Loyola of Los Angeles Law Review

Volume 40
Number 3 *Symposium: The Second-Person Standpoint and the Law*

Article 9

3-1-2007

Smoke, Mirrors, and ERISA: The False Illusion of Retirement Income Security

Michael Barbanell Landres

SMOKE, MIRRORS, AND ERISA: THE FALSE ILLUSION OF RETIREMENT INCOME SECURITY

*Michael Barbanell Landres**

I. INTRODUCTION

On February 1, 2006, UAL Corporation ("UAL"), the parent holding company of United Airlines, emerged from bankruptcy after approximately three years of Chapter 11 reorganization proceedings.[1] As part of its reorganization plan, UAL entered into an agreement with the Pension Benefit Guaranty Corporation ("PBGC")[2] to terminate defined pension plans that the airline had legally underfunded by almost $10 billion.[3] Pursuant to its federal mandate under the Employee Retirement Income Security Act[4] ("ERISA"), the PBGC is now liable for the pension benefits of 121,557 current and former UAL employees.[5]

Most of UAL's current and former employees lost significant retirement benefits when UAL terminated its retirement plans. While the terminated plans had provided employees with medical

---

* J.D. Candidate, May 2007, Loyola Law School, Los Angeles; B.A., June 2001, History and French Studies, Stanford University. Special thanks to Professor Daniel Schechter, who patiently advised me on this project while on sabbatical, and to Professor Lauren Willis, whose keen intellect and passion for the law have been a source of inspiration for me throughout law school. I also wish to thank Bruce Wu, Managing Director, Citigroup Corporate & Investment Bank, and Valerie A. Cohen, formerly of Disney Corporate Alliances, each of whom mentored me and helped expand my knowledge of the corporate world.

1. *See* Press Release, United Air Lines, Inc., United Exits Bankruptcy as a Strong Competitor Committed to Continuous Improvement (Feb. 1, 2006), http://www.united.com/press/detail/0,6862,53625,00.html [hereinafter United Exits Bankruptcy].

2. For a detailed description of the PBGC, see *infra* Part III.

3. Ass'n of Flight Attendants-CWA v. Pension Benefit Guar. Corp., 372 F. Supp. 2d 91, 94 n.1 (D.D.C. 2005) (denying flight attendants' request for a preliminary injunction to prevent the PBGC from terminating the UAL pension plans).

4. Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 832 (codified as amended in scattered sections of 29 U.S.C. (2006)).

5. *Ass'n of Flight Attendants*, 372 F. Supp. 2d at 94 n.1, 103.

coverage, the PBGC offers no such benefit. Furthermore, employees who spent their careers at UAL accepting lower wages and collective bargaining concessions in exchange for the company's guarantee of a defined pension benefit will now experience substantial decreases in their monthly retirement income, some by more than 50 percent.[6]

The loss of employee benefits is merely the tip of the iceberg. As the U.S. Government Accountability Office ("GAO") has noted, the bankruptcy of airlines with underfunded pension plans has the potential to create a "vicious cycle" of bankruptcies and plan terminations within the airline industry.[7] Now that UAL has emerged from Chapter 11 reorganization, the absence of its pension obligations, combined with a reduced debt load, will greatly reduce its costs and enable the airline to price its competitors out of the market.[8] Cognizant of this fact, Delta and Northwest have themselves filed for bankruptcy protection and appear to be modeling their own reorganization plans after that of UAL; it is therefore likely that they too will reduce labor costs by shedding their underfunded defined benefit plans before emerging from bankruptcy protection.[9] More disturbing yet, this cycle appears to have spread beyond the airline industry. The recent demise of Delphi Automotive[10] and the

6. *See* Pension Benefit Guar. Corp., Pension Guarantees, http://www.pbgc.gov/media/key-resources-for-the-press/content/page13542.html (last visited Apr. 16, 2007) [hereinafter Pension Guarantees]. *See generally* Broken Promises: The United Airlines Pension Crisis: E-Hearing Before Reps. George Miller & Jan Schakowsky, (2005), http://webharvest.gov/congress109th/20061114071951/edworkforce.house.gov/democrats/pdf/pensionehearingrecord.pdf.

7. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-05-108T, PRIVATE PENSIONS: AIRLINE PLANS' UNDERFUNDING ILLUSTRATES BROADER PROBLEMS WITH THE DEFINED BENEFIT PENSION SYSTEM 9 (2004), *available at* http://www.gao.gov/new.items/d05108t.pdf.

8. *See* United Exits Bankruptcy, *supra* note 1. For additional information on the long-term outlook of the airline industry, see U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-05-945, COMMERCIAL AVIATION: BANKRUPTCY AND PENSION PROBLEMS ARE SYMPTOMS OF UNDERLYING STRUCTURAL ISSUES (2005), *available at* http://www.gao.gov/new.items/d05945.pdf.

9. Dave Carpenter, *United Serving as Bankruptcy Model*, SEATTLE TIMES, Sept. 17, 2005, at E4, *available at* http://seattletimes.nwsource.com/html/businesstechnology/2002500628_airlinesunited17.html ("I think they looked at United and saw how United was able to shed pension liabilities. . . . United is showing that you can use bankruptcy in an intelligent manner to restructure." (internal quotation marks omitted)).

10. *See* Mary Williams Walsh, *Whoops! There Goes Another Pension Plan*, N.Y. TIMES, Sept. 18, 2005, at C1 (noting that the demise of Delphi Automotive is yet another example of an old-line company unlocking value by jettisoning its pension obligations); *see also* Wharton School of the Univ. of Pa., *Underfunded Pensions: Causes, Cures and Questions*, KNOWLEDGE@WHARTON, Oct. 20, 2004, at 3, http://knowledge.wharton.upenn.edu/createpdf.cfm?articleid=824&CFID ("While GM and other companies say they can handle the shortfall . . . some people and politicians see an unsettling resemblance to the steel industry.").

financial distress of both General Motors and Ford may indicate that the automotive industry too will soon suffer the same fate as the airline industry.[11]

Based on the PBGC's most recent estimates, the nation's single-employer defined benefit plans are currently underfunded by approximately $450 billion.[12] More troublesome yet, among companies whose pension plans meet the agency's criteria for risk of future termination,[13] the PBGC faces exposure to approximately $108 billion in unfunded future liabilities.[14] When combined with a sharp rise in the frequency of plan terminations and a growing PBGC deficit, such systematic underfunding suggests that the law governing the nation's defined benefit system is structurally flawed and in need of comprehensive reform.[15] Although the Republican Congress and Bush Administration hailed the recent passage of the Pension Protection Act of 2006[16] ("PPA") as the most comprehensive overhaul of the nation's retirement system since the inception of ERISA,[17] the legislation is not the panacea that politicians may believe it to be.

Legal scholarship on ERISA reform has focused on proposing *ex post* statutory deterrents to prevent companies from terminating

---

11. *See* Danny Hakim, *With Delphi Filing, Tougher Times for Auto Industry Workers*, N.Y. TIMES, Oct. 10, 2005, at C1 (commenting that Delphi's bankruptcy may force General Motors to restructure its labor costs and pension obligations).

12. PENSION BENEFIT GUAR. CORP., PERFORMANCE AND ACCOUNTABILITY REPORT: FISCAL YEAR 2005, at 5 (2005), *available at* http://www.pbgc.gov/docs/2005par.pdf.

13. *Id.* at 29. Factors that the PBGC uses to consider future risk of plan termination include, but are not limited to, the following:

> [S]ponsor is in Chapter 11 proceedings; sponsor received a minimum funding waiver within the past five years; sponsor granted security to an unsecured creditor as part of a renegotiation of debt within the past two years; sponsor is known to have been in default on existing debt within the past two years (regardless of whether it received a waiver of default); or sponsor's unsecured debt is rated CCC+/Caa1 or lower by S&P or Moody's respectively.

Id.

14. *Id.* at 13, 22. The PBGC has estimated future liabilities based upon ERISA disclosure requirements such as Form 5500 submissions and section 4010 filings. *Id.* at 23.

15. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-05-294, PRIVATE PENSIONS: RECENT EXPERIENCES OF LARGE DEFINED BENEFIT PLANS ILLUSTRATE WEAKNESSES IN FUNDING RULES 37–38 (2005), http://www.gao.gov/new.items/d05294.pdf [hereinafter PRIVATE PENSIONS: WEAKNESSES IN FUNDING RULES].

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

17. Press Release, Office of the Press Sec'y, The White House, President Looks Forward to Signing Pension Reform Legislation (Aug. 4, 2006), *available at* http://www.whitehouse.gov/news/releases/2006/08/20060804-4.html.

defined benefit plans in Chapter 11 proceedings. Specifically, commentators have recently suggested various changes to the PBGC's statutory lien priority status as a means of holding plan sponsors financially accountable for their long-term pension obligations.[18] Yet the rules governing ERISA's minimum funding requirements are vast and subject to a certain degree of flexibility.[19] Furthermore, federally mandated disclosure requirements for defined benefit plans remain opaque and fail to provide regulators, employees, and the investing public with an accurate and timely representation of the financial health and funding status of the nation's pension plans.[20]

This note explores ERISA's minimum funding rules as they existed prior to the enactment of the PPA and highlights the fundamental disconnect that exists between the actual funding level of the nation's defined benefit plans and the level required of public corporations in their reported regulatory filings. It also addresses the PPA's failure to adequately remedy the situation.

Given the complex nature of the statutes governing defined benefit plans, it is necessary to first understand the basic components of ERISA in order to identify and contextualize ERISA's shortcomings. Part II of this note describes the historical background that gave rise to ERISA and outlines the legislation's key funding

18. *See, e.g.*, Daniel Keating, *Pension Insurance, Bankruptcy and Moral Hazard*, 1991 WIS. L. REV. 65, 67 (1991) (proposing that Congress amend ERISA to grant the PBGC a non-lien "superpriority" to the corporate assets of underfunded pension plans, thereby shifting the risk of pension termination to creditors); Nicholas J. Brannick, Note, *At the Crossroads of Three Codes: How Employers Are Using ERISA, the Tax Code, and Bankruptcy to Evade Their Pension Obligations*, 65 OHIO ST. L.J. 1577, 1622 (2004) (proposing that Congress amend ERISA to empower the PBGC to regulate funding waivers and perfect its claims against employers who underfund pension liabilities on a "floating lien" basis); Jill L. Uylaki, Note, *Promises Made, Promises Broken: Securing Defined Benefit Pension Plan Income in the Wake of Employer Bankruptcy: Should We Rethink Priority Status for the Pension Benefit Guaranty Corporation?*, 6 ELDER L.J. 77 (1998) (proposing that Congress grant the PBGC lien priority status under the federal Bankruptcy Code in order to hold employers financially accountable for their pension obligations).

19. *See generally* PRIVATE PENSIONS: WEAKNESSES IN FUNDING RULES, *supra* note 15.

20. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-04-395, PRIVATE PENSIONS: PUBLICLY AVAILABLE REPORTS PROVIDE USEFUL BUT LIMITED INFORMATION ON PLANS' FINANCIAL CONDITION 3–4 (2004), *available at* http://www.gao.gov/new.items/d04395.pdf [hereinafter PUBLICLY AVAILABLE REPORTS]; *see also* U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-05-491, PRIVATE PENSIONS: GOVERNMENT ACTIONS COULD IMPROVE THE TIMELINESS AND CONTENT OF FORM 5500 PENSION INFORMATION 3–5 (2005), *available at* http://www.gao.gov/new.items/d05491.pdf [hereinafter CONTENT OF FORM 5500 PENSION INFORMATION].

rules. This section focuses on the tension between the statute's objective to establish fiscally responsible minimum funding levels, on the one hand, and to provide plan sponsors with a certain amount of financial flexibility on the other. Part III describes the statutory mandate of the PBGC and identifies structural problems that threaten the medium- to long-term viability of the pension insurance system. Part IV provides an overview of the federal reporting requirements that govern the nation's defined benefit system. Finally, Part V briefly discusses the shortcomings of the PPA and proposes an *ex ante* statutory solution to ERISA reform: greater financial transparency[21] of defined benefit plans in regulatory filings and a bifurcated approach with respect to accounting for pension obligations.

II. HISTORY OF ERISA AND ITS MINIMUM FUNDING RULES

A. Historical Background

Although Congress began its foray into the world of pension regulation with the passage of the Welfare and Pension Plans Disclosure Act in 1958,[22] the spectacular failure of Studebaker-Packard's pension plans in the 1960s[23] served as a national "focusing event"[24] that highlighted the need for a more comprehensive federal

21. According to the Securities and Exchange Commission ("SEC"), *transparent* financial reporting "provides investors and other users of financial statements with appropriate information to assess the material risks, rewards, rights, and obligations associated with arrangements." U.S. SEC. & EXCH. COMM'N, REPORT AND RECOMMENDATIONS PURSUANT TO SECTION 401(C) OF THE SARBANES-OXLEY ACT OF 2002 ON ARRANGEMENTS WITH OFF-BALANCE SHEET IMPLICATIONS, SPECIAL PURPOSE ENTITIES, AND TRANSPARENCY OF FILINGS BY ISSUERS 8 (2005), *available at* http://www.sec.gov/news/studies/soxoffbalancerpt.pdf [hereinafter ARRANGEMENTS WITH OFF-BALANCE SHEET IMPLICATIONS].

22. Pub. L. No. 85-836, 72 Stat. 997, *repealed by* Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829. As the first federal statute to exclusively address private-sector employee benefit plans, this legislation required plan sponsors to file both plan descriptions and annual financial reports with the Department of Labor. Employee Benefits Sec. Admin., U.S. Dep't of Labor, History of EBSA and ERISA, http://www.dol.gov/ebsa/aboutebsa/history.html (last visited Apr. 16, 2007). The legislation sought to provide plan participants and their beneficiaries with information sufficient in its scope to enable them to monitor their plans and prevent the mismanagement of plan assets. *Id.*

23. James A. Wooten, *"The Most Glorious Story of Failure in the Business": The Studebaker-Packard Corporation and the Origins of ERISA*, 49 BUFF. L. REV. 683, 733–34 (2001).

24. "As the political scientist John Kingdon observes, social problems often 'need a little push to get the attention of people in and around government. That push is sometimes provided by a *focusing event* like a crisis or disaster that comes along to call attention to the problem.'" *Id.*

pension regulation and re-insurance scheme.[25] Indeed, prior to the 1974 enactment of ERISA, there was a paucity of rules mandating basic pension funding requirements.[26] Additionally, plan participants lacked any kind of guarantee that they would receive their hard-earned, promised benefits in the event that their employers experienced financial difficulty.[27]

Thus in 1974, Congress passed ERISA legislation to protect the "well-being and security of millions of employees and their dependents [that] are directly affected by [employee benefit] plans."[28] At the time, defined benefit plans were the most popular form of employer-sponsored pensions and were rapidly growing in both overall plan numbers and individual participants.[29] In order to encourage the establishment, maintenance, and continuation of the defined benefit plan, ERISA mandated intricate minimum funding requirements for employer-sponsored pension plans.[30] It also created the PBGC to insure the benefits of plan participants in the event of employer default.[31]

The number of defined benefit plans peaked in the late 1970s.[32] Since then, the percentage of the U.S. labor force covered by such plans has decreased significantly, as employers have replaced defined benefit plans with defined contribution plans such as the 401(k).[33] Nevertheless, the PBGC continues to insure the pension benefits of more than 34 million workers and retirees with vested

---

at 684 (emphasis added) (quoting JOHN W. KINGDON, AGENDAS, ALTERNATIVES, AND PUBLIC POLICIES 94–95 (2d ed. 1995)).

25. *Id.* at 683 ("No single event is more closely associated with ERISA than the shutdown of the Studebaker plant in South Bend, Indiana.").

26. PRIVATE PENSIONS: WEAKNESSES IN FUNDING RULES, *supra* note 15, at 5.

27. U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-05-360T, PENSION BENEFIT GUARANTY CORPORATION: STRUCTURAL PROBLEMS LIMIT AGENCY'S ABILITY TO PROTECT ITSELF FROM RISK 4 (2005), *available at* http://www.gao.gov/new.items/d05360t.pdf [hereinafter PBGC STRUCTURAL PROBLEMS].

28. 29 U.S.C. § 1001(a) (2000 & Supp. III 2005) (amended 2006).

29. PRIVATE PENSIONS: WEAKNESSES IN FUNDING RULES, *supra* note 15, at 2.

30. *Id.* at 4.

31. *Id.*; *see also* 29 U.S.C. § 1302(a)(1) (2000) (amended 2006).

32. *Join the Queue: More Companies Move Towards Defined-Contribution Pension Plans*, ECONOMIST, Jan. 14, 2006, at 72.

33. *Id.* In recent months, blue chip companies such as IBM, Verizon, and Motorola have frozen their defined benefit programs and instead, set up 401(k) plans. *See id.* Recent research indicates that defined contribution schemes covered 62 percent of workers by 2004. *Id.* For a graphical representation of this trend, see *infra* figs.1 & 2.

retirement benefits in approximately 29,000 single-employer defined pension plans.[34] The defined benefit plan therefore remains an important component of the nation's retirement system.

B. Types of Employee Retirement Benefit Plans

To better contextualize recent trends in U.S. employee retirement benefits, it is necessary to understand the difference between defined benefit plans and defined contribution plans. Defined benefit plans guarantee participants a specific level of pension income upon retirement. In order to calculate a retiree's pension benefit, plan sponsors use formulae that take into account such variables as years of company service, final average salary, and age at retirement. Generally, plan participants receive either a specified dollar amount multiplied by their years of service at the company, or a percentage of their final average salary.[35]

In order to fund their defined pension obligations, companies make periodic contributions to defined benefit plans based upon "reasonable actuarial assumptions"[36] determined under ERISA's minimum funding requirements. Professionals then invest these contributions in a mix of stocks, bonds, and other investment vehicles according to the plan sponsor's overall demographics, liquidity needs, and risk/return profile. The accrued pension benefits of defined plan participants are independent from the value of the defined benefit plan's assets. Thus, employers bear the full financial risk of market fluctuations and are liable for funding shortfalls in their pension plans.[37]

The most widely known defined *contribution* plan used for retirement savings is the 401(k). Unlike defined benefit plans,

34. PENSION BENEFIT GUAR. CORP., *supra* note 12, at 6.

35. Memorandum in Support of the Debtors' Motion to Reject Their Collective Bargaining Agreements Pursuant to 11 U.S.C. § 1113(c), at 32–33, *In re* UAL Corp., No. 02-B-48191 (Bankr. N.D. Ill. Dec. 14, 2004), *available at* http://www.pd-ual.com/Downloads/1113MotionMemo.pdf [hereinafter Memorandum].

36. An *actuary* is a "mathematician employed by [a financial institution] to calculate premiums, reserves, dividends, and insurance, pension, and annuity rates, using risk factors obtained from experience tables. These tables are based on both the company's history of . . . claims and other industry and general statistical data." JOHN DOWNES & JORDAN ELLIOT GOODMAN, DICTIONARY OF FINANCE AND INVESTMENT TERMS 9 (5th ed. 1998). Federal regulations govern the standards for actuarial services performed under ERISA. *See* 20 C.F.R. § 901.0 to .71 (2006); *see also* PUBLICLY AVAILABLE REPORTS, *supra* note 20, at 8.

37. PUBLICLY AVAILABLE REPORTS, *supra* note 20, at 8.

401(k) plans do not guarantee participants any specific level of pension income. Instead, participants possess individual accounts into which they can make pre-tax contributions through payroll deductions.[38] Participants themselves bear responsibility for investing the funds contributed to their 401(k) and are often provided with a limited menu of investment options that might include mutual, bond, money market, and company stock funds.[39] In some cases, magnanimous plan sponsors will even match a portion of each employee's contribution.[40] Thus, plan participants (who may or may not be financially literate) must not only fund and invest in their 401(k), but also endure the financial risk of market fluctuations.[41] Thus, in stark contrast to defined benefit plans, defined contribution plans such as the 401(k) are liability-free to plan sponsors.[42]

C. *Funding Requirements*[43]

Congress legislated ERISA's funding rules in order to ensure that companies set aside and maintain sufficient assets to cover the retirement benefits they promise to their employees.[44] Yet according to GAO research, "recent terminations of large underfunded plans, along with continued widespread underfunding, suggest weaknesses in these rules that may threaten retirement incomes of these plans' participants, as well as the future viability of the . . . [PBGC] single-

38. *Id.* at 5 n.2. Other common types of defined contribution plans include, but are not limited to, profit-sharing plans, stock bonus plans, and employee stock ownership plans. Andrew L. Gaines, *An Introduction to Defined Contribution Plans*, *in* UNDERSTANDING ERISA 2005: AN INTRODUCTION TO BASIC EMPLOYEE RETIREMENT BENEFITS 57 (Joseph R. Simone ed., 2005).

39. Memorandum, *supra* note 35, at 32–33.

40. *Id.* at 33.

41. *See Caveat Investor: Individuals Are Taking on More Financial Responsibility, Not Least in Providing for Their Old Age. Maybe They Should Be Better Prepared*, ECONOMIST, Jan. 14, 2006, at 71 (arguing that many individuals who participate in defined contribution plans possess minimal financial literacy and do not necessarily manage their retirement investments effectively); *see also* Wharton School of the Univ. of Pa., *Hands-Off: Holders of 401(k) Retirement Accounts Are Not Your Typical Investors*, KNOWLEDGE@WHARTON, Mar. 8, 2006, at 1, http://knowledge.wharton.upenn.edu/createpdf.cfm?articleid=1405 ("Inattentive participants could get into trouble if they fail to rebalance their accounts from time to time." (quoting Professor of Insurance and Risk Management Olivia S. Mitchell)).

42. Wharton School of the Univ. of Pa., *Unlike Death and Taxes, Pensions Are No Longer Guaranteed*, KNOWLEDGE@WHARTON, Feb. 8, 2006, at 2–4, http://knowledge.wharton.upenn.edu/article/1375.cfm.

43. *See* Pension Benefit Guar. Corp. v. Sunarhauserman, Inc. (*In re* Sunarhauserman, Inc.), 1997 FED App. 0287P, at 6 n.3 (6th Cir.) (noting that ERISA and Internal Revenue Code rules governing minimum funding requirements are essentially the same).

44. PBGC STRUCTURAL PROBLEMS, *supra* note 27, at 1.

employer insurance program."[45] A closer examination of the ERISA funding rules reveals a number of their current flaws.

A significant difficulty facing companies with defined benefit plans involves the assumptions and methodologies they employ to assess pension assets and liabilities.[46] A defined pension plan involves a company's present-day promise to pay participant retirement benefits years (if not decades) in the future based upon a predetermined formula. On its face, such a situation presents the classic characteristics of a basic present value calculation.[47] Yet a scratch beneath the surface of the problem reveals a significantly more complex scenario. Indeed, such a calculation must take into account such variables as the future cost of retirement benefits, average retirement age, and expected mortality rates in addition to a plan sponsor's estimated return on plan assets.[48] For this reason, ERISA requires all costs, liabilities, rates of interest, and other factors under the plan to be determined on the basis of reasonable actuarial assumptions and methods.[49] Although teams of financial analysts, actuaries, and economists may use complex methodologies and intricate financial models to assign fixed values to these rather ephemeral variables, the fact remains that at best, such values represent good faith, educated guesses, and at worst, they provide an opportunity for plan sponsors to manipulate the net present value of their pension liabilities.[50]

---

45. PRIVATE PENSIONS: WEAKNESSES IN FUNDING RULES, *supra* note 15, at highlights.

46. *Id.* at 26.

47. The basic definition of *present value* is as follows:

> [The] value today of a future payment, or stream of payments, discounted at some appropriate compound interest—or discount—rate. For example, the present value of $100 to be received 10 years from now is about $38.55, using a discount rate equal to 10% interest compounded annually. . . . In security investments, the method is used to determine how much money should be invested today to result in a certain sum at a future time.

DOWNES & GOODMAN, *supra* note 36, at 464. For a graphical representation of the effect of discount rates on the net present value calculation, see *infra* fig.3.

48. PRIVATE PENSIONS: WEAKNESSES IN FUNDING RULES, *supra* note 15, at 26; *see also* BARBARA J. COLEMAN, PRIMER ON ERISA 32 (4th ed. 1993).

49. *See* 26 U.S.C. § 412(c)(3) (2000) (amended 2005); Treas. Reg. § 1.412(c)(3)-1 (as amended in 2005). Such assumptions include, but are not limited to, normal costs, accrued liability, past service liabilities, and experience gains and losses. 26 U.S.C. § 412(c)(1).

50. PRIVATE PENSIONS: WEAKNESSES IN FUNDING RULES, *supra* note 15, at 3–4, 14–15.

ERISA mandates that defined benefit plans track plan assets and liabilities using a "funding standard account" ("FSA").[51] Charges to the FSA are determined by assessing the "normal cost"[52] of the plan for the year and adding to it the amounts necessary to amortize in equal annual installments unfunded past service liabilities, net increases in unfunded service liabilities stemming from plan amendments (if any), net experience loss[53] (if any), and net loss resulting from changes in actuarial assumptions used under the plan (if any).[54] Credits to the FSA are determined by adding the amount considered contributed[55] for the plan year to the amount necessary to amortize in equal annual installments, the net increase in unfunded past service liability stemming from plan amendments (if any), the net experience gain (if any), and the net gain resulting from changes in actuarial assumptions used under the plan (if any).[56] When the sum of FSA charges and credits is *non-negative*, the plan will have met its ERISA-mandated minimum funding requirements.[57] To the extent that FSA credits *exceed* charges, the statute permits plan sponsors to accumulate funding credits ("FSA credits") and use them to offset future funding shortfalls.[58] Additionally, ERISA specifically provides for funding credits to accumulate interest based upon a statutorily defined interest rate.[59]

But if the FSA credits are *less than* charges, the plan is said to possess an "accumulated funding deficiency."[60] Generally, the accumulated funding deficiency will carry forward as a charge

51. 26 U.S.C. § 412(b)(1) (2000) (amended 2005).

52. Normal cost is the "[a]nnual cost to a pension plan for the benefits accrued that year by employees and administrative expenses." COLEMAN, *supra* note 48, at 212.

53. Experience gains and losses quantify the difference between a plan's actuarial assumptions and its actual experience. Thus, if an actuary had assumed that plan assets would earn a 10 percent return in a single year, but the actual return had been only 7 percent, the experience loss would quantify the 3 percent discrepancy. *See id.* at 63.

54. 26 U.S.C. § 412(b)(2) (2000) (amended 2005). The statute dictates specific amortization periods over which to spread each of the charges. *Id.*

55. *Id.* § 412(b)(3)(A) (2000) (amended 2005). Use of the words "considered contributed" is significant in that the statute permits plan sponsors to use non-cash credits to fulfill their minimum funding obligations under certain circumstances. *See id.* § 412(g).

56. *Id.* § 412(b)(3) (2000) (amended 2005). As was the case with charges to the FSA, the statute dictates corresponding amortization periods over which to spread each of the credits. *Id.*

57. *Id.* § 412(a) (2000) (amended 2005).

58. *Id.* § 412(g) (2000) (amended 2005).

59. *Id.* § 412(g)(3) (2000) (amended 2005).

60. *Id.* § 412(a) (2000) (amended 2005).

against the FSA in the following plan year.[61] However, if the plan sponsor experiences extreme business hardship, it may qualify for a waiver of the minimum funding requirement.[62] If the Secretary of the Treasury grants such a funding waiver,[63] the plan sponsor is entitled to amortize the funding deficiency over a period of five plan years rather than carry it forward as a single charge against the FSA in the following year.[64] However, if the value of a plan's assets falls below a statutory threshold,[65] ERISA imposes a "deficit reduction contribution" ("DRC") upon the plan sponsor.[66] Under such circumstances, the plan sponsor must contribute cash (or funding credits) sufficient to cover 90 percent of the plan's deficit within three to five years, *in addition to* any amounts necessary to meet its yearly minimum funding requirements.[67] Although the DRC is supposed to restore the financial health of underfunded plans, companies are often too financially distressed to afford the large cash payments required.[68]

---

61. Failure to meet the minimum funding requirement is not without penalty. The plan sponsor must pay a 10 percent excise tax based on the portion of the minimum requirement not met, *id.* § 4971(a); 29 U.S.C. § 1310(b) (2000) (amended 2005), and may be required to submit a form 4010 filing, 29 C.F.R. § 4010.6 to .8 (2006).

62. 26 U.S.C. § 412(d)(1) (2000) (amended 2005). The PBGC considers the following factors in determining *business hardship*:

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

Id. § 412(d)(2) (2000) (amended 2005).

63. The Secretary of the Treasury must supply the PBGC with notice of a completed application for the funding waiver and provide the corporation with an opportunity to comment. *Id.* § 412(f)(3)(B)(i)(I) to (II) (2000) (amended 2005). The Secretary may require a company to provide security with its plan as a condition for granting a funding waiver. *See id.* § 412(f)(3)(A) to (B) (2000) (amended 2005).

64. *Id.* § 412(b)(2)(C) (2000) (amended 2005).

65. A plan is responsible for a deficit reduction contribution if the value of its assets falls below 80 percent of its liabilities in the current year *or* if the value of its assets falls below 90 percent of liabilities in the current year and it did not maintain assets of 90 percent or more for any two consecutive years of the preceding three. *Id.* § 412(I)(9)(A) to (B) (2000) (amended 2005).

66. *Id.* § 412(*l*)(2) (2000) (amended 2005).

67. Memorandum, *supra* note 35, at 36.

68. *Id.* at 36–37. The burden and efficacy of the DRC is best described by the following analogy:

> Insofar as plan sponsors are concerned, it is as if Congress had issued an edict to homeowners with 30-year mortgages that, if the value of their homes drops below 80

The net effect of using actuarial methodologies to assess plan assets and liabilities is that companies' sponsors are insulated from short-term market volatility. Indeed, Treasury Regulations state that "[t]he funding of plan benefits and the charges and credits to the funding standard account required by section 412 are generally based upon the assumption that the defined benefit plan will be *continued* by the employer."[69] Because near-term fluctuations in both discount rate and fair market value tend to average out and correct themselves over the long term, the funding rules do not fully recognize changes in liabilities or assets during the precise period in which they occur.[70] In effect, Congress designed ERISA's funding metrics to smooth out fluctuations in plan assets and liabilities over a period of several years so that they would reflect significant, long-term market trends, rather than potentially volatile, present-day fair market value.[71]

For example, during the 2004 and 2005 plan years, ERISA funding rules mandated that the interest rate used to calculate a plan's current liability fall within a "permissible range," defined as

> a rate of interest which is not above, and not more than 10 percent below, the weighted average of the rates of interest on amounts invested conservatively in long-term investment grade corporate bonds during the 4-year period ending on the last day before the beginning of the plan year.[72]

> percent of the purchase price (for whatever reason), their loans will be accelerated such that the balance will suddenly become due in just three to five years. Worse yet, this accelerated funding requirement kicks in at a time when homeowners will likely find it most difficult to repay the loans because of the very same overarching economic circumstances that caused the value of their homes to drop.

Id.

69. Treas. Reg. § 1.412(c)(2)-1(a)(4)(ii) (2006) (emphasis added).

70. *Id.*

71. ARRANGEMENTS WITH OFF-BALANCE SHEET IMPLICATIONS, *supra* note 21, at 52.

72. 26 U.S.C. § 412(b)(5)(B)(ii)(I) to (II) (2000) (amended 2005). Historically, the Internal Revenue Code employed "the weighted average of the rates of interest on 30-year Treasury securities during the 4-year period ending on the last day before the beginning of the plan year." *Id.* § 412(b)(5)(B)(ii)(I) (2000) (amended 2005). In the event that the plan was sufficiently underfunded to trigger the DRC, the statute mandates that the highest permissible interest rate be reduced to five percent above the weighted average for the 1999 plan year. *See id.* § 412(l)(7)(C)(i)(I) to (II) (2000) (amended 2005). Yet for the 2002 and 2003 plan years, Congress changed the upper range to 120 percent of the weighted average. *See id.* § 412(l)(7)(C)(i)(III) (2000) (amended 2005). For a detailed discussion of the effect of interest rate selection on pension liabilities, see U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-03-313, PRIVATE PENSIONS: PROCESS NEEDED TO MONITOR THE MANDATED INTEREST RATE FOR PENSION CALCULATIONS (2003), *available at* http://www.gao.gov/new.items/d03313.pdf.

The code grants sponsors even wider latitude in determining the value of plan assets. Indeed, a plan actuary need only employ "any reasonable actuarial method of valuation which takes into account fair market value and which is permitted under regulations prescribed by the Secretary."[73] Treasury Regulations define the outer limits of reasonable actuarial value as an amount not less than 80 percent nor greater than 120 percent of the current fair market value of plan assets.[74]

As the GAO insightfully noted in a recent report, "[B]ecause of leeway in the actuarial methodology and assumptions that sponsors may use to measure plan assets and liabilities, underfunding may actually [be] more severe and widespread than reported."[75] Indeed, because ERISA's methodologies were designed to represent longer-term market trends, a precipitous drop in the fair market value of a plan's assets or a steep decline in interest rates would not be immediately recognized in minimum funding calculations, but instead gradually phased in over a period of several years.[76] For example, the falling interest rates and declining equity prices in the year 2000 would have significantly decreased the value of plan assets, while at the same time lowering the discount rate used to calculate the net present value of pension obligations. Technically, such a scenario should result in a dramatic *increase* in unfunded pension liabilities. Yet because the minimum funding rules permit a company to gradually factor market fluctuations into the minimum funding calculation, the plan sponsor might have actually reported a *decrease* in pension liabilities.

A similar disconnect exists in the valuation of FSA credits. For example, during the stock market bubble of the late 1990s, a plan

73. 26 U.S.C. § 412(c)(2)(A) (2000) (amended 2005). For detailed rules governing "reasonable actuarial valuation methods," see Treas. Reg. § 1.412(c)(2)-1.

74. Treas. Reg. § 1.412(c)(2)-1(b)(6)(i). The regulations also state that the actuarial value of assets reflect fair market value if they take into account average value of plan assets for a period not to exceed five years. *See id.* §§ 1.412(c)(2)-1(b)(4)(ii), 1.412(c)(2)-1(b)(7).

75. PRIVATE PENSIONS: WEAKNESSES IN FUNDING RULES, *supra* note 15, at 3.

76. *See* Treas. Reg. § 1.412(c)(2)-1(a)(4)(ii). Although the same is true of an *increase* in fair market value of plan assets and a steep rise in interest rates, failure to immediately recognize a positive funding trend is less disturbing, as it represents a net *improvement* in plan sponsor's financial health. One must also consider the market conditions of 2001 and 2002: not only did equity values drop precipitously, but interest rates also fell to their lowest level in 40 years. Greg Ip, *Lethargic Economy Could Tip Fed Toward Interest-Rate Cut*, WALL ST. J., Oct. 28, 2002, at A2. Such conditions would have effectively amplified the disconnect between the present day fair market and actuarial value of assets.

sponsor might have accrued $10 million in funding credits by contributing to its plan in excess of the minimum funding threshold. Perhaps the sponsor then invested this amount in a once high-flying (but now defunct) stock such as Enron. Notwithstanding the fact that the Enron stock certificates are no longer worth the paper on which they are printed, the statute allows the sponsor to slowly amortize its $10 million loss as a charge to the FSA over a period of several years. Furthermore, the plan sponsor may continue to carry forward the $10 million in prior funding credits, earn interest on the credits, and eventually use the credits as a non-cash plan contribution to offset future minimum funding obligations.[77]

To wit, ERISA's current funding rules leave plan sponsors with sufficient flexibility to report adequate funding levels based upon actuarial assumptions when the financial condition of the plan may in fact be rapidly deteriorating. Provided that the company sponsoring the plan is adequately capitalized, financially stable, and can continue to operate as a going concern, actuarial methodologies that assess plan funding levels based on long-term market trends may indeed be appropriate. On the other hand, a company in a troubled industry that experiences a combination of increased competition, shrinking profit margins, and deteriorating finances is more likely to liquidate or seek bankruptcy protection in the near- to medium-term. Under such circumstances, the utility of ERISA's minimum funding scheme—which assumes that defined benefit plans will be continued by employers—diminishes rapidly. Furthermore, statutory pension reporting requirements amplify the negative effects of the already opaque system of funding rules and represent a disservice to employees, government regulators, and investors.[78]

III. THE ROLE OF THE PBGC

A. Statutory Purpose and Financing

ERISA established the PBGC to maintain the overall integrity of the nation's voluntary private pension system.[79] The agency carries

77. PRIVATE PENSIONS: WEAKNESSES IN FUNDING RULES, *supra* note 15, at 22.

78. *See* discussion *infra* Part IV.

79. *See* 29 U.S.C. § 1302 (2000) (amended 2005). The PBGC's Congressional mandate is as follows:

out its mandate by providing plan sponsors with low-cost insurance to cover pension obligations in the event of plan termination,[80] and by monitoring the financial health of defined benefit plans covered by ERISA.[81] As a self-sufficient, federal corporation within the Department of Labor ("DOL"), the PBGC possesses a $100 million line of credit with the U.S. Treasury, but otherwise does not receive any funding from general tax revenues.[82] Instead, the agency funds its operations primarily through a statutorily defined premium structure set by Congress and paid by the companies who sponsor defined benefit plans.[83] The PBGC derives additional revenues from the assets of plans trusteed by the agency, recoveries from companies whose plans were terminated, and investment income.[84]

Yet Bradley Belt, Executive Director of the PBGC, has commented that the agency's "ability to manage its finances is severely limited. Unlike a private insurer, PBGC cannot control its revenues . . . [or] its expenses. PBGC's premiums are set by Congress, and companies sponsoring insured pension plans can transfer their unfunded liabilities to PBGC as long as they meet the statutory criteria."[85] Furthermore, according to the PBGC's 2004 Annual Report, "[t]he current massive underfunding of defined benefit pensions, compounded by the financial struggles of major industries that rely heavily on these pensions, has greatly increased the risk of loss for the pension insurance program."[86] Based upon recent estimates, the PBGC faces a medium- to long-term shortfall of approximately $23 billion.[87] Absent a government bailout or drastic

---

> The purposes of this subchapter, which are to be carried out by the corporation, are—(1) to encourage the continuation and maintenance of voluntary private pension plans for the benefit of their participants, (2) to provide for the timely and uninterrupted payment of pension benefits to participants and beneficiaries under plans to which this subchapter applies, and (3) to maintain premiums established by the corporation under section 1306 of this title at the lowest level consistent with carrying out its obligations under this subchapter.

Id. § 1302(a) (2000) (amended 2005).

80. *Id.*

81. *Id.* §§ 1302, 1308, 1310 (2000) (amended 2005).

82. *Id.* §§ 1305, 1306 (2000) (amended 2005).

83. *Id.*

84. PENSION BENEFIT GUAR. CORP., 2004 ANNUAL REPORT 24 (2004), *available at* http://www.pbgc.gov/docs/2004_annual_report.pdf.

85. *Id.* at 4.

86. *Id.* at 5.

87. *See id.* at 4, 12, 16.

changes to the PBGC's premium structure, the agency will continue to operate at a deficit and may ultimately default on its obligations.[88]

B. PBGC Insurance Coverage

Unlike other federal insurance schemes such as the Federal Deposit Insurance Corporation ("FDIC"), the PBGC does not possess the statutory authority to effectively protect itself from risk.[89] This is because ERISA requires the agency to provide insurance to any defined benefit plan that meets basic statutory requirements,[90] while at the same time restricting the PBGC's ability to charge premiums commensurate with market conditions.[91] Thus, the agency may not take into consideration a plan sponsor's financial health, industry outlook, or credit risk, but instead must assess premiums based upon a pre-determined statutory regime.[92] Prior to the Deficit Reduction Act of 2005, plan sponsors were required to pay a flat rate premium of $19 per participant per annum.[93] To the extent that a plan was not fully funded, sponsors paid a variable rate premium of $9 for every $1,000 of unvested benefits[94] per participant per annum.[95] Considering the potential liabilities at stake, PBGC

---

88. *See* Wharton School of the Univ. of Pa., *United Airlines' Pension Problem: Who, Ultimately, Is Going to Pay?*, KNOWLEDGE@WHARTON, Sept. 8, 2004, at 3, http://knowledge.wharton.upenn.edu/createpdf.cfm?articleid=1033&CFID=63602788CFTOKEN=641933198jsessionid=a83050ce09e46c73673F [hereinafter *Pension Problem*] ("The PBGC . . . was created as the 'pension fund of last resort' and is not equipped to cover the liabilities now looming." (quoting Professor Elizabeth Bailey)).

89. *See* PBGC STRUCTURAL PROBLEMS, *supra* note 27.

90. In order to qualify for PBGC insurance, a plan must fall under the statutory definition of "defined benefit plan." 29 U.S.C. §§ 1002(2)(A), 1321(a) (2000) (amended 2005).

91. PRIVATE PENSIONS: WEAKNESSES IN FUNDING RULES, *supra* note 15, at 15.

92. Changes in PBGC premium rates are subject to approval by a joint resolution of Congress. 29 U.S.C. § 1306(a)(2) (2000) (amended 2005).

93. Pension Benefit Guar. Corp., Pension Insurance Premiums, http://www.pbgc.gov/media/key-resources-for-the-press/content/page13541.html (last visited Apr. 16, 2007).

94. Unfunded vested benefits are the amount of unfunded current liability if only vested benefits are taken into account.

95. Under the recently enacted Deficit Reduction Act of 2005, Pub. L. No. 109-171, 120 Stat. 4, flat rate premiums increased to $30 per participant per annum, while the variable rate premium remained constant. The legislation also introduced a new termination premium of $1,250 per participant per annum that is triggered when a company transfers its underfunded pension plan to the PBGC. The termination premium is payable for three years after termination of the defined benefit plan. Press Release, Pension Benefit Guar. Corp., PBGC Premiums Rise with Enactment of Budget Reconciliation Bill (Feb. 8, 2006), http://www.pbgc.gov/media/news-archive/2006/pr06-26.html. It appears that Congress is attempting to reduce the PBGC's $23 billion funding shortfall by raising fixed rate premiums. In effect, today's most well-funded, responsible plan sponsors are paying the price for yesterday's terminated pension plans. Not only

premiums represent a somewhat paltry sum. Indeed, since the agency's inception in 1974, UAL paid approximately $50 million in premiums, yet it defaulted on approximately $6 billion in unfunded pension liabilities.[96]

Therefore, a company such as UAL may follow ERISA's minimum funding requirements to the letter of the law, exhibit a significant shortfall in funding its pension obligations, and still qualify for PBGC insurance at the below-market rates mandated by Congress. And the PBGC does not possess the regulatory authority to suspend such plans in order to hedge itself from additional liability. Nor may the agency require the plan sponsor to fund pension obligations in a manner that varies from ERISA's minimum funding and DRC requirements. In fact, the PBGC's only statutory remedy under ERISA is to preemptively terminate a pension plan and assume its unfunded liabilities in order to protect itself from incurring an even greater long-term loss.[97]

Upon the termination of a defined pension plan, the PBGC receives a lien against the employer for the amount of the unfunded vested pension obligations.[98] A lien arising from a plan termination during bankruptcy proceedings has not been perfected and therefore lacks priority status among creditors.[99] Nevertheless, even if the

---

does the new premium schedule impose excessively high fixed rates upon plan sponsors, but also it fails to adequately reflect the fair market value of the PBGC's risk.

96. *See Pension Problem*, *supra* note 88, at 2.

97. 29 U.S.C. § 1342 (2000) (amended 2005). ERISA authorizes the PBGC to file a petition in federal court to commence "involuntary termination" proceedings against a pension plan under the following circumstances: (1) a company has failed to meet the minimum funding requirement; (2) the pension plan can no longer afford to pay retiree benefits when due; or (3) failure to immediately terminate a plan will expose the PBGC to unreasonable liability. *Id.*

ERISA also permits a financially troubled sponsor to voluntarily file for "distress termination." In order to qualify for distress termination, the PBGC must find that the sponsor and all members of its control group have met one of the following criteria: (1) the sponsor has filed for Chapter 7 liquidation proceedings; (2) the sponsor has filed for Chapter 11 reorganization proceedings, and the bankruptcy court concludes that the financial burden of its pension obligations will prevent the company from continuing operations; or (3) pension costs have become overly burdensome solely on account a drastic change in workforce demographics. 29 U.S.C. § 1341(c) (2000) (amended 2005).

Although ERISA permits voluntary terminations as well, such rules apply to fully funded plans and are therefore outside the scope of the present paper.

98. 29 U.S.C. § 1368 (2000) (amended 2005).

99. *Id.*

PBGC did have priority status, ERISA caps the agency's ability to recover at 30 percent of the firm's value at the time of bankruptcy.[100]

C. *The Moral Hazard of PBGC Insurance*

The existence of moral hazard[101] in the PBGC's defined benefit insurance scheme is best described by Steven Kandarian, the former Executive Director of PBGC:

> Pension insurance creates moral hazard, tempting management and labor at financially troubled companies to make promises that they cannot or will not fund. The cost of wage increases is immediate, while the cost of pension increases can be deferred for up to 30 years.... In exchange for smaller wage increases today, companies often offer more generous pension benefits tomorrow, knowing that if the company fails the plan will be handed over to the PBGC.[102]

In effect, a financially distressed company may use its defined benefit plan as leverage to extract lower wage concessions from its workforce. Furthermore, the mere existence of federally mandated PBGC insurance may cause this promise to appear valuable to employees even if the company perennially underfunds its pension obligations.[103] In the meantime, the company itself has no incentive to shore up its pension plan and may instead reinvest free cash in its core business or pay shareholder dividends. The company may even be tempted to invest pension assets in risky securities in order increase its rate of return on plan assets and thus reduce future funding requirements. Finally, if a company finds that its defined benefit plan has become too onerous, it may even file for Chapter 11 protection and use bankruptcy proceedings as a means of reneging on

100. *Id.*

101. Judge Posner defines moral hazard as the "tendency of an insured to relax his efforts to prevent the occurrence of the risk that he has insured against because he has shifted the risk to an insurance company." RICHARD A. POSNER, ECONOMIC ANALYSIS OF LAW 121 (5th ed. 1998).

102. *Safeguarding America's Retirement Security: An Examination of Defined Benefit Pension Plans and the Pension Benefit Guaranty Corporation: Hearing Before the Subcomm. on Fin. Mgmt., the Budget, and Int'l Sec. of the S. Comm. on Governmental Affairs*, 108th Cong. 61 (2003) (statement of Steven A. Kandarian, Executive Director, Pension Benefit Guaranty Corporation), *available at* http://hsgac.senate.gov/_files/sprt108285retirementsecurity.pdf.

103. *See* Brannick, *supra* note 18, at 1592–94; *see also* PRIVATE PENSIONS: WEAKNESSES IN FUNDING RULES, *supra* note 15, at 9.

its promised pension obligations and transferring its defined benefit plan to the PBGC.[104]

Yet the benefits guaranteed by the PBGC are not the panacea that workers may believe them to be. Indeed, the moral hazard of pension insurance transfers pension termination risk onto unsuspecting employees as well.[105] For example, the current maximum PBGC guarantee for an underfunded pension plan terminated in 2007 is $49,500 per annum for an individual who retires at age 65.[106] Yet an employee may have worked at a company for his entire career, holding a vested pension benefit, the value of which greatly exceeds this statutory maximum guarantee. Worse yet, to the extent that an individual retires before reaching the age of 65, the PBGC is required by law to adjust the maximum guaranteed benefit downward.[107] For example, an individual might retire early at age 50 based on his company's promise of a yearly pension income of $45,000. Several years later, when the individual is only 55 years old, his company might file for bankruptcy and terminate a severely underfunded defined benefit plan. Under current law, the PBGC would only guarantee this individual $22,275 per annum.[108] Furthermore, unlike the FDIC, the PBGC does not enjoy the backing of the full faith and credit of the United States Treasury; if the PBGC continues to operate at a loss, it may ultimately default on the very pension obligations it insures.[109] Thus, ERISA legislation causes the PBGC and rank and file employees to be the unwitting beneficiaries of corporate America's unfunded pension obligations.

IV. FEDERAL DISCLOSURE REQUIREMENTS

ERISA requires that companies sponsoring defined benefit plans make annual reports to plan participants and government regulators alike.[110] To the extent that the plan sponsor is part of a publicly traded company, Securities and Exchange Commission ("SEC") regulations require that the company disclose certain aspects of its

104. PRIVATE PENSIONS: WEAKNESSES IN FUNDING RULES, *supra* note 15, at 9.

105. *See* Brannick, *supra* note 18, at 1592–94.

106. Pension Guarantees, *supra* note 6.

107. *Id.*

108. *Id.*

109. PRIVATE PENSIONS: WEAKNESSES IN FUNDING RULES, *supra* note 15, at 1.

110. 29 U.S.C. §§ 1023–1024 (2000) (amended 2005).

pension obligations in periodic filings as well.[111] Although such filings do indeed report important details on pension funding levels to employees, regulators, and investors, federal disclosure requirements are inconsistent and fall well short of providing the public with a clear and fully informed picture of the defined benefit plan's financial health.[112]

A. Form 5500 Reporting Requirements

The DOL, Internal Revenue Service ("IRS"), and PBGC jointly developed Form 5500 in order to monitor the health of retirement plans[113] and enforce compliance with ERISA's statutory requirements.[114] The core Form 5500 requires that the plan disclose basic information such as plan features, number of participants, funding method, and accrued vested benefits.[115] Various schedules accompanying Form 5500 include additional disclosures such as financial reports and information on future benefit obligations.[116] For example, Schedule H contains audited financial statements of plan operations that regulators use to assess the overall financial health of a defined benefit plan.[117] Schedule B, on the other hand, contains actuarial information on plan assets and liabilities as well as the basic assumptions used to arrive at these calculations.[118]

The DOL, IRS, and PBGC rely heavily upon data reported on Form 5500 and its schedules "to identify actual and potential

---

111. *See, e.g.*, FIN. ACCT. STANDARDS BD., STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 87: EMPLOYERS ACCOUNTING FOR PENSIONS 35–38 (1985), *available at* http://www.fasb.org/pdf/fas87.pdf [hereinafter STATEMENT OF FINANCIAL ACCOUNTING STANDARDS] (discussing the GAAP rules for reporting pension assets and liabilities); *see also* 15 U.S.C. § 78m (2000) (establishing periodic reporting requirements for publicly traded companies); 17 C.F.R. § 229.303 (2006) (delineating the basic elements that a company must disclose in the Management Discussion and Analysis ("MD&A") portion of Form 10-K to increase transparency of its financial statements).

112. *See* PUBLICLY AVAILABLE REPORTS, *supra* note 20, at 6; ARRANGEMENTS WITH OFF-BALANCE SHEET IMPLICATIONS, *supra* note 21, at 52–53.

113. Form 5500 covers both defined benefit and defined contribution plans, each of which has mandatory reporting requirements under ERISA. CONTENT OF FORM 5500 PENSION INFORMATION, *supra* note 20, at 6–7.

114. *Id.* at 11–13.

115. For a detailed description of Form 5500 reporting requirements, see INTERNAL REVENUE SERV. ET AL., INSTRUCTIONS FOR FORM 5500: ANNUAL RETURN/REPORT OF EMPLOYEE BENEFIT PLAN (2005), *available at* http://www.dol.gov/ebsa/pdf/2005-5500inst.pdf.

116. CONTENT OF FORM 5500 PENSION INFORMATION, *supra* note 20, at 12–13.

117. *Id.*

118. *Id.* at 13–14.

violations of ERISA and the [Internal Revenue Code], as well as for research and policy formulation."[119] Thus, the data reported provides the government with key metrics used to assess compliance with ERISA's minimum funding rules, establish potential PBGC liability, and assess PBGC premiums.[120] More important yet, the disclosures provided in Form 5500 serve as the basis for the statutorily mandated "Summary Annual Report," in which plan sponsors provide participants and their beneficiaries with information related to the financial health and funding level of their defined benefit plans.[121]

Termination liability, which may be the best measure of an underfunded plan's pension obligations, is conspicuously absent from the Form 5500 reporting requirements.[122] Indeed, plan sponsors need only report termination liability to the PBGC in the event that the value of the plan's unfunded vested benefits exceeds $50 million, the plan itself misses required contributions greater than $1 million, or the plan receives a minimum funding waiver greater than $1 million.[123] Additionally, the statute specifically prohibits PBGC disclosure of information reported under section 1310 unless the information has already been made public.[124] Consequently, reporting requirements fail to provide plan participants and investors alike with valuable information that the government itself considers material to assessing the risk profile of underfunded pension plans.[125]

Furthermore, due to a combination of statutory reporting requirements, ERISA Filing Acceptance System ("EFAST") processing complications, and the DOL procedures, Form 5500 data may not be released until three years after its initial filing.[126] Indeed, under ERISA, a plan sponsor must comply with reporting requirements within 210 days after the end of the plan's year.[127] Yet the law

---

119. *Id.* at 11.

120. *Id.* at 15–16.

121. *Id.* at 19.

122. PUBLICLY AVAILABLE REPORTS, *supra* note 20, at 19.

123. 29 U.S.C. § 1310(b) (2000) (amended 2005); 29 C.F.R. §§ 4010.6 to .8. In addition to termination liability, plan sponsors who meet the statutory criteria must submit detailed financial information to the PBGC in a 4010 filing. PUBLICLY AVAILABLE REPORTS, *supra* note 20, at 7–8.

124. 29 U.S.C. §§ 1310(c) (2000) (amended 2005), 29 C.F.R. § 4010.12.

125. *See* PUBLICLY AVAILABLE REPORTS, *supra* note 20, at 19.

126. CONTENT OF FORM 5500 PENSION INFORMATION, *supra* note 20, at 20. For a graphical representation of the Form 5500 filing deadlines, see *id.* at 21, and see also *infra* fig.4.

127. CONTENT OF FORM 5500 PENSION INFORMATION, *supra* note 20, at 20.

permits sponsors to make minimum funding contributions to their defined benefit plans as late as eight and one-half months after the end of the plan year.[128] Since plan actuaries cannot complete and certify Form 5500 until the plan has met its minimum funding requirement, sponsors often apply to the IRS for an automatic two and one-half month filing extension each year.[129]

To further complicate matters, the IRS permits plan sponsors to file Schedule T Amendments to cure certain reporting errors in Form 5500 as late as one month after the already extended filing deadline.[130] Moreover, despite this extended reporting window, the DOL notes that in 2001, approximately 11 percent of plans were late in filing Form 5500.[131] In fact, GAO research indicates that corporations prioritize SEC filings and income tax preparation over ERISA reporting obligations.[132]

The EFAST processing procedures also complicate the government's ability to process Form 5500 data in a timely manner.[133] Prior to the PPA, the law did not require that plan sponsors file Form 5500 electronically.[134] Consequently, nearly 98 percent of plan sponsors submit paper versions of the form.[135]

The DOL then processes the forms, audits them, identifies reporting errors, and works with plan sponsors to correct mistakes and discrepancies in data.[136] By the time the DOL has completed its administrative review of Form 5500 data, as many as three years may have passed, and the funding disclosures contained in the filings are stale.[137]

128. *Id.*; *see also* 26 U.S.C. § 412(c)(10)(a)(ii) (2000) (amended 2005).

129. CONTENT OF FORM 5500 PENSION INFORMATION, *supra* note 20, at 25.

130. *Id.* at 22–23.

131. *Id.* at 28.

132. *Id.* at 25–26.

133. *Id.* at 28; *see also* 29 C.F.R. § 2520.104a-5 (describing the operations of EFAST). For a graphical representation of the EFAST processing system, see CONTENT OF FORM 5500 PENSION INFORMATION, *supra* note 20, at 32 fig.9, and *infra* fig.5.

134. CONTENT OF FORM 5500 PENSION INFORMATION, *supra* note 20, at 30.

135. *Id.* at 28. In 2001, EFAST processed approximately 25 million paper pages of Form 5500 filings. *Id.* The DOL estimates that "paper filings take more than three times as long as electronic filings to process and have nearly as many errors." *Id.*

136. *Id.* at 30–31.

137. *Id.* at 33.

B. SEC Reporting Requirements and Financial Accounting Standards Board Accounting Conventions

Whereas Form 5500 seeks to provide government regulators with information on the funding status of defined benefit plans, SEC disclosures aim to provide investors with information on how retirement benefits affect earnings, cash flow, and overall financial position. For example, Item 303 of Regulation S-K requires that a company discuss its financial condition, changes in financial condition, and results of operations in the MD&A portion of its annual Form 10-K filings.[138] The company must not only discuss its current liquidity, capital resources, and results from operations, but also disclose any known trends, uncertainties, or other considerations that would have a material impact on its future business prospects.[139] Thus, the regulation serves as a "caveat investor" and requires that company management highlight key forward-looking considerations that would lead to a disconnect between its reported financial statements and future financial outlook.[140]

Yet a recent study by the SEC's Division of Corporation Finance revealed significant deficiencies in Item 303 disclosures, particularly as they related to company pension plans.[141] Cognizant of the fact that Generally Accepted Accounting Principles ("GAAP")[142] allow plan sponsors to employ actuarial methodologies that smooth plan assets and liabilities,[143] the SEC noted that the "negative stock market returns of the last three years caused many companies to have *significant unrecognized losses* related to their

---

138. 17 C.F.R. § 229.303(a) (2006).

139. *Id.*

140. *See generally* JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 554–56 (4th ed. 2004) (discussing the importance of MD&A disclosure mandated by SEC Regulation S-K Item 303).

141. U.S. Sec. & Exch. Comm'n, Summary by the Division of Corporation Finance of Significant Issues Addressed in the Review of the Periodic Reports of the Fortune 500 Companies, http://www.sec.gov/divisions/corpfin/fortune500rep.htm (last visited Apr. 16, 2007) [hereinafter Review of Periodic Reports] (reporting the results of a study involving the financial and non-financial disclosures of Fortune 500 companies in their 2002 Form 10-K filings).

142. GAAP are "conventions, rules, and procedures that define accepted accounting practice, including broad guidelines as well as detailed procedures." DOWNES & GOODMAN, *supra* note 36, at 234. The independent body responsible for establishing and interpreting GAAP is the Financial Accounting Standards Board ("FASB"). *Id.* at 202.

143. *See, e.g.*, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS, *supra* note 111 (describing FASB's accounting treatment of pension plans).

pension plans, which are often not transparent to investors."[144] In order to increase transparency, the agency requested that companies expand their Regulation S-K 303 disclosure to include discussion of significant assumptions and estimates used to account for pension plans as well as the underlying methodologies used to determine them.[145] The agency also noted that companies should disclose "[t]he amount of current unrecognized losses on pension assets and the estimated effect of those losses on future pension expense . . . ."[146] Furthermore, the SEC requested that companies identify expected changes in pension trends, especially those involving estimated investment returns and discount rates, and the effect that such changes would have on their future financial condition.[147] Finally, the SEC asked that companies provide investors with a sensitivity analysis that demonstrates how hypothetical changes to actuarial assumptions would affect future expected pension returns.[148]

C. A Paradigm Shift: Pension Accounting and Financial Accounting Standards Board Reform

As noted by a research fellow at the TIAA-CREF Institute, "Pension accounting in the U.S. has widely been recognized as one of the most backward areas of all accounting and in dire need of reform. . . . [W]e got ourselves in a terrible mess the last few years. The accounting rules are part of this."[149] Enhanced pension disclosure in the MD&A portion of Form 10-K will certainly improve the public's understanding of corporate defined benefit obligations. But the SEC requires public companies to employ GAAP to prepare financial statements.[150] And the Financial

---

144. Review of Periodic Reports, *supra* note 141 (emphasis added).

145. *Id.*

146. *Id.*

147. *Id.*

148. *Id.*

149. Wharton School of the Univ. of Pa., *How Should Retirement Policy Be Reformed? Don't Speak All Together, Please*, KNOWLEDGE@WHARTON, June 2, 2004, at 4, http://knowledge.wharton.upenn.edu/createpdf.cfm?articleid=986&CFID=49471148CFTOKEN=53631401 (quoting principal research fellow Douglas Fore).

150. *See generally* 15 U.S.C. § 78m (2000 & Supp. IV 2006) (describing the periodic filing requirements of the Exchange Act of 1934); 17 C.F.R. 229.10(e) (2006) (describing standards for use of non-GAAP financial measures in periodic filings); 17 C.F.R. § 240.13a-1 (2006) (requiring annual reports to be made on Form 10-K); U.S. SEC. & EXCH. COMM'N, SEC1673(03-07), FORM 10-K: GENERAL INSTRUCTIONS 10 (2007), *available at* http://www.sec.gov/about/forms/form10-k.pdf [hereinafter FORM 10-K] (requiring the use of GAAP by incorporation).

Accounting Standards Board ("FASB") permits accountants to use smoothing mechanisms and actuarial assumptions that effectively distort the true funding status of defined benefit plans.[151]

The GAAP conventions governing pension accounting are as complex as ERISA's minimum funding requirement—and equally deceptive.[152] Although companies must include a yearly charge for "pension expense" in their calculation of net income, this value is in effect an accounting fiction that fails to reflect the true periodic cost for maintaining a defined benefit plan.[153] The primary component of pension expense consists of the plan's annual service cost, which is the present value of accrued benefits for the most recent plan year. Because accountants calculate each year's pension expense based upon actuarial assumptions for interest rates, investment returns, and participant mortality rates, the actual performance of pension assets may differ—sometimes drastically—from the original estimate.[154] The resulting difference between actual experience and actuarial assumptions is relegated to an off-balance sheet "unrecognized gains or losses account" that appears as a footnote to the company's financial statement.[155] In the event that the "unrecognized gains or losses account" reaches a certain FASB-mandated threshold, the company must recognize the difference between the threshold and the "unrecognized gains or losses account" in its periodic pension expense.[156]

In effect, GAAP permits companies to relegate pension assets and liabilities to the footnotes of key financial statements to such an extent that they almost function as off-balance sheet vehicles.[157] It should therefore come as no surprise that a recent study by the Federal Reserve postulated that pension accounting artificially

151. STATEMENT OF FINANCIAL ACCOUNTING STANDARDS, *supra* note 111, at 15–19; *see also* PUBLICLY AVAILABLE REPORTS, *supra* note 20, at 21–23; Howard Silverblatt, *America's Other Pension Problem*, BUS. WK. ONLINE, Dec. 19, 2005, http://www.businessweek.com/investor/content/dec2005/pi20051219_9796_pi015.htm.

152. *See generally* STATEMENT OF FINANCIAL ACCOUNTING STANDARDS, *supra* note 111, at 38–47 (describing GAAP accounting conventions for pension assets and liabilities).

153. *See* PUBLICLY AVAILABLE REPORTS, *supra* note 20, at 22–23.

154. *Id.*

155. *Id.* at 23 n.34.

156. *Id.*

157. ARRANGEMENTS WITH OFF-BALANCE SHEET IMPLICATIONS, *supra* note 21, at 52.

inflated corporate earnings and partially contributed to the stock market bubble of the late 1990s.[158]

D. Revised FASB Pension Accounting Rules

If pension reforms were to promote financial transparency, then new rules for pension accounting would also be necessary. In late 2005, the board of the FASB unanimously voted to review its standards on pension accounting.[159] It proposed adding pension obligations and other pension related expenses to the balance sheet by the end of 2006 and began conducting studies to explore new methodologies for pension accounting.[160] As an initial step in what is likely to be a comprehensive, long-term overhaul of pension accounting standards, the FASB issued Statement 158, which mandates that companies "[r]ecognize the overfunded or underfunded status of a single-employer defined benefit postretirement plan . . . as an asset or liability in its statement of financial position . . . ."[161] Under the FASB's new rule, the extent to which a plan is "overfunded" or "underfunded" appears on the sponsor's balance sheet and is determined as of the plan sponsor's fiscal year-end as the difference between the fair value of a plan's assets and its projected benefit obligation.[162] Additionally, Statement 158 requires plan sponsors to take a charge against other comprehensive income for pension expenses that had previously been relegated to the off balance sheet "unrecognized gains or losses" account under FASB Statement 87.[163]

---

158. *See generally* Julia Lynn Coronado & Steven A. Sharpe, *Did Pension Plan Accounting Contribute to a Stock Market Bubble?*, 1 BROOKINGS PAPERS ON ECON. ACTIVITY 323 (2003) (describing the effect of pension accounting on non-core corporate earnings).

159. Silverblatt, *supra* note 151; *see also infra* note 186.

160. *Id.*; *see also* ANDREW D. WOZNIAK & DAVID B. CHITTIM, FASB PENSION ACCOUNTING OVERHAUL BEGINS 1 (2005), *available at* http://www.melloninstitutional.com/public/library/documents/knowledge/pdfs/FASB.pdf ("The objective is to improve financial statement reporting of pensions and other postretirement employee benefits (OPEB) plans by making the information more useful and transparent for investors, creditors, plan participants, and other users.").

161. FIN. ACCT. STANDARDS BD., NO. 284-B, STATEMENT OF FINANCIAL ACCOUNTING STANDARDS NO. 158: EMPLOYERS' ACCOUNTING FOR DEFINED BENEFIT PENSION AND OTHER POSTRETIREMENT PLANS 1 (2006), *available at* http://www.fasb.org/pdf/fas158.pdf [hereinafter NO. 158] (footnote omitted). The FASB has indicated that the next phase of pension accounting reform will address, *inter alia*, income statement recognition, liability measurement, and assumption setting guidance. WOZNIAK & CHITTIM, *supra* note 160, at 1.

162. NO. 158, *supra* note 161, at 3–6.

163. *See id.* at 62–64, 86; *see also supra* notes 145–48 and accompanying text.

Since the FASB's new pension accounting standards have just taken effect, it is not yet possible to ascertain their full financial impact on large industrial companies with significant funding shortfalls, such as UAL, Delta, General Motors, and Ford.[164] Nevertheless, analysts at Credit Suisse Group recently estimated that the FASB's effort to improve the financial transparency of pension and postretirement benefits might reduce shareholder equity in the S&P 500 index by as much as $255 billion, or seven percent.[165]

V. PROPOSAL FOR TRANSPARENT PENSION DISCLOSURE

A. Enactment of the PPA

According to Congressman Howard McKeon, Vice-Chairman of the House-Senate pension reform conference, "The *Pension Protection Act* [H.R. 4] ensures that worker pension plans are fully funded, encourages companies and unions to keep their pension promises to workers and retirees, and provides workers the peace of mind that their retirement savings will be there for them when they need it."[166] The PPA does indeed take a number of important steps to strengthen the nation's defined benefit plans. For example, the legislation strengthens ERISA's minimum funding rules by: (i) closing the statutory loophole that permitted plan sponsors to make non-cash contributions using FSA credits;[167] (ii) requiring companies to measure pension assets and liabilities more accurately;[168] (iii) prohibiting companies with under-funded plans from promising their

164. According to Statement 158, the new pension accounting standards apply to companies whose fiscal year ends after December 15, 2006. *See* NO. 158, *supra* note 161, at 7–8, 80–82, 84.

165. BNA, *FASB's Pension Accounting Proposal Will Cut Shareholder Equity Significantly*, *in* FASB'S CHANGES TO PENSION ACCOUNTING 4, 4 (2006), *available at* http://www.bna.com/tm/ads/fasb.pdf.

166. Press Release, House Comm. on Educ. & the Workforce, President Signs Measure to Reform Outdated Worker Pension Laws: Legislation Strengthens Pension Funding Rules, Modernizes Retirement Security Laws (Aug. 17, 2006), http://republicans.edlabor.house.gov/archive/press/press109/second/08aug/pensionsigning081706.htm.

167. JOINT COMM. ON TAXATION, JCX-38-06, TECHNICAL EXPLANATION OF H.R. 4, THE "PENSION PROTECTION ACT OF 2006," AS PASSED BY THE HOUSE ON JULY 28, 2006, AND AS CONSIDERED BY THE SENATE ON AUGUST 3, 2006, at 9–11, 19–20 (2006), *available at* http://www.house.gov/jct/x-38-06.pdf [hereinafter TECHNICAL EXPLANATION OF H.R. 4]; *see also* Pension Protection Act of 2006, Pub. L. No. 109-280, §§ 101, 102, 111, 112, 120 Stat. 780, 784, 789, 820, 826.

168. TECHNICAL EXPLANATION OF H.R. 4, *supra* note 167, at 14–22, 75. These include specific assumptions for mortality tables, interest rates, at risk plans, etc. *Id.*; *see also* Pension Protection Act §§ 101, 102, 111, 112.

workers additional retirement benefits unless such promises are paid for up front;[169] and (iv) raising the limit on employer pension contributions, so that companies can contribute more cash during periods of economic expansion and build a funding cushion to keep plans solvent during periods of economic contraction.[170] Additionally, the PPA seeks to improve transparency by requiring plan sponsors to file an updated version of Form 5500 using EFAST and mandating that the DOL make public the contents of the form no later than 90 days after it has been filed.[171] Finally, the law makes permanent the temporary PBGC premium increases that were enacted as part of the Deficit Reduction Act of 2005.[172]

Although comprehensive in scope, the PPA also contains a number of fundamental flaws. Indeed, the legislation makes significant concessions to special interest groups such as government contractors, bus operators, and airlines that effectively eviscerate the statute's intent.[173] For example, the PPA permits Pentagon contractors with over $5 billion in sales to delay implementing the statute's new funding requirements for up to three years.[174] Additionally, the statute permits bankrupt airlines with frozen pension plans, such as Delta and Northwest, to make up their funding shortfalls over a span of 17 years.[175] By comparison, airlines such as Continental and American, which enjoy greater financial stability and have not yet frozen their pension plans, are given up to 10 years to make up their funding shortfalls.[176]

Since large government contractors and commercial airlines are among the very industries burdened by legacy pension obligations, it

---

169. TECHNICAL EXPLANATION OF H.R. 4, *supra* note 167, at 26–27; *see also* Pension Protection Act §§ 103, 113.

170. TECHNICAL EXPLANATION OF H.R. 4, *supra* note 167, at 14–22, 75; *see also* Pension Protection Act §§ 101, 102, 111, 112.

171. TECHNICAL EXPLANATION OF H.R. 4, *supra* note 167, at 107, 111–13, 121; *see also* Pension Protection Act §§ 501, 503, 504.

172. TECHNICAL EXPLANATION OF H.R. 4, *supra* note 167, at 81; *see also* Pension Protection Act § 401; *supra* note 92.

173. *See* TECHNICAL EXPLANATION OF H.R. 4, *supra* note 167, at 35–36, 38, 84–88; *see also* Pension Protection Act §§ 106, 114, 402.

174. TECHNICAL EXPLANATION OF H.R. 4, *supra* note 167, at 35–36; *see also* Pension Protection Act §§ 106, 114.

175. Pension Protection Act § 402.

176. Under the PPA, most defined benefit plans have only seven years to make up their pension shortfalls. TECHNICAL EXPLANATION OF H.R. 4, *supra* note 167, at 84–88; *see also* Pension Protection Act § 402.

follows that they are also most likely to suffer from endemic pension funding deficiencies. That Congress would exempt such companies from the requirements of comprehensive reform legislation therefore seems self-defeating.

Equally disturbing is the fact that the PPA made permanent the PBGC premium hikes enacted under the Deficient Reduction Act of 2005. Indeed, it appears that Congress is attempting to reduce the PBGC's $23 billion funding shortfall by raising fixed-rate premiums. In effect, today's most well-funded, responsible plan sponsors are paying the price for yesterday's terminated pension plans. Not only does the new premium schedule impose excessively high fixed rates upon plan sponsors, but it also fails to adequately reflect the fair market value of the PBGC's risk.

B. Additional Reform Still Necessary

Congress enacted ERISA to protect the "well-being and security of millions of employees and their dependents [who] are directly affected by [employee benefit plans]."[177] Yet the ubiquity of plan underfunding, the frequency of large plan terminations, and the magnitude of the PBGC's growing deficit all indicate that ERISA is structurally flawed and fails to achieve its statutory purpose. Under such circumstances, the law governing the nation's defined benefit system will continue encouraging "moral hazard," thus permitting corporations such as UAL to legally underfund and ultimately shirk their pension obligations to employees.

The newly enacted PPA is unlikely to deter many of the widespread abuses that were rampant yet legal under the previous legislative regime. Federal disclosure requirements remain inconsistent and fall well short of providing the public with a clear, timely, and fully informed picture of the defined benefit plan's financial health. Historically, the combination of ERISA's flawed funding rules and the FASB's pension accounting conventions have amplified the fundamental disconnect that exists between the actual funding levels of the corporate defined benefit plans and those which companies are legally obligated to report in public filings. Consequently, neither government regulators nor the free market have wielded sufficient information to hold corporations accountable

177. 29 U.S.C. § 1001(a) (2000).

for shirking their pension obligations until it is too late. Indeed, by the time corporations begin to hint in public filings that their defined benefit plans may be *slightly* underfunded, it is likely that their pension plans are in fact in financial distress and on the brink of termination.[178]

C. Streamlining Pension Reporting Obligations

Accordingly, it is crucial that Congress amend ERISA to enhance the financial transparency of corporate defined benefit plans. New legislation should provide the DOL, IRS, and PBGC with greater statutory flexibility and encourage these agencies to work with the SEC to streamline pension reporting obligations. In fact, Congress might immediately improve the timeliness and accuracy of pension reporting obligations simply by requiring public companies to attach Form 5500 as an exhibit to Form 10-K filings.

The simultaneous filing of Forms 10-K and 5500 would encourage companies to report a single, synchronized set of pension disclosures. The metrics contained in Form 5500 include actuarial assumptions and pension funding levels, each of which companies must report under current SEC regulations.[179] Yet the information currently reported in Forms 10-K and 5500 is inconsistent, not only because companies employ different actuarial assumptions, but also because reporting periods may not match.[180] Nevertheless, in a post-Enron environment in which government regulators and investors closely scrutinize SEC filings, it is likely that market forces alone would incentivize companies to synchronize pension disclosure.

Additionally, the SEC's filing requirements are significantly more stringent than those of the DOL.[181] Whereas electronic filing historically has been the exception for Form 5500, it is the norm for SEC filings.[182] Not only is it mandatory for companies to submit Form 10-K electronically, but also its filing window is significantly shorter than that required for Form 5500.[183] If companies are late in

178. *Cf.* PRIVATE PENSIONS: WEAKNESSES IN FUNDING RULES, *supra* note 15, at 28 (describing the funding status of Bethlehem Steel immediately prior to bankruptcy).

179. *See supra* Part IV.B; *see also* Review of Periodic Reports, *supra* note 141.

180. *See* Review of Periodic Reports, *supra* note 141. For a graph depicting the difference in interest rate assumptions disclosed in Forms 5500 and 10-K, see *infra* fig.6.

181. *See generally* FORM 10-K, *supra* note 150 (outlining Form 10-K filing requirements).

182. 17 C.F.R. § 232.101 (2006).

183. FORM 10-K, *supra* note 150, at 1.

filing Form 10-K, they face stiff financial penalties from the SEC and stand to lose significant credibility in the financial markets.[184] Furthermore, the SEC immediately discloses Form 10-K filings to the public, whereas the PPA permits the DOL to take up to 90 days to process Form 5500 data before releasing them.

Although streamlined reporting solves the problem of consistent and timely access to pension funding levels, certain information is still missing from Form 5500. Indeed, key metrics such as termination liability are so material to the financial health of corporate pension plans that the DOL, IRS, and PBGC should require that *all* companies disclose them on Form 5500 filings.[185] Similarly, Congress should amend section 1310 of ERISA so that government agencies may publicly disclose information contained in 4010 filings. Taken as a whole, these improvements would provide the public with the necessary tools to hold companies accountable for their pension obligations.

D. Bifurcated Pension Accounting

As part of its recently announced reforms, the FASB announced that it would move pension assets and liabilities from the footnotes of financial statements onto the balance sheet.[186] Although such a paradigm shift will promote the financial transparency of corporate pension obligations, it may be overly broad in scope. Indeed, a sharp dichotomy exists between well-run, credit-worthy companies that will continue to operate as going concerns, and poorly managed, undercapitalized, and financially distressed corporations that teeter on the brink of insolvency. A bifurcated approach to reporting underfunded pension liabilities may therefore be more appropriate.

Credit-worthy companies will continue to operate as long-term, going concerns; their risk of insolvency in the near- to medium-term

---

184. *See* 15 U.S.C. § 78ff (2000 & Supp. IV 2006) (describing penalties for late filers).

185. Under the PPA, section 1310 filings remain separate from Form 5500 and need not be publicly disclosed. TECHNICAL EXPLANATION OF H.R. 4, *supra* note 167, at 115; *see also* Pension Protection Act of 2006, Pub. L. No. 109-280, § 505, 120 Stat. 780, 946.

186. FIN. ACCT. STANDARDS BD., FASB RESPONSE TO SEC STUDY ON ARRANGEMENTS WITH OFF-BALANCE SHEET IMPLICATIONS, SPECIAL PURPOSE ENTITIES, AND TRANSPARENCY OF FILINGS BY ISSUERS 3 (2006), *available at* http://www.fasb.org/fasb_response_sec_study_obs.pdf ("[T]his phase seeks to improve financial reporting by requiring that the funded or unfunded status of postretirement benefit plans, measured as the difference between the fair value of plan assets and the benefit obligation . . . be recognized in the statement of financial position.").

is effectively nil. Although the use of actuarial assumptions may distort pension assets and liabilities in the near-term, over longer periods of time, volatile swings in valuation will tend to average out and yield relatively accurate results. Absent an Enron-like accounting fraud fiasco, such corporations have stable enough outlooks to adequately fund their future pension obligations. Requiring such companies to report pension shortfalls on their balance sheet rather than in footnotes therefore seems counter-intuitive and unnecessary: short-term market fluctuations do not affect the viability of such financially secure companies, and accounting rules should not punish them for operating a successful business.

However, as credit quality deteriorates, so too does a corporation's prospect for survival. Simultaneously, the "moral hazard" built into current ERISA legislation becomes increasingly tempting to companies. According to recent GAO research, corporations with speculative credit ratings are more likely to have underfunded pension plans and incur DRC charges.[187] Evidence also exists that such companies are more likely to employ aggressive actuarial assumptions as a means of reducing their minimum funding requirements.[188] Most telling of all, 39 of the 41 largest plan terminations involved companies with speculative credit ratings immediately prior to termination.[189] Of these, approximately 80 percent of the corporations were speculatively rated 10 years prior to termination.[190]

Based on such compelling data, it seems possible to interpolate a credit-rating-based inflection point, at which time the likelihood of "moral hazard" and insolvency places a corporation's pension plan at imminent risk for termination.[191] As a corporation approaches insolvency, termination liability and the fair market value of assets become increasingly important. At this point in time, the corporation

---

187. PRIVATE PENSIONS: WEAKNESSES IN FUNDING RULES, *supra* note 15, at 30.

188. *Id.*; *see also infra* fig.7.

189. PRIVATE PENSIONS: WEAKNESSES IN FUNDING RULES, *supra* note 15, at 30; *see also infra* fig.7.

190. PRIVATE PENSIONS: WEAKNESSES IN FUNDING RULES, *supra* note 15, at 30.

191. Although it may be tempting to define such an inflection point based upon a multi-factorial or sliding scale test, one must remember that the credit rating itself already represents an amalgam of synthesized financial and economic data. This note therefore proposes drawing a bright line at a credit rating of BBB– or equivalent.

should no longer be viewed as a long-term, viable entity. Consequently, the use of actuarial methodologies to assess pension obligations becomes grossly inadequate and obscures the corporation's true financial condition. It is under such circumstances that a company should be required to report underfunded pension liabilities on the balance sheet.

From a legal perspective, Congress should consider using the same inflection point to impose a statutory freeze upon a company's defined benefit plan. Although this would prevent employees from accruing additional benefits, it also would provide the financially distressed company with an opportunity to fully fund promised retirement benefits. Furthermore, a statutory freeze would reduce the reliance of employees upon the "false promise" of generous defined benefit pensions and might even provide them with bargaining power to request higher pay or an alternative defined contribution benefit that would survive bankruptcy.

VI. CONCLUSION

This note has elaborated upon the fundamental disconnect that exists between the actual funding level of the nation's defined benefit plans and that which public corporations are legally obligated to report in regulatory filings. Although the defined benefit plan is no longer the dominant pension vehicle it once was at the inception of ERISA, it lingers within the capital structures of the nation's oldest and largest companies and continues to play an important role in the retirement security of millions of Americans.

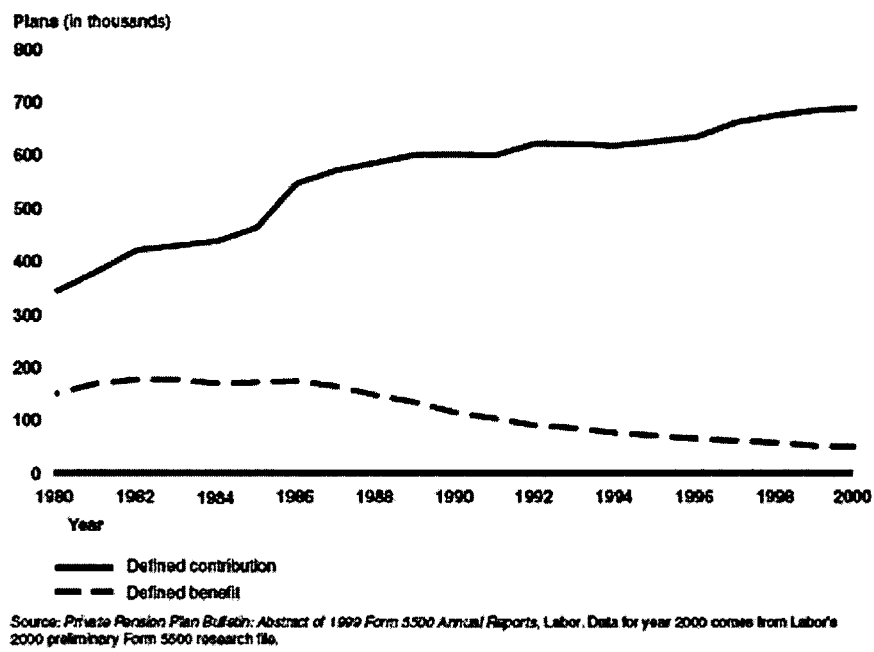
The failure of Corporate America to fulfill its pension promise stems directly from the shortcomings of ERISA and the inability of Congress to enact an effective long-term remedy. Indeed, financial transparency is the *sine qua non* for efficient capital markets to function.[192] Yet the current disclosure requirements mandated by ERISA, the SEC, and the FASB have failed to provide the public with consistent, accurate, and timely information regarding the financial health of defined benefit plans. In the late 1960s, the spectacular failure of the Studebaker Corporation served as a catalyst for enactment of the original ERISA legislation.[193] The UAL

192. Silverblatt, *supra* note 151 ("[F]or capital markets to function properly, sufficient timely data, similar to earnings reports, are necessary.").

193. Wooten, *supra* note 23, at 683.

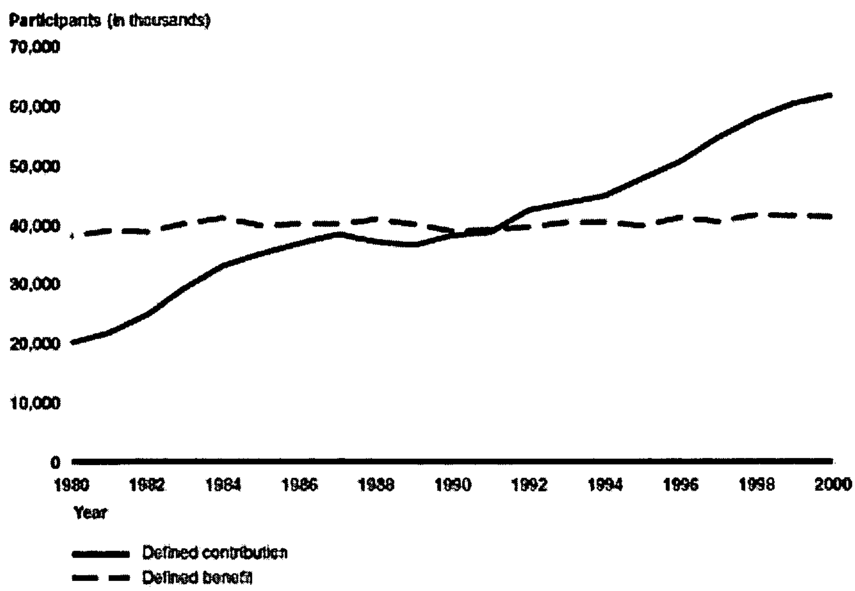
bankruptcy may well be this generation's "focusing event," and should serve as an impetus for Congress to enact a new, meaningful pension reform that not only promotes financial transparency, but also encourages corporate responsibility.

FIGURE 1: PARTICIPANTS OF DEFINED BENEFIT AND CONTRIBUTION PLANS, 1980–2000



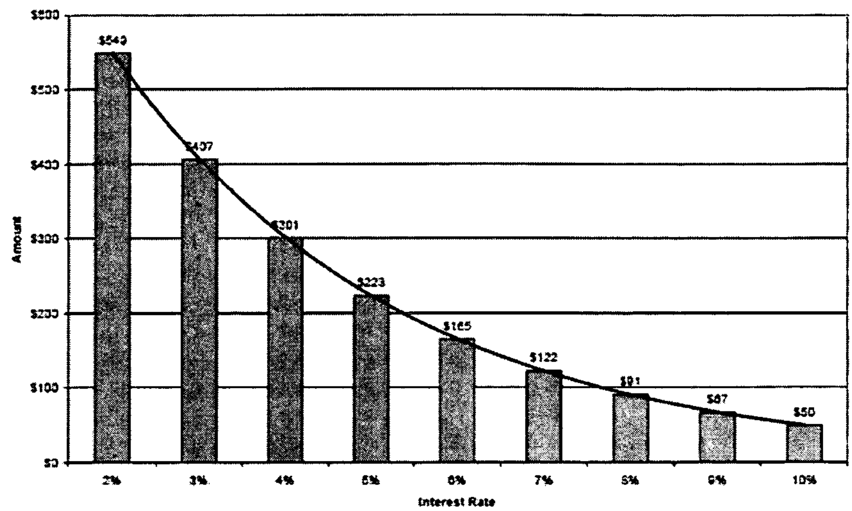
Source: CONTENT OF FORM 5500 PENSION INFORMATION, *supra* note 20, at 8.

FIGURE 2: DEFINED BENEFIT AND CONTRIBUTION PLANS, 1980–2000



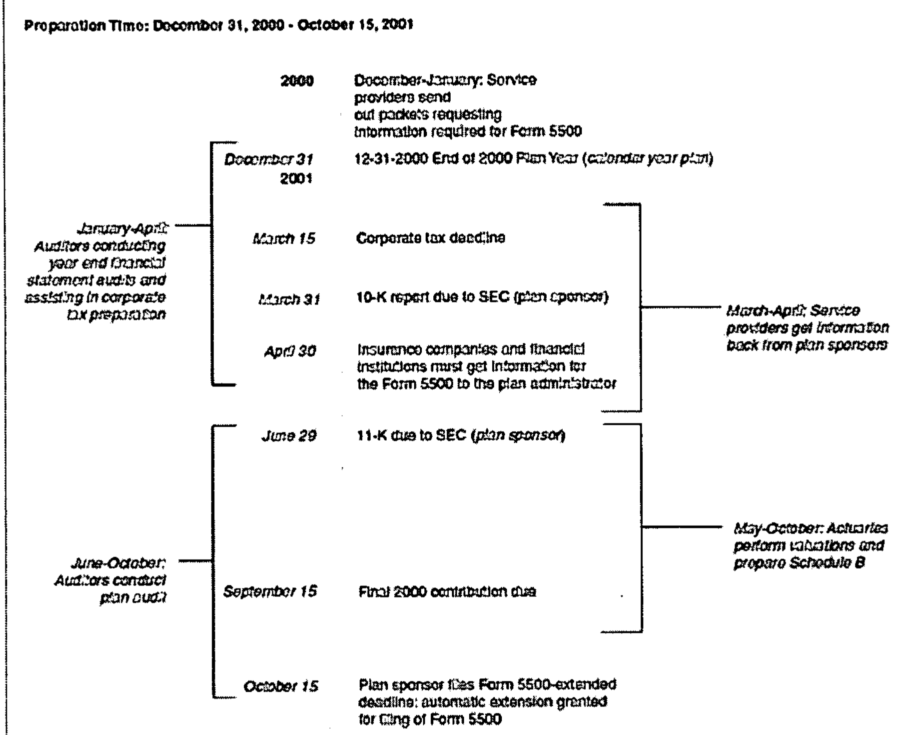
Source: CONTENT OF FORM 5500 PENSION INFORMATION, *supra* note 20, at 10.

FIGURE 3: INITIAL BALANCE REQUIRED TO FUND $1000 IN 30 YEARS



Source: OPTIMAL BENEFIT STRATEGIES, LLC, PROMISES TO KEEP: THE TRUE NATURE OF THE RISKS TO THE DEFINED BENEFIT PENSION SYSTEM 9 (2005), http://www.americanbenefitscouncil.org/documents/pbgcdraft 092205.pdf.

FIGURE 4: EXAMPLE OF A TIMELINE OF FORM 5500 PREPARATION FOR A CALENDAR YEAR DEFINED BENEFIT PLAN



Source: CONTENT OF FORM 5500 PENSION INFORMATION, *supra* note 20, at 27.

FIGURE 5: EXAMPLE OF FORM 5500 BEING PROCESSED THROUGH EFAST WITH ERRORS

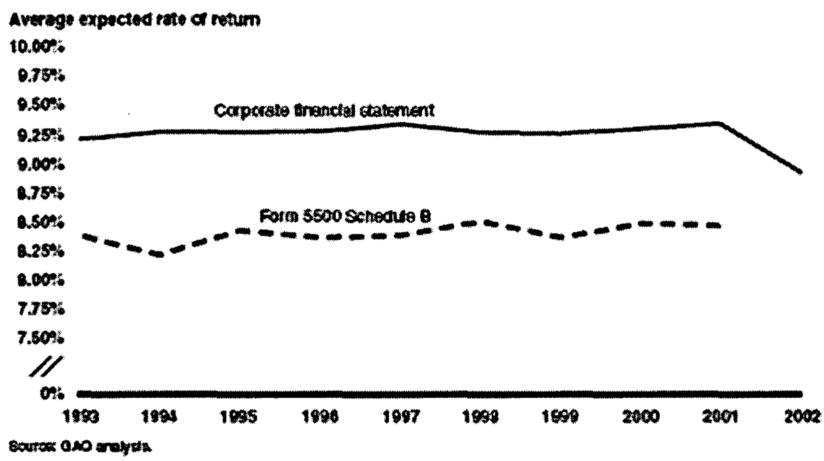
EFAST processing cycle plan year 2000: 7/1/2001-6/30/2003

2001	
July 1	EFAST processing of 2000 plan year forms begins (as submitted) Any forms submitted prior to this date are held until now.
October 15	Extended deadline for calendar year plan Form 5500 filings. The form is submitted, marking the beginning of processing.
2002	
January 15	The Form 5500 Report is initially processed by January 15. If errors are found, a letter is sent out to the filer seeking clarification.
March 15	A filer response is received and processed by this date. If the response is insufficient to correct the error, a second letter is sent to the filer.
May 14	The second filer response is received and processed by this date. The filing is marked as complete, regardless of whether the error has been resolved.
2003	
June 30	EFAST processing of 2000 plan year forms officially closes.

Note: The processing cycle remains open for two years to account for all filings, including non-calendar year filings that may be due up to a year after the filings used in the above example.

Source: FORM 5500 PENSION INFORMATION, *supra* note 20, at 32, *available at* http://www.gao.gov/new.items/d05491.pdf.

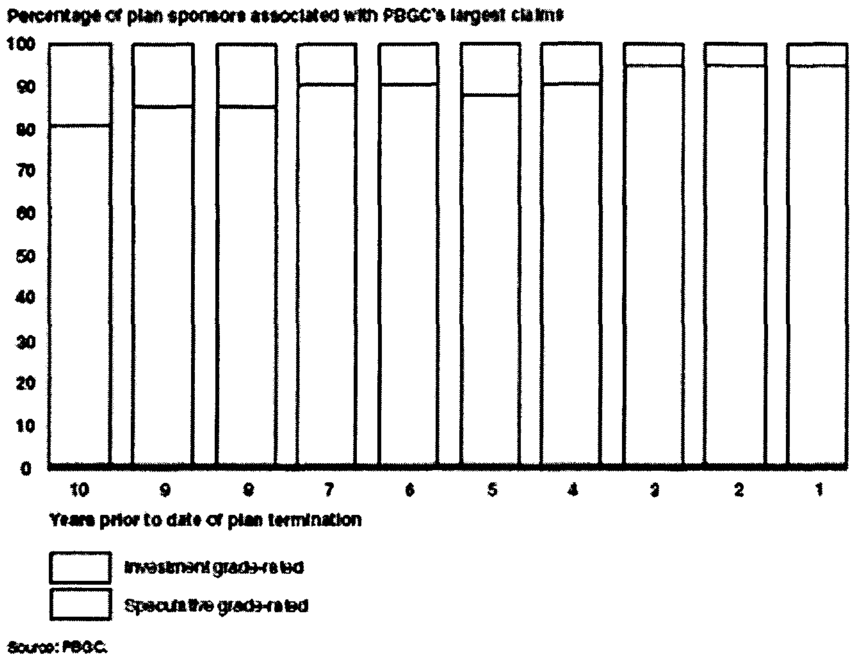
FIGURE 6: COMPARISON OF AVERAGE EXPECTED RATES OF RETURN REPORTED IN FORM 5500 SCHEDULE B AND CORPORATE FINANCIAL STATEMENTS FOR A SAMPLE OF FORTUNE 500 COMPANIES



Note: Companies in this sample were all listed in the 2003 Fortune 500. Data from Form 5500 reports for 2002 were not fully available at the time of this analysis.

Source: PUBLICLY AVAILABLE REPORTS, *supra* note 20, at 16.

FIGURE 7: OVER 80 PERCENT OF SPONSORS ASSOCIATED WITH PBGC'S LARGEST TERMINATION CLAIMS HAD SPECULATIVE GRADE CREDIT RATINGS 10 YEARS PRIOR TO TERMINATION



Note: Based on 41 of PBGC's largest gross claims in which the rating of the sponsor was known, representing over 67 percent of total gross claims from 1975–2004. These 41 claims may include sponsors with more than one plan and are not limited to those plans in the GAO sample. Ratings based on S&P rating.

Source: PRIVATE PENSIONS: WEAKNESSES IN FUNDING RULES, *supra* note 15, at 36.