# Employer Guarantee of Pension Benefits

*by*

**DAN M. McGILL**
*Chairman and Research Director*
Pension Research Council
Wharton School

*Published for the*

**PENSION RESEARCH COUNCIL**
Wharton School
University of Pennsylvania

*by*

**RICHARD D. IRWIN, INC.** Homewood, Illinois 60430
IRWIN-DORSEY INTERNATIONAL, London, England WC2H 9NJ
IRWIN-DORSEY LIMITED, Georgetown, Ontario L7G 4B3

*First Printing, October 1974*

ISBN 0-256-01704-2
Library of Congress Catalog Card No. 74–17252
*Printed in the United States of America*

# Chapter 2

# Concept of Employer Guarantee

No one ought seriously to question the need and wisdom for an employer to reserve the right to reduce the rate at which pension benefits would accrue in the future, or even to terminate the plan altogether. After all, a pension plan is a long-term undertaking, and the financial circumstances of the plan sponsor may change drastically over the years, as recent events amply demonstrate, making it impossible to continue the plan without threat to the solvency of the enterprise itself. Such action would have an effect only on benefit credits that would have accrued in the future. Yet it is a different and more serious matter for the plan sponsor to reserve the right to terminate the plan or discontinue contributions, and thereafter to limit the recovery of plan participants to assets already accumulated in the plan. The exercise of this right can adversely affect the fulfillment of benefit rights that have already accrued and have led to justifiable expectations on the part of plan participants and their beneficiaries.

It would seem desirable that employers and the community of professional advisers that make up the pension establishment re-examine the wisdom and propriety of limiting the employer's obligation for *accrued* pension credits to contributions already made. To put the proposition in positive terms, employers should consider the feasibility and desirability of making accrued pension benefits a claim against their corporate assets to the extent that assets in the plan are insufficient to satisfy all such claims. This concept was advanced by the present author 15 years ago[1] and at various times since, but only recently has it been given serious consideration. Significantly, Congress included a limited form of corporate guarantee of pension benefits in connection with the recently enacted program of plan termination insurance.[2]

Under the general concept of employer responsibility for *accrued* pension benefits, the employer guarantee would become operative only upon termination of the plan and only to the extent that the plan assets were insufficient to meet the claims subject to the guarantee. The employer could discharge his obligation by making additional contributions to the plan or by paying a portion of the accrued benefits directly to the eligible claimants.

The guarantee would not necessarily be extended to all benefits that had accrued at the point of plan termination.

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1 "Keys to Security of Pension Expectations," *Proceedings* of the Fifty-fourth Annual Meeting of the Life Insurance Association of America, 1960, pp. 205–26. See also Dan M. McGill, *Fulfilling Pension Expectations* (Homewood, Ill.; Richard D. Irwin, 1962), pp. 275–78 and 295–99.

2 Section 4062 of the Employee Retirement Income Security Act of 1974 provides that a company which terminates its pension plan shall be responsible for the unfunded insured benefits, up to 30 percent of the firm's net worth computed on a day chosen by the insuring agency but not more than 120 days prior to plan termination. The net worth is to be computed without regard to this contingent liability. However, a company can avoid this liability by paying an additional premium for each of the five plan years immediately preceding the plan year in which termination occurred. (See section 4023 and sections 4062 through 4068 for a more complete statement of the employer's liability and the circumstances under which it can be invoked and waived.)

At one extreme, the employer might guarantee only those benefits that had matured as claims and were in process of payment. This would include benefits being paid to retired and disabled employees and benefits to the survivors of former participants. This type of guarantee would have only minimal fiscal implications, since in ordinary circumstances the plan assets would be more than sufficient to meet the demands of this class of claimants. At the other extreme, the guarantee might attach to all accrued benefits, whether or not they had vested prior to termination of the plan. This would be the most burdensome guarantee and would require additional contributions from the employers if the plan were not fully funded.

An intermediate position would be for the employer to guarantee only those benefits that had vested through satisfaction of the age and service requirements of the plan. As time goes on, this category of benefits would constitute an ever increasing percentage of the total. The employer might limit his obligation further by guaranteeing only those vested benefits that accrued as a result of service after establishment of the plan. In other words, the guarantee could exclude past service benefits.

Two major objections, apart from philosophical considerations, have been raised to the concept of employer guarantee of pension benefits. The first is that it could cost the firm money and under certain circumstances could force it into bankruptcy. The likehood of these developments depends, among other things, upon the scope of the guarantee and the funding policy being pursued by the employer. If the terminated plan was not fully funded, the employer could be called upon to make further contributions to, or on behalf of, the plan, depending upon the scope of the guarantee. Indeed, this would be the intended result of the guarantee. Whether the guarantee would force the firm into bankruptcy is more difficult to assess. The basis for the allegation is that the unfunded liability of the plan may exceed the net assets of the firm. Again, this risk depends upon the guarantee and the status of funding. If the employer is following a normal funding policy and has not recklessly granted retroactive benefit increases, the unfunded liability with regard to the guaranteed benefits is not likely to exceed the net assets of the company.[3]

The second objection is that the pension guarantee would adversely affect the credit rating of the firm. This concern is based upon the fact that the unfunded portion of the pension guarantee would be a legal liability of the employer, the magnitude of which would not be subject to the control of other creditors or even predictable. This is a real concern, almost universally shared, and is deserving of serious consideration. The severity of the threat depends upon the creditor status that would be enjoyed by the pension claimants. This would have to be defined by law.[4] The most favorable status that the

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[3] See the results of the questionnaire discussed in Chapters 3 and 4. It might logically be argued that the most relevant comparison is that of the unfunded accrued liability to the total financial resources available to meet it. This would include the borrowing capacity of the firm, as well as its net assets.

[4] Section 64 of the Federal Bankruptcy Act establishes a series of five priorities, each of which must be satisfied in full before any payment is made to the next. In descending order, the priorities are as follows:

*a.* The costs and expenses of administration of the bankrupt estate.
*b.* Wages and commissions accruing during the three months period preceding the date of bankruptcy, up to a total of $600 per claimant. (A National Bankruptcy Commission has recently proposed a new

pension claims could logically command would be that equal to unpaid wages, on the theory that pensions are deferred wages, at least in the collective sense. This is the preference given to the pension benefits “contracted out” under the social insurance program of the United Kingdom, which must in effect be guaranteed by the employer. The preference is limited to one year's contribution and is thus not open-ended. There is a precedent for such a status in section 71 of the New York Stock Corporation Law which makes *stockholders* liable in certain cases for amounts due to employees for wages or salaries and defines “wages or salaries” to include “employer contribu-

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and drastically changed Federal Bankruptcy Act which *inter alia* would raise the wage priority to $1200, including up to $300 in fringe benefits.)

*c.* Legal and other expenses incurred by anyone who successfully challenges an action of the trustee in bankruptcy.

*d.* Taxes owed to the United States or any state, other debts owed to the United States, and rent.

*e.* Debts, other than for taxes, owed to any person (including the United States) who by the laws of the United States is entitled to priority. It should be noted that this class of priority can be established by any federal statute, without amending the Federal Bankruptcy Act.

After all the foregoing priorities have been satisfied in full, any balance remaining in the bankrupt estate is distributed to all other creditors in proportion to their claims. The most recent statistics on bankruptcies reveal that no recoveries are made by general creditors in about 90 percent of the cases, and in the other 10 percent of the cases the recoveries average about 7 percent of the claims. Thus, unless pension claimants are given a status superior to that of general creditors, they are not likely to realize anything from their claims against a *bankrupt* employer. Of course if the employer is solvent, the claims would be fully enforceable and collectible, subject to any limits that might be established by law.

It should be understood that creditors with secured interests have a right to the pledged property that is superior to the claim of the trustee in bankruptcy, and hence they outrank all creditors pressing claims against the trustee under the Bankruptcy Act. In effect, they simply take their own property.

tions to, or payments of, insurance or welfare benefits, [and] employer contributions to pension or annuity funds." Section 4062 of the Employee Retirement Income Security Act, which deals with plan termination insurance, assigns a class five (see footnote 4) priority to the claim that the Pension Benefit Guaranty Corporation, the insuring agency, would have against an employer with regard to his contingent liability under the law.[5]

While a preferred creditor status would obviously enhance the protection of pension plan participants, it could impair the ability of the plan sponsor to arrange outside financing on favorable terms.

A second possibility would be to give pension claimants the status of general creditors of the employer. With this status, they would share pro rata in the remaining assets of the bankrupt employer after all secured and preferred creditors had been satisfied. Employers who currently guarantee all or some portion of their pension promises generally assume that the guarantee carries a general creditor status.[6] To bestow general creditor status on the claims of pension plan participants could adversely affect the debt financing of the plan sponsor.

Another possibility would be to give the claims of pension plan participants a status in bankruptcy or insolvency proceedings subordinate to that of all other creditors, including general creditors. They would be subordinated creditors whose claim to the employer's assets would be

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[5] The corporation is authorized under section 4067 of the law to subordinate its lien to that of any other creditor of the employer if, in the judgment of the corporation, such subordination would enhance the ultimate collectibility of the sum represented by the lien.

[6] See the results of the questionnaire discussed in Chapters 3 and 4.

only one step above that of preferred and common stockholders. With such a low order of preference, guaranteed pension claims could not pose a threat to other creditors and hence would not impair the credit rating of the firm.[7] Yet, the fact that the plan participants would outrank the stockholders in the distribution of the firm's assets should instill a sense of prudence and responsibility on the part of the firm's management in designing, revising, and financing the pension plan. The firm should not grant pension benefits that can not be financed without threat to the continued solvency of the firm. A subordinated creditor status for guaranteed benefits would conform well with plan termination insurance where an employer's contingent liability for unfunded insured benefits (which would cover only vested benefits, up to a specified limit) would have the primary purpose of encouraging employer discipline in the granting and funding of pension benefits. Lessening the financial burden on the insuring agency through recoveries from the sponsor of the terminated plan would be only a secondary purpose, although not an unimportant one.

The concepts described above would probably have to be modified somewhat in the case of collectively bargained, multiemployer pension plans, under which the participating employers' commitment is expressed in terms of specified contributions to the plan. As a minimum, the employer should be—and is—under a legal obligation to make the contributions called for by the collective bargaining agreement. To apply the guarantee concept in full, it

[7] An employer's contingent liability of this nature could encourage debt financing in preference to equity financing.

would be necessary to prorate the unfunded liabilities of a terminated plan among all the participating employers whose work force helped to create the liabilities, including those employers who had withdrawn from the plan prior to its formal termination. This would be most difficult, if not impossible. However, it is patently inequitable and unrealistic to expect the employers still in the plan to be responsible for the entire unfunded accrued liability at time of termination, whether or not the liabilities accrued with regard to service in their firms. To impose such an obligation would be to encourage wholesale defections from a plan that seems headed for financial difficulties.

One possible solution would be to assess a withdrawing employer with his share, however determined, of the unfunded accrued liabilities of the plan at that point, with the residual unfunded liabilities being absorbed by the employers still in the plan at its termination. That approach is contained in the recent pension reform legislation which provides that when a "substantial employer" withdraws from a multiemployer plan, he shall be liable to the Pension Benefit Guaranty Corporation (up to 30 percent of his net worth) for his share of the unfunded accrued liabilities, computed as if the plan had terminated in its entirety on the date of the employer's withdrawal.[8] His share of the liabilities is determined by a fraction

[8] Section 4063 of the Employee Retirement Income Security Act. A "substantial employer" is defined in section 4001(a)(1) of the act as any employer who has made contributions to a multiemployer plan for each of the two immediately preceding plan years or for the second and third preceding plan years in an amount each year equaling or exceeding 10 percent of all employer contributions paid to the plan in each of such years.

whose numerator is the amount that he was required to contribute to the plan over the last five years and whose denominator is the amount required to be contributed by all employers over the last five years.[9] The amount paid to the corporation under this provision is held in escrow for five years and is returned without interest to the withdrawing employer at the end of the period, if the plan has not terminated. In lieu of paying money to the corporation in discharge of his obligation, the employer may furnish a surety bond in an amount not exceeding 150 percent of his liability.

Under an alternative procedure, the employees of a withdrawing substantial employer would be allocated an equitable share of the plan assets, and the plan would be treated as terminated with respect to those employees and those monies,[10] the employer being responsible for the unfunded accrued liabilities associated with the insured benefits of his employees.

The corporation is entitled to waive the use of either of these procedures if there is an indemnity agreement between all the other employers in the plan sufficient to satisfy all plan liabilities.

In lieu of the foregoing procedures, the Pension Benefit Guaranty Corporation is authorized to determine the liability of a withdrawing substantial employer on any other equitable basis, as prescribed in regulations.

The foregoing procedures do not deal with the problem of unfunded liabilities left in the plan by withdrawing employers who do not meet the test of a "substantial

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[9] Section 4063(b).

[10] Section 4063(b).

employer." Under section 4604 of the act, the employers who are still participating in a multiemployer plan at the time of its termination (or who participated at any time during the preceding five years) are liable for their respective portions of the unfunded liability for insured benefits, the share of each employer being determined by the proportion of his required contributions to the plan over the last five years to the aggregate required contributions over the same period. As with single-employer plans, the liability of each employer is limited to 30 percent of his net worth as of some date within 120 days prior to the date of plan termination. It remains to be seen whether these prescribed procedures will solve the problems involved.

The employer liability concept may also need some modification for collectively bargained, single-employer plans. The employer's legal commitment under these plans is not always clear. Generally speaking, however, the employer commits himself to one or the other of two types of undertakings: (1) to credit all eligible employees with deferred pensions in accordance with a specified formula for service in each of the years covered by the related labor agreement or (2) to provide lifetime benefits on a specified scale to all employees who *retire* during the term of the labor agreement. The first type of agreement is usually supplemented by the employer's commitment to fund the plan on some acceptable basis, but there is typically no funding commitment in connection with the second type of agreement. Under both arrangements, it is always tacitly assumed that the pension plan will be continued indefinitely through successive labor contracts. The basic legal question is what would be the effect of termination of the plan, or of the labor agreement (s) under which it was established and operated, on the benefit rights that were created during the term of the labor contract or contracts.

Under the first type of agreement, the employer's obligation is generally considered to be the same as that under a comparable unilateral plan, the liability at plan termination being limited to funds already contributed—assuming that the funding commitment had been met. Pursuant to general IRS policy, the employer would not have the right to recover any of his contributions (unless they turned out to be excessive); but by the same token he would not be required to make good on any deficiency if the assets proved to be inadequate to provide the benefits promised under the plan and the labor contract. It would seem appropriate—and feasible—for the employer to guarantee the accrued benefits on the same basis as would be done by the sponsor of a nonbargained plan, although he might demand some concession from the union for the guarantee.

In contrast, the second type of agreement is generally thought to create a legally enforceable obligation on the employer to provide the promised benefits, without regard to any financial arrangements that he may have made. No obligation exists with respect to participants who do not retire during the term of the labor agreement, but the obligation to those who do retire continues beyond the expiration of the labor contract that gave rise to the obligation.