Pension Plan Legislation: Overview of ERISA and its Shortcomings

Erin Alston

Illinois State University

Abstract

Before ERISA, there was very little to guarantee that pension plan participants would receive their benefits, or that plan sponsors would use pension plan funds appropriately. Many plans were terminated underfunded leaving plan participants with nothing. ERISA was enacted to create an extensive legislative framework to both bring security to the plan participants and to regulate the plan sponsors. Despite the necessity under which ERISA was created, there are criticisms of its effect on the private pension market and of its sweeping and heavy handed legislation.

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Private pension plans originated in the United States in the 1800s as more of a reward for long service than a guaranteed retirement income. As they grew in popularity, this lack of guarantee became a more pronounced issue. Companies could receive preferential tax treatment such as tax deductions on contributions to pension plans and tax exemptions on pension trust funds; however there was nothing to guarantee that these funds would eventually be distributed to the pension plan participants as intended. Additionally, though pension plans were used as a means to increase compensation during wartime and as a negotiating tool for unions, there was nothing to guarantee that employers would follow through on these promises. In 1974, The Employee Retirement Income Security Income Act (ERISA) was introduced as a solution to these shortcomings. ERISA was designed to be an exhaustive protection of employee benefits and consists of extensive provisions covering everything from requirements on information disclosure and funding, civil action, and fiduciary duty. Despite this and the fact ERISA and its amendments were a necessary outcome of the shortcomings that initially existed in the private pension markets, there are criticisms to its broad sweeping and often heavy handed legislation. This paper will give a brief history of pension legislation leading up to ERISA, a detailed look into the requirements of ERISA and subsequent legislation including the Pension Protection Act of 2006 and why it was necessary, and finally conclude with a discussion of the current shortcomings that still exist in pension legislation today.

History of Defined Benefit Plans

Private pension plans first officially developed in the United States in the late 1800s in the railroad industry. The American Express Company is credited with establishing the first private pension plan in 1875. In the early stages, pension benefits were viewed as rewards for employees with long service records instead of retirement income. There were no laws enforcing the payment of benefits, which were often paid directly from company revenues and reduced or eliminated if the company fell on hard times. Despite this, pension plans continued to grow in popularity throughout the early 1900s with large companies like General Electric Co., Goodyear Tire and Rubber Co. and many others beginning to offer them. At the same time, the federal government began to regulate some aspects of pension plans, mostly relating to preferential tax treatment. Early regulations had allowed for the exemption of pension trust income and made available tax deductions on employer contributions to qualified pension trusts exceeding current pension liabilities. Later regulations in the 1930s and 1940s focused more on setting stricter guidelines on pension plans that could receive this preferential tax treatment under the Internal Revenue Code (IRC). An important development that arose at this time was nondiscrimination testing for coverage and benefits. These tests were developed to ensure that pension plans did not unfairly benefit highly compensated employees. During the Second World War employers used pension plans as a way to bypass wage controls and increase their employees' compensation. It was also during this time that pension plans became a negotiating tool for unions. In 1948, "The National Labor Relations Board ruled that Congress intended pensions to be part of wages and that they fell under 'conditions of employment' mentioned in the act, although this was not specifically defined." (McDonnell, 1998). Thus, though pension plans had become an important piece of retirement income for about 41% of the private-sector workforce by the mid-1900s, current pension regulation was still missing a very important aspect: There was no legislation in place guaranteeing pension benefits or preventing employers from terminating pension plans when they could no longer fund them or for using funds set aside for the purpose of paying pension benefits for other purposes. At first, Congress tried to deal with this shortcoming by creating more transparency in pension finances with *The Welfare and Pension Plans Disclosure Act.* It was hoped that forcing fiduciaries to disclose information on the finances of their pension plans would prevent them from underfunding or utilizing the funds in other capacities. The major drawback of this legislation, however, was that it fell on the plan participants themselves to monitor the plan for fiduciary wrongdoing and fraud. Thus, plans continued to be underfunded and terminated, culminating in 1963 with the collapse of Studebaker's underfunded pension plan, which left thousands of workers without benefits. It became clear that stronger pension legislation was needed and in 1974, The Employee Retirement Income Security Act (ERISA) was introduced as a solution.

ERISA was signed into law on Labor Day 1974 to provide retirement security that was so clearly lacking in current legislation. It encompassed aspects of bills from House and Senate labor committees, the House Ways and Means Committee, and the Senate Finance Committee. Before ERISA, pension legislation was considered a labor issue. However, as preferential tax treatment had become implicit in most private pension plans under the IRC, pension legislation was now also a tax issue and considered in the jurisdiction of the Senate Finance Committee.

Summary of ERISA

As outlined by Beverly Peltier-Labadie and Brian H. Kleiner (2002) in *An Overview of ERISA* and Leeroy Chaffin and Kleiner (2001) in *What is ERISA*, ERISA is organized into four titles:

Title I – Employee Benefits Protection

Arguably the most important, this title addresses the main shortcoming in previous legislation by protecting employees' rights and giving them the opportunity to take legal action for unpaid benefits or remedy transgressions for fiduciary duty. (Peltier-Labadie & Kleiner, 2002). This title can be further broken down into provisions on Reporting and Disclosure of Plan Information, Participation, Vesting, Funding, Fiduciary Responsibilities and Enforcement and Administration which will be discussed in detail later. (Chaffin & Kleiner, 2001)

Title II – IRS Rules

This title involves tax provisions and makes amendments to the IRC. Participation, vesting and funding provisions under this title are set up to mimic those of the first title.

Title III – Jurisdiction

This title assigns jurisdiction for regulation to the Departments of Labor and Treasury. The Labor department is responsible for reporting, disclosure, and fiduciary issues, while the Treasury department is responsible for participation, funding, and vesting issues.

Title IV – Termination Insurance

Under this title, the Pension Benefit Guaranty Corporation (PBGC) is created with the responsibility of insuring against the loss of pension benefits for the participants of a terminated plan. (Chaffin & Kleiner, 2001)

Four Titles of ERISA

Title I

The following sections will explore in more detail the four titles of ERISA as outlined extensively by Patrick Purcell and Jennifer Staman (2008) in the *CRS Report for Congress: Summary of the Employee Retirement Income Security Act.*

As mentioned above, Title I deals specifically with the protection of employee benefit rights in private sector pension plans. The first important provision of Title I deals with the reporting and disclosure of plan finances among other things. This provision requires that certain information is disclosed to both plan participants and governmental agencies. Under ERISA, plan participants must be provided with a summary plan description, which outlines the rights and obligations of plan participants. Specifically, it must outline participation and vesting requirements, benefits offered, and procedures for denied benefit claims. This summary must be presented in a way that can be understood by the average participant.

The second document required to be furnished by most plans is the annual report. This document is filed with the department of labor and can be accessed by participants with a written request. The main function of the annual report is to disclose plan asset and liability information as well as actuarial information.

Many reporting requirements of ERISA are now satisfied by the Form 5500 series which was developed by the Department of Labor, the IRS, and the PBGC and is required to be filed yearly by pension plans. The Form 5500 consists of a variety of different "schedules" that disclose information including participant counts, investment and asset information, service provider information and actuarial information. The schedule SB (for single and multiple employer plans) and the schedule MB (for multiemployer plans) disclose actuarial information including assumptions and methods, credit balances and funding percentages in addition to the value of plan assets and future liabilities and are required to be certified and signed by an enrolled actuary. Another required form, which is no longer part of the Form 5500, is the 8955-SSA. The purpose of this form is to report separated participants with deferred vested benefits to the Social Security Administration which in turn notifies the individual of existing pension benefits when they first file for social security.

Though *The Welfare and Pension Plans Disclosure Act* had already brought some transparency to pension finance, the reporting and disclosure required under ERISA put in place a more organized and extensive framework of transparency accessible by both plan participants and regulators. An important aspect of this transparency is that, unlike with the *The Welfare and Pension Plans Disclosure Act,* the responsibility of monitoring pension plans and their fiduciaries does not fall completely on the plan participants themselves. This will be discussed in greater detail in the provisions related to enforcement and administration.

The next set of provisions covered by title I of ERISA deals with participation and vesting requirements. Specifically, ERISA restricts the amount of time that an employee can be excluded from participating in a plan, stating that an employee can only be excluded based on age or service if they are younger than 21 or haven't yet completed a year of service, where year of service is the a 12 month period in which 1,000 hours or more have been completed. Vesting requirements can differ from participation requirements and determine when plan participants' accrued benefits become non-forfeitable. This means that even if the participant terminates employment before retirement they may still be able to receive the vested portion of their benefits. Under ERISA, an employee is entitled to their vested "normal retirement benefits" when they reach normal retirement age. Normal retirement age can differ among plans, but ERIAS does require that it must be no later than the later of the age of 65 of the fifth anniversary of the time the participant commenced participation in the plan. Additionally, ERISA outlines two acceptable vesting schedules. Either a participant's benefits are fully vested after five years of service or the following graded vesting schedule may be used.

Years of Service	**Vesting Percentage**
3	20%
4	30%
5	60%
6	80%
7	100%

(Purcell & Staman, 2008)

ERISA also allows plan participants to receive vesting credit for earlier years of service if they terminate and return to work within five years. Additionally, up to one year's absence due to maternity leave does not count as a break in service.

The next set of provisions in Title I focus on benefit regulations. ERISA outlines three acceptable methods for benefit accrual:

- 133 1/3 rule – a later rate of accrual for one year of plan participation cannot be more than 133 1/3% of the rate for any other plan year
- 3% rule – a participant must accrue at least 3% of the participant's anticipated normal retirement benefit in each year of participation, up to a maximum of 33 1/3 years
- Fractional rule – benefit accrual is based on a employee's proportionate years of service under the plan (Purcell & Staman, 2008)

The purpose of these guidelines is to limit "backloading" which is when a higher accrual rate is used for later years of service than what is used for earlier years. Backloading is of concern because it can delay the accrual of benefits sometimes to the point that a participant is "terminated, either intentionally or unintentionally, just in advance of accruing significant pension benefits." (Kotlikoff & Wise, 1987). Backloading can also be seen as a means of skirting around ERISA mandated vesting requirements. For example, if a plan sponsor wanted a 30 year vesting schedule, "the employer could theoretically provide that participants accrue $1 per year for the first 29 years of service and accrue their full benefit in year 30; this would effectively result in 30-year vesting." ("BACKLOADING ISSUE", 2007). ERISA also put in place various rules that protect an employees' accrued benefits. The "Anti-cutback rule" prohibits plan amendments that eliminate or reduce already accrued benefits. However, future benefit accrual rates are not limited by this rule. Similarly, ERISA prohibits rate reduction or the ceasing of benefit accrual based on a participants' age.

ERISA also protects the benefits of plan participants' spouses. *The Retirement Equity Act of 1984* amended ERISA to require preretirement and postretirement survivor annuities to the spouses of plan participants. The default postretirement spouse benefit required under ERISA is a joint and survivor annuity equal to at least 50% of the joint benefit paid to the participant while living. Under ERISA, qualified domestic relations orders (QDROs) dividing pension benefits must also be honored.

Funding rules under ERISA require that defined benefit plan liabilities are fully funded. Specifically, plans are required to prefund the normal cost, which is the pension benefits that the participants will earn in a year. If the present value of the plan's future liabilities, which are all of the benefits already accrued by participants at the beginning of the plan year, called the funding target, exceed the plan's current assets by more than the percentage deemed acceptable by law then the plan is called underfunded. These unfunded liabilities are required to be amortized over a specified period of years. In 2006, ERISA funding requirements were modified with the passing of the Pension Protection Act (PPA). The PPA will be discussed in greater detail later.

The final provisions under Title I focus on fiduciary responsibilities and regulations and administration and enforcement of ERISA. These last provisions are some of the most important as they address the shortcomings in previous pension legislation by holding accountable plan fiduciaries and giving participants the means to bring legal action against plans that have broken ERISA regulations.

ERISA requires that every plan have at least one plan fiduciary and lays guidelines for what a fiduciary is:

a. Someone who exercises discretionary authority or control with respect to plan management or the management of plan assets.
b. Someone who provides investment advice for a fee with regard to plan assets
c. Someone who has any discretionary responsibility for plan administration.

Plan fiduciaries are expected to provide four specific duties as outlined under ERISA:

1. Duty of Loyalty – Plan fiduciaries should act "solely in the interest of the participants and beneficiaries" with the purpose of "providing benefits to participants and beneficiaries." (Purcell & Staman, 2008) This guideline is especially important in situations where the fiduciary may have a conflict of interest. If a fiduciary makes a decision that in addition to benefitting the plan also benefits the corporation or the fiduciaries themselves, then they have not committed a breach of duty; however, the fiduciaries should avoid putting themselves in positions where they will be forced to act in the interest of the corporation instead the participants.
2. Duty of Prudence – The purpose of this guideline is to ensure that a proper process is followed by plan fiduciaries when making decisions about plan assets. The fiduciary is expected to determine "that the particular investment or investment course of action is reasonably designed, as part of the portfolio…to further the purposes of the plan." (Purcell & Staman, 2008)
3. Duty to Diversify Investments - Plan fiduciaries are required to diversify investments "to minimize the risk of large losses." Generally, an unreasonably large portion of a plan's portfolio should not consist of single security or type of security. For example, in the case of GIW Industries, Inc v. Trevor Stewart, the court concluded that the investment manager breached his duty by investing 70% of the plans assets in long term bonds

which exposed the fund to greater risk. "Expert testimony had indicated that short-term bonds or bonds with staggered maturity dates would have minimized exposure if the bonds were sold before maturity." (Purcell & Staman, 2008)

4. Duty to Act in Accordance with Plan Documents – Plan fiduciaries are required to enact their duties "in accordance with the documents and instruments governing the plan insofar as such documents and instruments are consistent with ERISA." Thus, if a plan provision is not in agreement with the terms of ERISA the plan fiduciaries are required to ignore this provision. Fiduciaries who do not follow plan documents due to "erroneous interpretations" do not breach duty. (Purcell & Staman, 2008)

In addition to the four above mentioned duties, ERISA lays other requirements for plan fiduciaries including those related to prohibited transactions and fiduciary liability. Fiduciaries are prohibited from engaging in transactions "likely to injure a pension plan." (Purcell & Staman, 2008) Plan fiduciaries may also be held personally liable for breaches of duty under ERISA and would therefore be required to forfeit to the plan any profits gained through breaches of duty.

Perhaps the most important provisions under Title I are the ones that focus specifically on protecting the interests and benefits of participants and beneficiaries by providing "appropriate remedies, sanctions, and ready access to the Federal courts." Civil action for breeches of ERISA may be brought forth by both participants, beneficiaries, or plan fiduciaries and government entities like the Secretary of Labor. ERISA was also designed to have "'exclusive' federal remedies" available, and was therefore set up to preempt all states laws dealing with employee benefits. (Purcell & Staman, 2008) This means that, "if a state law claim is considered within the scope of ERISA's 502(a) civil enforcement provisions, the state law claim is completely preempted." (Purcell & Staman, 2008) The purpose of this preemption is to simplify pension regulation and create a "nationally uniform administration of employee benefit plans." (Purcell & Staman, 2008) The actual success of this "doctrine of complete preemption" and available federal remedies is to this day one of the most controversial aspects of ERISA as it often greatly limits the course of action that those filing a claim may take. Though ERISA was designed specifically with the intention of protecting the benefits of plan participants, Congress also wanted to avoid regulation so stringent that it would discourage employers from starting or maintaining their plans. Therefore, ERISA's exhaustive legislative provisions are something of a compromise, and they do not "provide plan participants with every right and remedy they might find useful." (Brauch, 2000)

Some examples of situations in which authorized civil action may be brought forward under section 502 of ERISA include:

502(a)(1)(A)	Failure of a plan administrator to provide information necessary for reporting and disclosure.
502(a)(1)(B)	To recover benefits due under the terms of the plan or to enforce or clarify the rights to future benefits.
502(a)(2)	To receive relief due to breaches of fiduciary duty
502(a)(3)	To put a stop to practices that violate ERISA or plan terms.

Title II

The second title of ERISA focuses on the tax provisions of ERISA, and many of these provisions, especially those relating to participation, vesting and funding, line up identically with those of Title I. The main purpose of Title II is to lay out the guidelines necessary for a pension plan to maintain qualified tax status under the IRC with a specific focus on ensuring that pension plans do not favor highly compensated employees. In addition to similar provisions as those described under Title I, this is done through compensation and benefits limits, which prevent employees with high annual compensation from receiving disproportionately high pension benefits and minimum coverage and nondiscrimination testing.

ERISA places limits on the amount of yearly compensation that may be considered in the calculation of pension benefits and on the benefit amount that may be paid annually. These limits are adjusted when IRS cost of living indexes (COLAS) reach certain thresholds. The below table gives a four year comparison of annual compensation and annual benefit limits.

Year	**2013**	**2014**	**2015**	**2016**
Annual Compensation Limit	$255,000	$260,000	$265,000	$265,000
Annual Benefit Limit*	$205,000	$210,000	$210,000	$210,000

*The annual benefit for a participant is the lesser of 100% of their average compensation for the three highest years and the amount listed in the table.

In order to ensure that plans do not favor highly compensated employees, ERISA first sets the following guidelines to determine which employees are considered to be highly compensated in a plan:

- An employee who owns 5% or more of the company,
- One whose annual compensation exceeds $120,000 in 2015 or 2016
- Or highly compensated employees may be defined as those employees ranking in the top 20% in compensation (all employees owning 5% of the company must be included regardless).

Next, ERISA outlines various requirements to make sure that plans do not favor these employees over others. First are the minimum coverage requirements; a pension plan must satisfy one of the following two tests:

Ratio Percentage Test: The percentage of nonhighly compensated plan participants must be at least 70% of the percentage of highly compensated plan participants.

Average Benefit Test: First, the plan must "benefit a classification of employees that does not discriminate in favor of highly compensated employees," such as salaried or hourly employees and second the "average benefit percentage of nonhighly compensated employees must equal at least 70 percent of the average benefit percentage of highly compensated employees." (Purcell & Staman, 2008) In order to satisfy the first requirement, the chosen classification must be a "business classification" such as hourly or salaried and pass a ratio percentage test with the necessary percent set equal to the safe harbor percentage instead of 70%. If this is not possible, the plan must present other facts arguing for the classification of employees and pass a percentage ratio test with the necessary percentage set as an unsafe harbor percentage. "The safe (or unsafe) harbor percentages are based on the concentration percentage of all nonhighly compensated employees within the employer's work force," where concentration percentage is "the ration of the nonhighly compensated employees to the employer's total work force." (Purcell & Staman, 2008) For example, the safe harbor percentage starts at 50% and is then "reduced by 3/4 of a percentage point for each whole percentage point by which the nonhighly compensated employee concentration percentage exceeds 60 percent." ("Nondiscriminatory classification test.," 1991)

ERISA also outlines the following three nondiscrimination requirements that pension plans must satisfy:

1. The amount of benefits provided by the plan must be nondiscriminatory
2. Benefits, rights, and features of the plan must be nondiscriminatory

3. The effects of plan amendments, past service credits, and plan terminations must be nondiscriminatory

In order to satisfy the first requirement, pension plans must have uniform retirement and post-retirement benefits and must consider the number of years of service for every employee when calculating benefits. Employee contributions are also prohibited. To satisfy the second requirement, optional forms of payment and other special benefits must be available to participants who have met the age and service requirements. The third requirement ensures that any plan amendments or other special circumstances are not discriminatory toward nonhighly compensated employees.

Title III

Title III of ERISA is responsible for delegating enforcement and administrational responsibilities between the Department of Labor, the Treasury Department, and the PBGC. Additionally, ERISA ensures that these three departments must communicate with each other and work together in order carry out these responsibilities. For example, when deciding whether a plan has met the requirements of the IRC, the Treasury Department must first give the Department of Labor and the PBGC the opportunity for comment before an official letter of determination is filed. Likewise, if the Department of Labor or the PBGC want to file a claim for a breach in participation, vesting or funding provisions, the Secretary of Treasury must be allowed to review the claim.

Title IV

The final title of ERISA is responsible for establishing the PBGC to “protect the retirement income of participants and beneficiaries in private-sector defined benefit plans.” (Purcell & Staman, 2008) In order to achieve this, the PBGC provides “termination insurance” meaning that if a plan terminates with insufficient funding the PBGC will ensure that at least a portion of vested benefits are paid to plan participants. The PBGC receives revenue solely from premiums paid by employers, assets of terminated plans it has taken over, and investment income from its trust funds. Single-employer plans and multiemployer or collectively bargained plans are treated differently by the PBGC and separate reserve funds are held for each type. The legislation and regulations discussed here will focus on single-employers plans in the PBGC.

Though the PBGC is funded by the premiums that they receive from employers, they do not set the amount of these premiums themselves. Instead, Congress has the authority to set the premium amount. There are two premiums that may be charged to single-employer plans; a per participant flat rate that is charged to all single-employer defined benefit plans and variable rate premium that is charged to underfunded plans. The variable rate is an amount charged per $1,000 of unfunded vested benefits (UVBs) and is capped at a specified dollar amount times the number of plan participants. Premium rates are indexed and therefore increase automatically overtime. They may also be increased by government legislation. The below table provides a comparison of the flat rate premium amount and the amount per $1,000 of UVBs of the variable rate premium over three years.

Plan Year	**2014**	**2015**	**2016**
Flat Rate Premium	$49	$57	$64
Variable Rate per $1,000 UVBs	$14	$24	$30
Per Participant Cap of Variable Premium	$412	$418	$500

There are limits to what kinds of benefits are protected by PBGC termination insurance. Only “basic benefits” are covered, including “pension benefits beginning at normal retirement age (usually age 65), certain early retirement and disability benefits, and benefits for survivors." ERISA also sets a limit on the amount of benefits that may be covered. For plans terminating in 2015, the maximum annual benefit amount guaranteed to a retiree aged 65 is $60,136. This amount is reduced for early retirement or if the benefit is received in a form other than life annuity.

Pension plans may be voluntarily terminated by the plan sponsor in one of two ways under the PBGC. If the plan is fully funded (meaning the plans assets are sufficient to cover all of the plans liabilities) then there is a standard termination procedure. If the plan is in financial distress and is less than fully funded, then a special distress termination must be followed. Under standard termination procedure, the plan assets must first be certified as sufficient by an actuary and plan participants must be notified of the impending termination before it can take place. Afterwards, the plan sponsor either purchases annuities or distributes benefits in lump-sums. To qualify for distress termination, an underfunded plan must satisfy one of the following requirements:

- Bankruptcy procedures seeking liquidation have been filed.
- The company is undergoing reorganization under the Bankruptcy Code.
- The company is unable to pay debts when due and will not be able to continue is business if the plan is continued.
- The company has experienced unreasonably burdensome pension costs solely as a result of a decline in workforce. (Purcell & Staman, 2008)

In addition to the two voluntary methods of termination mentioned above, the PBGC may decide of its own volition to terminate a pension plan for the following reasons:

- The plan failed to meet minimum funding requirements.

- The plan cannot pay current benefit obligations.
- A lump sum has been paid to a plan participant who owns a substantial portion of the company
- Failure to terminate the plan will cause an unreasonably large increase in the loss the PBGC will experience.

Even if a plan is terminated under distress or involuntarily, the plan sponsor is still liable for unfunded benefit liabilities which are due on the plan termination date.

The Pension Protection Act

After ERISA, the largest reform of pension legislation was the PPA which was signed into law in 2006 with the purpose of addressing issues still plaguing the private pension sector. Despite ERISA's extensive regulation to ensure the proper handling of pension plan funds and its creation of the PBGC to ensure that participants received their benefits, the current funding rules were proving insufficient in preventing plans from being underfunded. This in turn led to an "increasing deficit" of the PBGC. "The possibility that the termination of defined benefit plans with large unfunded liabilities might eventually lead to the insolvency of PBGC…lent a particular urgency to the effort to mandate improved pension plan funding." (Purcell, 2006) This "urgency" was due in part to the fear that the insolvency of the PBGC would force congress to "step in and engineer a financial bailout,' even though PBGC receives no appropriation from Congress." (Purcell, 2006) Some of the specific funding issues outlined by Purcell (2006) in the *CRS Report for Congress*: *Summary of the Pension Protection Act.*:

- Additional contributions were not required to be made toward underfunded plans as long as they were 90% funded.

- Plan assets and liabilities were not being measured correctly due to the inconsistent averaging of interest rates. Liability rates could be averaged over four years and asset rates could be averaged over five.
- Funding shortfalls were allowed to be amortized over unreasonably long periods of time.
- The use of "credit balances" or contributions made beyond the minimum required contribution in the past allowed plan sponsors of underfunded plans to avoid making contributions for several years, which in turn led to greater underfunding of these plans.

The main focus of the PPA was to increase minimum funding requirements for pension plans including "new rules for determining whether a plan is fully funded, the contribution needed to fund the benefits that plan participants will earn in the current year, and the contribution to the plan that is required if previously earned benefits are not fully funded." (Purcell, 2006) As mentioned previously, under ERISA plan sponsors of defined benefit plans were already required to prefund the benefits owed to participants in the upcoming year.

The PPA raised the percentage by which the present value of the plan's future liabilities must equal the plan's assets to 100%. The period of time in which plan sponsors are allowed to amortize unfunded liabilities is shortened to seven years under the PPA. Credit balances are still allowed to be put toward required contributions, but only for plans that are at least 80% funded. Additionally, credit balances are required to be adjusted to reflect changes in market value of the plans assets since the credit balances were created. Initially, legislators sought to eliminate credit balances all together, as employers were using them to "rely on artificially high estimates of previous payments to the plan funds to reduce current payments;" however as a compromise they instead required the credit balances to be valued at market value. (Klaff, 2007). Under the PPA, credit balances can be broken into prefunding balances and standard carryover balances. A prefunding balance is “the accumulation of the contributions that an employer makes for a plan year that exceed the minimum required contribution for the year,” while a plans carryover balance is “based on the funding standard account credit balance as determined under section 412 for a plan as of the last day of the last plan year beginning in 2007.” (“Measurement of Assets and Liabilities,” 2009). A plan with a nonzero carryover balance must first exhaust this balance before any portion of the prefunding balance may be used to offset the minimum required contribution. Decisions to elect to use carryover or prefunding balances to offset minimum required contributions or to add to the plan’s prefunding balance must be delivered in writing to both the plan’s enrolled actuary and the sponsor. (“Effect of prefunding balance,” 2009).

The rates used to value the plan’s liabilities are also dictated by the PPA to capture a more “realistic measurement of risk.” (Purcell, 2006). Plan liabilities are required to be discounted at three different rates prescribed by the Secretary of Treasury. Liabilities that will be due in five years are discounted with a short term rate. Liabilities that will be due in five to fifteen years are discounted with a midterm rate. Finally, liabilities that won’t be due for more than fifteen years are discounted with a long term rate. The mortality tables used in discounting liabilities will also be prescribed by the Secretary of Treasury, though very large plans may appeal to use mortality tables based on their own experience.

Similarly, the valuation process of plan assets is also modified by the PPA. Before the PPA, plan assets were valued using actuarial methods that smoothed asset values over five years and allowed the determined value of assets to differ from the market value by a corridor of 80% to 120%. Averaging assets is an acceptable way of reducing yearly volatility in plan assets due to “fluctuations in interest rates and the rate of return on investments;” however, the PPA reduces the acceptable range by which the smoothed value of assets may differ from the market value to between 90% and 110%. (Purcell, 2006)

Another big change to plan funding rules under PPA, is the determination of "at risk" plans. A plan is "at risk" if it is likely to default on previously earned benefits. In order to be classified as 'at risk" under the PPA, a plan must fail either of two following tests:

1. A plan is considered "at risk" is liabilities are less than 70% funded under the following two "worst case scenarios"
    a. The use of credit balances is not permitted to reduce contributions
    b. Employees will both retire at the earliest age and take the most expensive form of payment.
2. If a plan does not pass the first test it is considered "at risk" unless its liabilities are at least 80% funded under standard actuarial assumptions.

Plans failing to meet certain funding thresholds face various restrictions in terms of the benefits that they are allowed to offer to their participants. Specifically, "the PPA places limits on (1) plan amendments that would increase benefits, (2) benefit accruals, and (3) benefit distribution options." (Purcell, 2006). The funding percentage used for comparison to these thresholds is called the plan's adjusted funding target attainment percentage or AFTAP. The AFTAP is determined by taking the ratio of the plan's actuarial value of assets minus credit balances minus the amount of annuities purchased for non-highly compensated employees over two years to the plan's funding target minus annuity purchases. The plan's AFTAP is required to be certified by an actuary and must be determined using the same assumptions and methods as disclosed in the schedule SB. The following are restricted when the plan's AFTAP is below the required threshold:

- “Contingent event benefits” such as benefits paid when a factory shuts down are prohibited in plans less than 60% funded.
- Plans less than 60% funded must also stop benefit accruals.
- Plans less than 80% funded are prohibited from making amendments that raise benefit amounts.
- Plans less than 60% funded are restricted from lump sum distributions.

Criticisms of ERISA

Though ERISA brought increased security to pension plan participants, there has been scrutiny on various aspects of the bill over the years. Some critics blame ERISA in part for the shrinking private pension market. Additionally, difficulties with civil actions and the bill’s “doctrine of complete preemption” remains one of the biggest points of contention. Finally, the financial state of the PBGC has been a source of criticism over the past decade. Though the PPA was passed in part to try to strengthen the PBGC, issues still remain.

ERISA certainly provided the retirement security that was initially lacking in the private pension sector; however, some critics believe that the heavy regulation necessary to orchestrate this security is at least partially responsible for the decline of the private pension market. Initially, the private pension market continued its expansion under ERISA with almost 46% of the private sector market covered by 1980. However, around this time defined contribution plans started to grow in popularity due in part to the increasingly mobile workforce, and defined benefit plans began their decline. Though there are many theories for why defined benefit plans began to decrease in popularity, including the more mobile workforce and increasing participant life expectancy, it is clear that the heavy regulation guidelines that ERISA set in place could also be to blame. “…government regulation is known to be more onerous on DB plans than on DC plans. The PBGC requires firms offering DB plans to pay premiums to maintain insurance; the regulations for DB plans impose a complicated set of funding rules, limitations, and regulations pertaining to pension investment." (Zurlo, 2012). Tighter funding rules for pension plans meant that there were "fewer tax-free dollars in pension plans and more taxable dollars in the economy." (Kujawa, 2014). As Patty Kujawa (2014) says, "while Congress was able to give Americans tax breaks on their income, these new laws gave plan sponsors no incentive to prepare for hard times." Due to this strain on pension plan sponsors, many closed their plans. According to Kevin Wagner, senior consultant at Towers Watson & Co., "it was a virus that infected defined benefit plans." (Kujawa, 2014). Small employers were hit especially hard by costs associated with the increased regulation under ERISA. "[T]he increased administration cost associated with government regulations exceeded the tax advantages of pension saving for workers at lower pay levels in small employers, many small employers terminated their DB plans over the past two decades." (Zurlo, 2012).

The civil action provisions of ERISA were constructed as a "comprehensive statute for the regulation of employee benefit plans" and in order to achieve this the bill was given "complete preemption" over all state laws that "relate to any employee benefit plan." (Purcell & Staman, 2008). This "[p]reemption is so broad that ERISA preempts even those laws that are consistent with its purposes." (Brauch, 2000). Though Congress intended this legislation to create a uniform system of available civil action, the cumbersome nature of the legislation and the courts' interpretation of when state laws are preempted and of the other civil action provisions of ERISA mentioned has often proved controversial.

The monetary remedies available under ERISA's "exhaustive" provisions have often proved to be especially limiting. Ideally, a winning plaintiff in a claim for the recovery of benefits would receive the benefits they were entitled but previously denied. Other monetary compensation including compensatory and punitive damages that may be available under state law are not allowed under ERISA. “Section 502 of ERISA…has been held to preempt state or common law causes of action that may provide for more generous remedies than what is available under ERISA.” (Purcell & Staman, 2008).

Another difficulty with recovering employee benefits under ERISA is that, “none of ERISA’s federally provided remedies squarely addresses the inconsistent promise.” (Brauch, 2000). ERISA provisions allow for the recovery of benefits as outlined in writing in the summary plan description which is required to disclose to the participants the plan terms and benefits they are entitled and is intended to be constructed in a way that is “sufficiently accurate and comprehensive.” (Brauch, 2000). However, benefits stemming from promises made outside the plan document are not officially protected under ERISA. “None of the remedies listed in [ERISA] specifically addresses the situation in which a promise is made that is inconsistent with the terms of the written plan.” (Brauch, 2000). Due to this, “many courts have been wary of enforcing representations – especially oral ones – that contradict clear, formal, written plan terms.” (Brauch, 2000). For example, in the *Cefalu v. B.F. Goodrich co.* case, “the Fifth Circuit refused to enforce an oral representation about a written pension plan. The main prerogative behind informal amendments to plan documents is to “prevent collusive or fraudulent side agreements between employers and their employees.” (Brauch, 2000). Despite this, when these informal agreements do happen and then fall through it is the employees who suffer, as they are not easily able to recover the benefits promised to them. “Congress’s desire to provide certainty in the area of employee benefits…has played a powerful role in deciding when and if promises inconsistent with plan terms should be enforced.” (Brauch, 2000). One means of attempting to recover benefits promised outside of written plan terms has been to define them as a separate, informal employee benefit plan that could be enforced under ERISA. However, this course of action has been largely unsuccessful for the following two reasons: “First several courts have refused to apply the informal plan doctrine when [it] would merely contradict the terms of an existing written plan. Second, it is very rare for the alleged promise to meet the requirements of the *Donovan* test.” (Brauch, 2000). The “Donovan test” comes from a court case where it was decided that ERISA would “enforce *any* employee benefit plan, not just ‘formal, written plans.’” (Brauch, 2000). However, to be considered a true employee benefit plan it is up the court to determine from the circumstances if the following could be reasonably ascertained:

- Intended benefits
- Intended beneficiaries
- Source of financing
- Procedures for receiving benefits

Thus, many plan participants are unable to recover benefits promised outside the plan document.

As mentioned previously, the increasing deficit of the PBGC in the early 2000s led to a fear that if this financial decline continued, congress would eventually be forced to orchestrate some sort of financial bailout to allow the “self-financing” PBGC to stay afloat. (Brown, 2008). In 2003, the PBGC gained a record unfunded liability of nearly 3.7 billion dollars from the Bethlehem Steel Company. This was quickly surpassed in 2005 by the 7.1 billion dollar unfunded liability from United Airlines. Though the PBGC had posted a record surplus of 9.7 billion in its Single Employer Program in 2000, by the end of 2006 the PBGC’s net financial position was an 18.1 billion dollar deficit. As of 2014, the PBGC’s Single Employer Program posted a net financial position of 19.3 billion. While falling interest rates and stock prices during this time certainly contributed to the PBGC's financial decline, the structure of the PBGC as defined under ERISA is also to blame. As outlined by Jeffery R. Brown (2008) in his paper *Guaranteed Trouble: The Economic Effects of the Pension Benefit Guaranty Corporation* the following design flaws have contributed considerably to the PBGC's decline:

1. Improperly priced insurance led to excessive risk taking by plan sponsors
2. Adequate funding of funding of pension obligations was not promoted
3. Sufficient information disclosure to market participants was not promoted

Brown (2008) says that, "together these three flaws produced a system in which many firms fail to fund their pension obligations adequately, knowing that in financial distress, they can dump their pension liabilities onto the PBGC." While the PPA made various changes to the PBGC, including raising the premium rates charged, the three flaws mentioned above were not fully corrected.

There are still many issues remaining with the adequacy of PBGC premiums as set forth by ERISA and modified by the PPA. Namely, the premiums are still too low and are not risk-based. "The PBGC is prohibited by Congress from charging risk-adjusted premiums." (Brown, 2008). Thus, PBGC premiums do not account for "the probability that the firm will experience financial distress, or for the full extent of underfunding, or for any mismatch in risk characteristics between plan assets and plan liabilities." (Brown, 2008). Similarly, PBGC premiums are not varied between high and low risk plan sponsors.

The PPA addressed many of the shortcomings in funding regulations that existed under ERISA including stricter guidelines on the use of credit balances, a reduction in the range for smoothing assets and liabilities to two years, and conservative methods of calculating future liabilities for plans deemed at risk by the PBGC. Despite this, funding regulations are still lacking in certain aspects which negatively impact the PBGC by creating an opportunity for plans to underfund. "For example, assets and liabilities still do not reflect market values," and while they are more strictly regulated the use of credit balances was not eliminated altogether. (Brown, 2008).

Finally, the lack of transparency in pension plan funding is still a major issue plaguing the PBGC. As summed up by Brown below,

> In efficient financial and labor markets, firms would be appropriately rewarded for good behavior or penalized for bad behavior with respect to pension plan funding. For example, financial markets would place a lower value on firms with poorly funded pensions, knowing that these pension obligations will eat into future cash flows. Unfortunately, most of the information needed to make informed decisions about a plan's funding status is not readily available to workers, investors, or other market participants. While pension plan sponsors are required annually to file a Form 5500, which provides detailed information on pension plan assets and liabilities, this public information is often quite stale by the time it is available for public consumption. "…It is exceedingly difficult to make informed business and policy decisions based on such dated information, given the dynamic and volatile nature of markets." (Brown, 2008).

Conclusion

ERISA was a necessary action to bring retirement security to pension plan participants. Before it was enacted, there was nothing in place to stop plan sponsors from terminating their plans during a financial decline or from using funds set aside specifically to pay participant benefits for other purposes within the company. Thus, before ERISA many participants retired empty handed. ERISA enacted an extensive framework of guidelines and regulations which in addition to protecting the interests of the plan participants also sought to increase transparency in pension finances and to set codes of conduct for plan fiduciaries. Though numerous amendments to ERISA have been passed over the past four decades, the most significant of these was the PPA which was enacted with the purpose of correcting the shortcomings that still remained in pension legislation, namely the ease with which many plans were still able to exist and eventually terminate with large unfunded liabilities. Though the PBGC was put in place to ensure the benefit security of plan participants, the large nature of the liabilities the PBGC was forced to take on ultimately led to its financial decline. The sizeable deficit still faced by the PBGC is only one of the criticisms that ERISA has faced over the years. Many have claimed that the heavy legislation put in place by ERISA is at least partially responsible for the considerable decline of the private pension market over the past few decades. The cumbersome nature of ERISA civil action provisions have also led to criticism. Ultimately, though ERISA and the PPA have created a landscape of greater security in relation to private pension plans, issues still remain in the landscape of pension legislation.

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