Chapter 9

TICK, TICK, TICK . . . THE PENSION BOMB

I. Defined Benefit Pension Plans in the United States: Arbitration in a Time of Reckoning

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In the United States, defined benefit pension plans have been in the news since 2007. The news is (1) many plans don't have the money to pay the benefits promised, and (2) the days of reckoning for their funding deficiencies are at hand. Many U.S. labor arbitrators have heard disputes involving defined benefit pension plans. Most of those disputes involved negotiation impasses or prosaic breach of contract grievances. But there are other kinds of defined benefit pension disputes that are the most statutorily enmeshed and complex of labor arbitration, and that entail the greatest risk of financial liability for the arbitrator. They are disputes (1) between employers and plan trustees, (2) among plan trustees, and (3) between beneficiaries and trustees. They entail regulations and interpretative decisions that are both extensive and highly technical. This paper will furnish an overview of the pertinent law while attempting to avoid immersion in the minutiae, and will also examine the causes of the funding crisis and the roles that arbitrators are playing in resolving plan-related disputes.

The Concept of Underfunding: A Simple Example

In exchange for services to be rendered, your employer agrees to pay you $200 in ten years. The employer deposits $100 in an investment fund assuming that, in 10 years, it will grow to satisfy that $200 obligation. Has the deposit adequately funded the promise made to you? If this were 2006, the answer would be "Yes" because, in 2006, investments were growing at 8 percent a year

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and were expected to do so forever. An 8 percent return meant that $100 invested one day would grow to $200 a decade later. But times have changed. In 2013, the answer is "No." Today, and for the foreseeable future, the likely rate of return—about 3 percent annually—will see that $100 deposit grow to only $134 in 10 years. Today, the employee's investment account is underfunded by $50 because, today, $150 is needed to meet a $200 obligation due in 2023. The employer must write a check for an additional $50, increasing to $150 the contribution that is payable today.

In reality, the task of determining the current funding requirement for a defined benefit plan is more complex because it entails multiple moving targets. Consider:

- The employer is not funding a single payment, but a retiree's stream of income payable for life, beginning at about age 65.
- If the persons being hired are 25 years old, they won't retire for another 40 years and may draw benefits for 30 years after that. During that 70-year interval, the employer's workforce may grow or shrink, its employee turnover and vesting rates may be high or low, wage rates may change, tax rates may change, profitability may change, the plan's rate of investment return may change, and, thanks to lifestyle changes and medical improvements, the beneficiaries may live to be 120 years old.

Over a 70-year interval, small deviations from the employer's original assumptions will be amplified. Its plan actuary will need to continually reevaluate and adjust assumptions in light of experience, and the employer's current contribution obligations may, as a result, escalate. And there is no easy way out. The benefits must be paid regardless of whether the employer or the pension trust has the money. Hence, the name "defined benefit." So-called "anti-cutback" rules of the Employee Retirement Income Security Act (ERISA) prohibit reducing employees' vested benefits.

During stable economic times, plan funding has generally been manageable because reality has had the good grace to unfold as the plan actuary has fore-ordained. But plan funding can become a problem—it is a problem now—when economic growth slows below what was projected and is forecast to remain low. In the years following 2007, the deviations from actuarial assumptions strayed so far from what was imaginable that plan underfunding has, in many cases, become irremediable.

In the five years preceding the 2007 recession, stocks and real estate produced annual returns of better than 10 percent and Treasury notes and bonds earned 5 percent. So plan actuaries considered an 8 percent return on plan assets to be reasonable. From 2007 on, even half that rate of return can no longer be assumed.

Stocks: 2003 to 2013

In the four years between 2003 and 2008 (point 1 to point 2 in Figure 1), the Dow Jones Industrial Average (DJIA) increased from a little below $8,000 to a little above $13,000, or about 10 percent annually. Between 2007 and today (point 2 to point 4), the annual increase has been about 3 percent.

Figure 1. Dow Jones Industrial Average—January 1, 2003 to April 15, 2013

Commercial Real Estate: 2003 to 2011

Between 2003 and 2007, commercial real estate increased about 14 percent annually. In the succeeding five years, it has crept back to its 2007 level (see Figure 2).

Figure 2. Property Values—2003 to 2012.

Bonds

The yields on 10-year and 30-year federal debt have dropped to about 2 percent and 2.5 percent, respectively (see Figures 3 and 4).[2]

Other Causes of Underfunding

To aid the economic recovery, the Federal Reserve has kept interest rates low. The corporate bond rates used to compute the present values of future pension benefits have been correspondingly low. Those bond rates are the basis for calculating present values and their low rates have, consequently, decreased present values. Thus, one of the consequences of the Fed's "priming the economic recovery pump" with low interest rates has been to require employers to divert capital away from hiring and expansion and into pension funding.

In the public sector, where ERISA does not apply, benefits promised at the bargaining table have often not been adequately budgeted for. During the recession, when hard choices had to be made between using dwindling tax revenues to keep the parks open,

[2]From 2001 through 2006, the federal government stopped selling 30-year Treasury bonds and sold only 10-year notes.

Figure 3. 10 Year Treasury Note (Historical Yields).

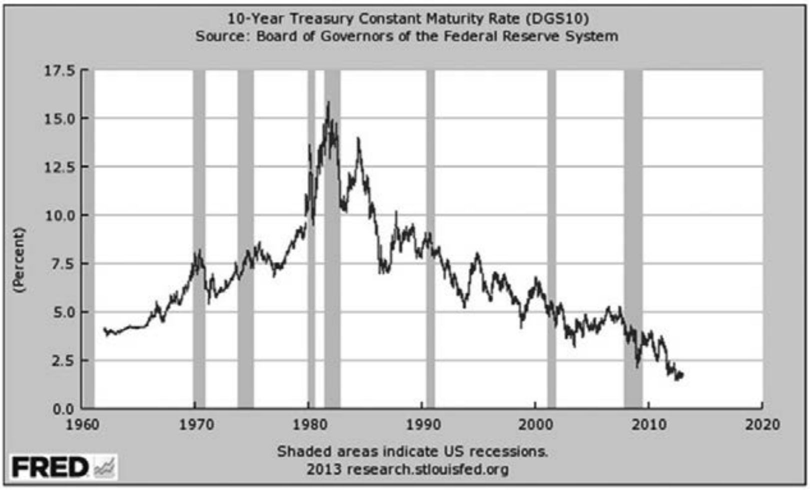
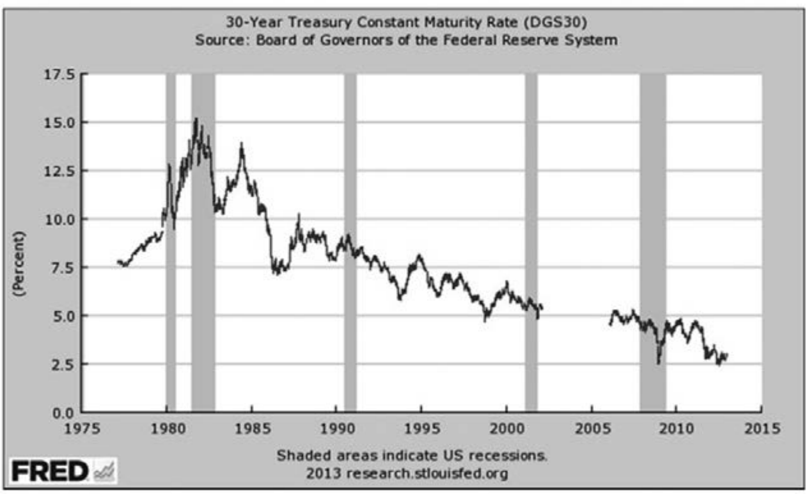


Figure 4. 30 Year Treasury Bond (Historical Yields).



collect the trash and plow the streets, paying pension obligations has sometimes been given a lower priority than funding essential services. Until recently, the payment of pension obligations could be deferred beyond the horizon of political consequences. Today, thanks to changes in accounting rules promulgated by the Governmental Accounting Standards Board (the GASB), about which more will be said, that horizon has been crossed and we are seeing the result play out in political arenas.

Where retirement benefits have been based on the employee's last several years' earnings, some public employees and employers have boosted overtime and income in those years. Referred to as "pension spiking," this has been the exception and not the rule.

Tranches of the riskiest portions of mortgage loans were camouflaged in derivatives that obfuscated their risk. The three bond rating agencies—Fitch, Moody's, and Standard & Poor's—blessed them as AAA. And plan trustees purchased them, believing the ratings.

Delaying the Day of Reckoning

Even though, by 2009, investment returns had declined from about 8 percent to about 3 percent, public employers (again, not governed by ERISA) were still using unrealistic forecasts in order to postpone recognizing the extent of their unfunded liabilities (see Figure 5).

As of 2013, unrealistically high rates of return (and, therefore, discount rates) have persisted.

- CalPERS, the California Public Employees' Retirement System, still assumes a 7.25 percent rate of return.
- Illinois: As of 2013, Illinois was assuming a rate of 8.2 percent.
- Private industry: Until recently, the 100 top U.S. public companies with plan assets of $1.3 trillion had been imputing a 7.5 percent rate of return.[3]

For all companies in the S&P 500, the total unfunded pension liability is about $350 billion (see Figure 6).

The Pension Benefit Guaranty Corporation (PBGC) protects beneficiaries of private sector pensions. The maximum annual benefit in 2013 is $57,500. A March 5, 2013 Government Accountability Office report titled "Multiemployer Plans and PBGC Face

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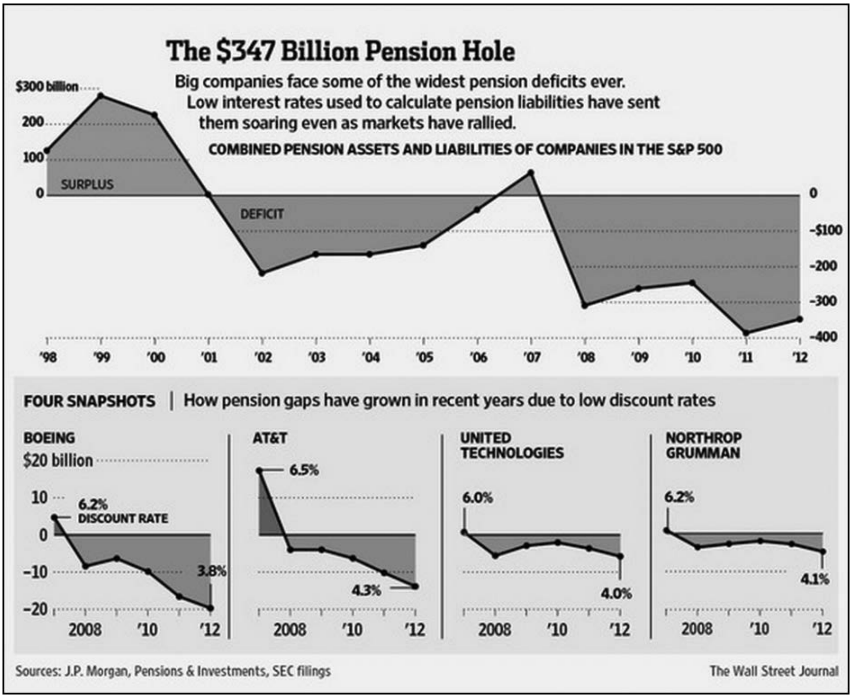
[3]Data source: the actuarial firm of Milliman, Inc.

Figure 5. Five States with the Largest Unfunded Pension Liabilities.

Urgent Challenges"[4] stated that, in 2012, the PBGC's liability for multiemployer plans that are insolvent or expected to become insolvent within a decade was $7 billion. To cover that $7 billion

[4]U.S. Government Accountability Office, Private Pensions: Multiemployer Plans and PBGC Face Urgent Challenges, Testimony Before the Subcommittee on Health, Employment, Labor and Pensions, Committee on Education and the Workforce, House of Representatives (statement of Charles Jeszeck, Director, Education, Workforce, and Income Security Issues), *available at* http://www.gao.gov/assets/660/652687.pdf.

Figure 6. The $347 Billion Pension Hole.



liability, the PBGC had $1.8 billion in assets in 2012. PBGC officials project that expected claims will exhaust the fund in about 2023, at which point retirees will see their benefits dwindle to a fraction of their original value, because the source of those payments will be the reduced stream of insurance premiums that the PBGC will be receiving.

The Factors That Brought Underfunding to a Head

Three factors have accelerated the day of reckoning for underfunded plans.

(1) In 2012, the GASB changed the disclosure guidelines for governmental entities (non-federal) by requiring that unfunded pension liabilities be plainly stated. Making that disclosure has often lowered bond ratings and increased borrowing costs for states, counties, municipalities, and

other non-federal governmental entities. This disclosure has increased the public's awareness of the magnitude of the problem and, in some instances, has engendered a political and politicized response.

(2) In 2011, the Financial Accounting Standards Board increased the already significant disclosure requirements for private multiemployer pension plans.
(3) The Pension Protection Act of 2006 requires corporations to remedy the unfunded status of their plans sooner than the 30 years that had previously been allowed.

These new disclosure and compliance requirements have removed the elasticity that had been available for employers to reallocate funds, to modify actuarial assumptions, to disguise their liabilities, and, thereby, to further postpone recognizing the true magnitude of their pension debts. As described by one observer, "all the knobs and levers that can be pulled to delay Armageddon have already been used."[5]

Today, employers are attempting to extricate themselves from their plan obligations. Often, those attempts are being contested and those contests are being arbitrated. The result has been an increase in the volume of pension arbitration cases, a volume that will likely increase in the years to come. The cases fall into six general categories:

(1) Disputes pertaining to Employee Benefit Claims where the plan document provides for arbitration of those matters.
(2) The Resolution of Impasses between Trustees of Joint Employee Benefit Trusts,[6] including impasses under the Pension Protection Act regarding the terms of rehabilitation plans.
(3) Multiemployer Pension Plan disputes dealing with
    - the levels of employee contributions,
    - the terms of the employer's withdrawal or,
    - if the employer is deemed to have withdrawn and to have thereby triggered its withdrawal liability assessment, any

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[5] Andy Kessler, *The Pension Rate-of-Return Fantasy,* Wall St. J. (U.S. ed.), Apr. 10, 2013, at A13.

[6] Under the Labor-Management Relations Act of 1947, 29 U.S.C. §§141–197 (2012), employees and employers must be equally represented in the administration of pension funds. If there is deadlock in the administration of such a fund, the two groups may seek an impartial umpire to decide the case.

challenge to that assessment (which, under ERISA, is subject to mandatory arbitration).

(4) Public sector interest arbitration disputes over employer/employee contributions, benefits, inclusiveness, and conversion into cash balance or other defined contribution plans.

(5) Collective bargaining agreement disputes, where the issue pertains to claimed breach of an agreement provision dealing with a pension and related arbitrability issues.

(6) Arbitrations that arise following litigation, in which the arbitrator, rather than the court, is asked to resolve the underlying dispute that gave rise to the litigation.

II. Panel Discussion

The panelists, each experienced in various aspects of the arbitration of pension disputes, discuss the varieties and complexities of the cases they have heard, the lack of precedent for and the internal inconsistencies of the law they are required to apply, and the unique fiduciary relationships that pertain. They offer advice to labor arbitrators contemplating accepting appointment to such cases.

Moderator: **Mark I. Lurie,** National Academy of Arbitrators, West Palm Beach, FL

Panelists: **Norman Brand,** National Academy of Arbitrators, San Francisco, CA

Ira F. Jaffe, National Academy of Arbitrators, Potomac, MD

Catherine Harris, National Academy of Arbitrators, Sacramento, CA

John E. Sands, National Academy of Arbitrators, Roseland, NJ

Mark L. Irvings, National Academy of Arbitrators, Brookline, MA

Mark I. Lurie: John, how did you get your first pension case?

John E. Sands: After law school, I worked for a law firm that represented unions and employee benefit funds. As the new associate, I represented the employee benefit funds. This was pre-