing basis. The proposed regulations would fold this waiver into a new safe harbor for financially sound plans, but would consider a plan to be "financially sound" only if the plan assets equal or exceed 120% of the value of vested benefits, calculated on an ongoing basis, or 100% of the value of vested benefits, calculated on a termination basis. Unlike the existing well funded plan waiver, the new safe harbor for financially sound plans would not excuse a sponsor from reporting the liquidation of, or default on a loan by, the plan sponsor or a member of the sponsor's controlled group. Separately, the duty to report the transfer of plan liabilities to a plan outside of the controlled group would no longer be waived for cases where all benefits and liabilities are transferred simultaneously.

Assessing the Impact of PBGC's Proposed Changes on Credit Agreements

These proposed regulations are subject to change, so renegotiating credit agreements at this point would be premature. However, borrowers that have relied on the well funded plan waiver may wish to evaluate their likelihood of satisfying the standards for either the financially sound plan safe harbor or the financially sound plan sponsor safe harbor. Lenders should focus their attention on whether the proposed financially sound plan safe harbor or the expanded small plan waiver would lead to underreporting of ERISA risks and require tightening of the ERISA-related default terms in their credit agreements.

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