



**WEAVING THE SAFETY NET FOR AN AGING WORLD:
LESSONS LEARNED FROM THE PENSION AND
INSOLVENCY SYSTEMS OF THE US, THE UK, AND
GERMANY**

by James H.M. Sprayregen, and James J. Mazza

**Meeting held on
27-28 April 2006**

This document reproduces a report by Mr. James H.M. Sprayregen, and James J. Mazza written after the Fifth Forum for Asian Insolvency Reform (FAIR) which was held on 27-28 April 2006 in Beijing, China. It will form part of the forthcoming publication “Legal & Institutional Reforms of Asian Insolvency Systems”.

CORPORATE AFFAIRS DIVISION, DIRECTORATE FOR FINANCIAL AND ENTERPRISE
AFFAIRS
ORGANISATION FOR ECONOMIC CO-OPERATION AND DEVELOPMENT
2 RUE ANDRÉ-PASCAL, PARIS 75116, FRANCE
[HTTP://WWW.OECD.ORG/DAF/CORPORATE-AFFAIRS/](http://www.oecd.org/DAF/corporate-affairs/)

WEAVING THE SAFETY NET FOR AN AGING WORLD: LESSONS LEARNED FROM THE PENSION AND INSOLVENCY SYSTEMS OF THE US, THE UK, AND GERMANY

*by James H.M. Sprayregen, and James J. Mazza**

1) Introduction

A Chinese proverb says “respect for one’s parents is the highest duty of civil life.” These words carry particular significance today. As life expectancies increase and birth rates fall around the world, the global population is aging rapidly. This phenomenon already has reached a critical point in many developed nations. In 1995, there were 1.3, 2.3, 2.6, 2.7, 3.6, and 4.2 workers per retiree in Italy, Germany, Japan, the United Kingdom, Canada and the United States respectively. By the year 2050, it is predicted that there will only be 0.7, 1.2, 1.5, 2.1, 1.6 and 2.3 workers respectively per retiree in these countries.¹ Meanwhile, developing nations are also in the midst of a major demographic shift. Indeed, while nearly 60 percent of the elderly currently live in developing countries, that percentage is projected to increase to 80 percent by 2050. In developing economies such as China, Indonesia, and Korea the percentage of these countries’ populations over 60 is expected to be over 30 percent by 2050. In a trend similar to that in developed countries, the ratio of workers to the elderly in China is expected to drop from 9:1 to 2.6:1 over the next 40 years.²

* Mr. Sprayregen, a partner of Kirkland & Ellis LLP, heads the firm’s international restructuring practice. He is widely recognised as one of the world’s leading restructuring lawyers, serving as debtor’s counsel in such cases as United Airlines, Calpine, Conseco and Collins & Aikman. Mr. Mazza is an associate in the restructuring group of the firm’s Chicago office. The views expressed herein are those of the authors.

With fewer workers to support pensioners in developed countries, these nations currently have daunting agendas of pension reform, which include substantial overhauls of government supported social security systems. In addition, corporations in these countries currently offering occupational pension plans, particularly defined benefit pension plans, are finding it difficult to sustain these retirement vehicles for employees. Indeed, it is fair to say that certain developed nations, such as the US and the UK, are in the throes of a defined benefit pension crisis. Germany, which does not rely as heavily as the US and UK on funded pension systems, is also, nevertheless, experiencing certain problems in this arena. Each of these countries' respective experiences with defined benefit pension plans provide some lessons for developing countries to consider as they formulate their own occupational pension systems and their corresponding insolvency laws.

2) The United States

The coalescence of a number of forces in recent years, including a decline in the US stock market, the lowering of interest rates, and an increase in the ratio of retirees to active workers, has saddled US employers with massively underfunded defined benefit pension plans.³ Defined benefit plans, which set the level of benefits that an employee will receive upon retirement, place the risk of loss of pension plan assets on employers. Thus, if, for example, a defined benefit pension plan's investment returns are lower than expected, then assets in the plan may not be sufficient to pay retirees their benefits. As a result, the plan is deemed underfunded, and the employer is responsible for the difference. This is in contrast to defined contribution plans where employees make contributions to retirement accounts and bear the risk of loss in the event of a market decline.

In 2005, corporate America's unfunded pension liabilities were estimated to be USD (United States dollars) 146 billion.⁴ As a result, companies in the United States with burdensome pension "legacy" costs increasingly have been turning to Chapter 11 of the United States Bankruptcy Code to eliminate the effects of these obligations on their balance sheets and remain competitive in the global marketplace.

Pension termination

The basic principles of pension plan termination in the United States' Chapter 11 context are as follows. Under the Employee Retirement Income Security Act of 1974 (ERISA), a pension plan sponsor may terminate its defined benefit pension plan if, among other things, a bankruptcy court finds that termination of that plan is necessary for the sponsor to operate outside

of bankruptcy.⁵ This is often referred to as “voluntary” or sponsor-initiated termination. The Pension Benefit Guaranty Corporation (PBGC), which is the quasi-governmental agency that insures and oversees the defined benefit pension system in the United States, may approve a sponsor-initiated “distress termination” of a pension plan if certain termination criteria are met.⁶

But the PBGC may not process a sponsor-initiated termination that “would violate the terms and conditions of an existing collective bargaining agreement.”⁷ The plan sponsor must obtain relief from its collective bargaining obligations under Section 1113 of the Bankruptcy Code, which affords special protection to these contracts. In contrast, in ERISA §4042, Congress vested in the PBGC the right to seek an “involuntary” termination of a pension plan if it determines that, among other things, the plan has not been properly funded, or the PBGC’s possible long-run loss with respect to the plan may reasonably be expected to increase unreasonably if the plan is not terminated.⁸ It is important to note that the PBGC may terminate a pension plan under ERISA §4042 notwithstanding any alleged limitations that may exist in the plan sponsor’s collective bargaining agreements with its unions.⁹

For example, in the United Air Lines, Inc. Chapter 11 case, the PBGC agreed through a settlement with the company to terminate the company’s defined benefit pension plans by invoking its involuntary termination power, thereby abrogating the need for the company to seek Section 1113 relief in its Chapter 11 case from its collective bargaining agreements, which had required maintenance of defined benefit pension plans. The PBGC accepted a package of consideration from United (including notes—some of which are contingent on the reorganised company satisfying certain performance metrics—and stock) in exchange for settling all pension issues with the company. Although a number of United’s unions challenged PBGC’s power to enter into such an agreement with an employer, the courts have upheld United’s settlement agreement with the PBGC.¹⁰

PBGC’s role after termination

Upon an employer’s termination of a defined benefit pension plan through the Chapter 11 bankruptcy process, the PBGC takes over the plan and administers it going forward by, among other things, paying pension benefits up to a guaranteed amount to plan participants. The maximum PBGC guaranty is capped at approximately USD 47 000 per year and depends on factors such as a retiree’s age. However, because pension plans terminated in the bankruptcy context often do not have sufficient assets to pay plan participants’ statutorily guaranteed benefits, the PBGC is now

running a deficit of approximately USD 24 billion as a result of terminated, unfunded benefit plans. With some three-quarters of the companies on the S&P 500 index having defined benefit pension plans and PBGC estimating its future exposure at approximately USD 108 billion on account of future plan terminations, some believe that the defined benefit pension crisis in the US has yet to reach a crescendo.¹¹

The PBGC's rights

While ERISA provides the PBGC with certain statutory lien rights to protect itself when certain events occur in connection with an underfunded pension plan (*e.g.* the sponsor ceases making minimum funding contributions), after a Chapter 11 filing is commenced, the Bankruptcy Code's automatic stay generally prevents the PBGC from attaining secured or priority status in a bankruptcy case. The PBGC has crafted many arguments over the years in an attempt to increase its recovery in bankruptcy cases, but has had little success in bankruptcy courts. The PBGC has thus lobbied diligently for a change in the Bankruptcy Code's priority scheme to protect its interests. The PBGC has also sought to change ERISA's minimum funding rules to help prevent plans from becoming too underfunded in the first place. However, it has not succeeded in these endeavours.

While the PBGC has yet to improve its own position through its lobbying efforts, PBGC's very existence has mitigated the impact of the defined benefit crisis in the US by providing retirees who lose their pension benefits with some recovery. Indeed, certain workers' earned pension benefits may not be affected at all in a bankruptcy case because PBGC's statutory guaranty will cover them.¹² The question remains whether the PBGC will be able to sustain itself over the years if it takes over responsibility for many more underfunded pension plans.

Transition to defined contribution plans

It should also be noted that the trend in the US (and other countries) is now toward employer offerings of defined contribution plans in lieu of defined benefit plans. Thus, employees will bear the market risk of a diminution in pension assets in the future. "As a general matter, worker interests in defined contribution plans are not affected by corporate reorganisations or bankruptcy."¹³ This does not mean, however, that defined contribution plans are fully protected, because the funds in an employee's defined contribution account ebb and flow with the vicissitudes of the market, thereby leaving workers exposed to potential pension benefit loss.

The Enron bankruptcy case in the United States highlighted this stark reality.¹⁴ In that case, employees' defined contribution plans were heavily invested in Enron's stock, which was rendered worthless as a result of the company's bankruptcy filing. In addition, under US pension law, Enron's rapid stock decline prevented employees from unloading the Enron stock in their defined contribution accounts. Thus, with Enron employees chained to a rapidly declining stock, their defined contribution plans suffered significant diminutions in value.

3) The United Kingdom

The US is not alone in its pension crisis. A number of British businesses face similar issues, including British Airways and Corus, which operate respectively in the airline and steel industries. Both have been protagonists in the US defined benefit pension crisis.¹⁵ Pension liabilities have also struck the British retail industry by derailing takeover bids at Marks & Spencer and WH Smith.¹⁶ Approximately 60 000 people have lost part or all of their pension benefits in the United Kingdom as a result of recent pension terminations there.¹⁷

The Pensions Act of 2004

The British government recently passed legislation (the Pensions Act of 2004) to stem the tide on the country's pension problem. The act has introduced the Pension Protection Fund (PPF), which is modelled after the United States' PBGC, to pay compensation to members of defined benefit pension plans when an employer becomes insolvent or when there are insufficient assets to cover guaranteed levels of PPF pension compensation.¹⁸ Like the PBGC, the PPF is not supported by the government. Rather, it is funded by compulsory premiums charged to employers with pension plans covered by the PPF's programme. In addition, benefits are capped at approximately GBP (United Kingdom pounds) 25 000 per year. Finally, the Pensions Act has effectively increased employer's pension funding requirements by adding in a risk based premium, which is calibrated to the risk of a particular plan's termination (including its underfunded status). To avoid this risk premium, some British companies have been using creative means to remedy their plans' underfunded status. For example, Marks & Spencer used capital raised from a debt issuance to improve its plan's funding status.¹⁹

Powers of the pension regulator

Where a British pension scheme is underfunded and the principal employer of the scheme is subject to an event (for example a takeover, sale of assets, or payment of dividend) the Pensions Regulator (TPR—an ombudsman created by the Pensions Act), may seek to secure extra financial support for the pension scheme by issuing a financial support direction (FSD) or contribution notice (CN). These demands may be issued against the principal employer or a group company, which directly or indirectly holds more than 30% of the principal employer’s share capital (“associates” and “connectees”).

An FSD can only be issued where the principal employer is a service company (*i.e.* the only income of the principal employer is from supplying services to the group), or the value of the assets of the principal employer and its associates/connectees is less than 50% of the scheme when valued on a buyout basis (the cost of purchasing annuities to provide all the benefits that the scheme promises). Meanwhile, a CN may only be issued where the employer has acted with a purpose so as to avoid pension liabilities—the valuation basis for any liability being calculated on a buyout basis.

It should be noted that for either an FSD or a CN to be issued, the pension scheme must be underfunded on an FRS17 basis—the pension valuation accounting standard used by UK companies—and an event must have occurred. Additionally, a CN can be issued against a natural or legal person whereas an FSD can only be issued against a corporation. An FSD can be issued up to a year after an event, and a CN can be issued up to six years after an event.

4) Germany

Germany, in contrast, does not rely heavily on funded pension plans. The German system is based on a three-tier system of pensions. The first tier is the state-run mandatory pension system (Rentenversicherung),²⁰ which covers all employees and certain other beneficiaries. The second tier is made up of company-sponsored occupational pension schemes (Betriebliche Altersvorsorge), while the third tier consists of private pension planning. Companies are not required to offer pensions at all, but if they offer pensions they need to abide by mandatory law (Gesetz zur Verbesserung der Betrieblichen Altersversorgung)²¹ which prescribes, *inter alia*, how pensions fare in a restructuring or an insolvency of the company.²²

In contrast to the US and the UK, the second tier company sponsored pension plans usually do not need to be “funded” and they are backed by the

general assets of a company (as opposed to a specific asset pool set aside for the beneficiaries).²³ The liabilities are recorded as general unsecured liabilities of a company. Accordingly, there are no “underfunded” pension plans—as long as the corporation is solvent, the pension obligation is deemed to be covered. If the company commences a formal insolvency proceeding, a collective insurance scheme (the Pensionsicherungsverein, or PSV) takes over.

The PSV is funded through contributions of those companies that have non-funded pension plans.²⁴ In an insolvency, the PSV assumes the pension liabilities and is subrogated (as a general unsecured creditor) to the claims of the beneficiaries.²⁵ Because of the historically low return to unsecured creditors in German insolvencies, the PSV usually has to shoulder the burden of an insolvency, and there is an increasing trend by distressed investors in Germany to strategically use insolvency proceedings to shed burdensome pension liabilities.²⁶ The PSV has already raised concerns as to its financial health based on demographic trends in Germany (particularly, an aging populace) and waning contributions to the PSV as a result of German corporations’ transition to pension plans not covered by the PSV.²⁷ It will be interesting to see how Germany deals with its upcoming pension problem and whether there will be an increasing trend towards “funded” pension plans.

5) Lessons learned

While the recent experience in developed countries is no doubt unique—particularly in the US where employer defined benefit plans have been battered by a “perfect storm” as the US stock market has declined and America’s so-called “baby-boomer” generation has reached retirement age—developing countries may still glean some important lessons. As occupational pension plans became more generous in developed economies, particularly in the United States, they became less sustainable for businesses operating in a competitive global marketplace. With more businesses turning to insolvency, and the respective institutional pension backstops in the US, UK, and Germany likely to be facing their own financial problems in upcoming years, consideration will be given to providing these key players with more protection in insolvency proceedings. After all, without such backstops, many pensioners would be even worse off. Any additional protections afforded to pension insurers would have to be considered cautiously, however, as overbroad rights for these parties could stifle reorganisation proceedings designed to maximise the value of corporations by maintaining their healthy core operations. Other approaches, such as

higher pension premiums to increase revenues of pension insurance funds, might also be considered.

With corporations' transitioning toward defined contribution systems, new challenges lie ahead, as evidenced by the Enron experience in the United States. Provided that employees are given control over their investments, employees will have the opportunity to manage their own retirement responsibly, and the situation that occurred in Enron could be avoided. While corporations in developing countries, which are also in the midst of profound demographic change, embark on implementing new occupational pension plans to attract and retain talented employees, they would be well advised to monitor the state of occupational pension plans in developed countries. While developed countries attained their economic prosperity before their populations became too old, developing countries are getting old before they ultimately get rich. Thus, while developing countries can assess with hindsight the occupational pension mistakes made in developed countries, their situation is somewhat precarious as an aging population will need support for years to come from economies that have yet to hit their stride.

-
- ¹ Congressional Testimony by James B. Lockhart III, Deputy Commissioner, Social Security Administration (18 May 2004).
- ² Trinh, Tamara (2006), "China's Pension System: Caught Between Mounting Legacies and Unfavourable Demographics", Deutsche Bank Research.
- ³ The Economist (2005), "Corporate America's Legacy Costs: Now for the Reckoning", 13 October 2005.
- ⁴ Levitt, Harry (2006), 22 No. 2 Journal of Compensation & Benefits.
- ⁵ See 29 USC. §1341.
- ⁶ *Id.*
- ⁷ See 29 USC. §1341(a)(3).
- ⁸ See 29 USC. §1342(a).
- ⁹ See 29 USC. §1341(a)(3).
- ¹⁰ In re UAL Corp., 428 F.3d 677 (7th Cir. 2005) (Circuit Court ruling affirming lower courts' approval of United-PBGC settlement agreement).
- ¹¹ Indeed, the US Congressional Budget Office estimates that PBGC's shortfall will expand to USD 86.7 billion by 2015.
- ¹² In contrast, other employee losses (such as wage or job loss) suffered by employees in US bankruptcy cases are provided fewer protections. For example, the US Bankruptcy Code only allows workers unsecured, priority claims against their employer of up to USD 10 000 for unpaid wages earned up to 180 days prior to the company's bankruptcy filing. 11 USC. §507(a)(4). If the employer ultimately fails to emerge from bankruptcy, then the employee may not be paid for lost wages because his or her claim will only be paid after claims of higher priority (*e.g.* secured or other priority creditors)

are paid in full. As one commentator sees it, the US system relies on market forces to correct temporary setbacks such as job or wage loss, rather than an institutional backstop such as the PBGC. See Willborn, Steven L. (2004), “Workers in Troubled Firms: When Are (Should) They Be Protected?”, U. Pa. J. Lab. & Empl. L. 35. An employee that loses his or her job can simply look for another job at another company. On the other hand, loss of a benefit such as pension compensation, which has taken considerable time to earn, requires some sort of social safety net, because an employee cannot simply turn to the marketplace to recoup their loss.

¹³ Willborn, Steven L. (2004), “Workers in Troubled Firms: When Are (Should) They Be Protected?”, U. Pa. J. Lab. & Empl. L. 35.

¹⁴ *Id.*

¹⁵ *The Economist*, *supra* note 3.

¹⁶ *Id.*

¹⁷ Hewitt Associates (October 2004), UK Pension Rules (Part I).

¹⁸ Risk Based Levy Update, Comp. Law. 2006, 27(1), 22 (2006).

¹⁹ See Hewitt Assocs., *supra* note 17.

²⁰ See Schaub ArbR-Hdb. §80 *et seq.* for a detailed description of Rentenversicherung.

²¹ Gesetz zur Verbesserung der Betrieblichen Altersversorgung (BetrAVG) vom 19.12.1974, BGBl. I, S. 3610.

²² See §7-15 BetrAVG.

²³ See Mercer Human Resource Consulting (2005), *Pension Funding in Germany*, June 2005, for a more detailed overview.

²⁴ See §10 BetrAVG

²⁵ See §7(1) and (2) BetrAVG

²⁶ In certain defined circumstances the PSV can also take over pension obligations in an out-of-court restructuring (see §7(1)(2) BetrAVG). However, the instances where the PSV has consented to such an out-of-court restructuring are rare as the PSV usually wants to avoid creating a precedent, thus incentivising companies to offload their pension liabilities in an out-of-court restructuring.

²⁷ Companies can opt out of the PSV or significantly lower their contributions to the PSV by converting to “funded” models or by transferring their pension liabilities to a third party such as a pension insurance fund or life insurance company. Alternatively, the companies can opt to segregate an asset pool (Pensionsfonds) and back pension obligations with external investments as is the case in other countries such as the United States and United Kingdom (see “German Pensions Insolvency Protection Fund Proposes Move to a Full-Funding Model”, *European Pensions and Investment News*, May 2005, for more details).