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Defined Benefit Plan Provisions of the Pension Protection Act of 2006

The newly-enacted Pension Protection Act of 2006 (the "Act") includes many changes for both defined benefit and defined contribution plans. A significant number of those changes focus on the ongoing funding crisis affecting defined benefit plans.

In recent weeks, the Benefits Law Group issued News Alerts summarizing the impact of the Act on defined contribution plans, particularly the Act's automatic enrollment and fiduciary provisions.

This News Alert addresses the ways in which the Act modifies the minimum funding requirements for defined benefit plans under the Employee Retirement Income Security Act of 1974 ("ERISA") and the Internal Revenue Code (the "Code"), imposes limitations and additional funding requirements on plans that are considered "at risk" or "endangered," and expands a plan sponsor's obligation to notify plan participants and beneficiaries of the plan's funded status. Most of these provisions are effective for plan years beginning after December 31, 2007.

Funding of Defined Benefit Plans

In general, the Act requires that all single-employer defined benefit plans be fully funded within a seven-year period, beginning in 2008. The Act replaces the prior rules for funding single-employer defined benefit plans with a new standard that hinges solely on the plan's funded status. The general principle is that a plan's required contribution equals the present value of benefits earned by participants during the current year, plus the amount needed to amortize any funding shortfall over the seven-year period.

Plan Liabilities. Funding must be determined using specified interest rates and mortality tables for calculating a plan's costs and liabilities and the present value of a participant's benefit. Current liability is determined using an interest rate assigned to one of three segments based on when benefits are expected to be paid (0-5 years, more than 5 years up to 15 years, over 15 years). The interest rate is based on a corporate bond yield curve averaged over two years, or, at the plan sponsor's irrevocable election, a single blended rate (also based on a yield curve). The corporate bond yield curve rates will be phased in over three years beginning in 2007, resulting in the blending of those rates with current rates, until full implementation in 2010.

The Act also requires the Department of the Treasury to establish a new mortality table for valuing benefits, to update the table every 10 years, and to establish a separate table for disabled participants. Actuaries also will be required to apply assumptions regarding participants' likelihood of electing optional forms of distribution more valuable than the normal form in determining the plan's liabilities.

Note on Lump Sums: The Act also includes provisions that change the method for calculating lump sums and the limits on lump sums. Lump sum distribution calculations can continue to be made using the 30-year Treasury bond rates until 2008, when the three-segment approach starts phasing in. The Treasury bond rate will typically be higher, resulting in smaller lump sum payments. However, the Section 415 benefit limit on such distributions is to be calculated separately, *beginning in 2006*, using an interest rate that is the greatest of (1) 5.5%; (2) the plan's rate; or (3) the rate that would provide a benefit of not more than 105% of the benefit that would be provided

using the lump sum distribution rate. We anticipate that guidance will be issued to address those lump sums paid in 2006, before the Act became law, that were limited using the incorrect interest rate.

Plan Assets. Although plan assets continue to be valued at fair market value as of a specified valuation date, the Act will permit less flexibility in the smoothing permitted for market fluctuations. The Act reduces the longest permissible averaging period from five years to two years and requires that the value fall between 90% and 110% of fair market value on the valuation date. Contributions made after the valuation date cannot be included in this valuation unless they are made on account of an earlier plan year.

Funding Status and Contributions. Ultimately, a plan's liabilities and assets will be compared to determine whether the plan is overfunded, funded, underfunded or "at risk." The plan sponsor's minimum required contribution for a plan year will be the plan's target normal cost and that year's shortfall amortization installment. Adjustments will be made for funding waivers and any carryover of funding standard account or prefunding balances.

- The target normal cost is the present value of all benefits that are expected to accrue under the plan during the plan year, including any prior year benefit accruals that increase due to compensation increases in the current year. The liability for these benefits is determined using the actuarial assumptions described above.

- The shortfall amortization installment is determined by calculating level annual installments over seven years of any shortfall of plan assets compared to the plan liabilities. If plan assets increase beyond the present value or remaining installments, the shortfall is recalculated. Payment or recalculation is required until the value of plan assets at least equals the value of benefit liabilities. The shortfall is phased in for 2008, 2009 and 2010, comparing plan assets to a lesser percentage of the plan's liabilities, at 92%, 94% and 96%, respectively.

Underfunded Plans. Plans that are less than 80% funded will be deemed to be "at risk," and will be subject to additional contributions and funding assumptions. This 80% "at risk" standard will be phased in over a four-year period (65% in 2008, 70% in 2009, 75% in 2010 and 80% in 2011). Small plans (500 or fewer participants) will not be subject to the additional at risk contributions, while collectively bargained single-employer plans that are at risk will not be subject to the additional at risk contributions until the earlier of the expiration of the collective bargaining contract or plan years beginning in 2010.

If a plan is at risk, there are restrictions on the funding of executive compensation and on the ability to increase plan benefits. An amendment increasing benefits is also prohibited if, taking into account the amendment, the plan would be considered to be at risk. Plans that are less than 60% funded are also prohibited from triggering shutdown benefits and from paying lump sums, and benefit accruals must be frozen.

The Act also adds new funding rules and benefit limitations for multiemployer plans, categorizing a plan that is less than 80% funded as "endangered" or "seriously endangered," and a plan that is less than 65% funded as "critical." If a plan has been certified by an actuary as critical, the plan sponsor may provide for cutbacks in benefits or an increase employer contributions, or both. The Act's endangered and critical provisions offer only a limited opportunity for relief, as they sunset in 2014.

Notice of Funding Status

Administrators of single-employer defined benefit plans will be required to send out an annual funding notice due 120 days after the beginning of the plan year. This notice must include detailed information on the plan's funding status, whether the plan is endangered or critical, and how to get a copy of any funding improvement plan or the rehabilitation plan. The notice must be sent to participants, beneficiaries, contributing employers, unions and to the PBGC. Plans with fewer than 100 participants may send out this notice when the plan's Form 5500 is filed.

Impact on Plan Design

The Act imposes substantial cash demands on sponsors of defined benefit plans and offers protection for certain alternative plan designs. As a result, the Act makes alternative plan designs such as cash balance plans and DB(k) plans more appealing to employers. These alternatives will be the focus of our next News Alert.

For more information regarding the Pension Protection Act and how it may affect your qualified plans, please contact a member of the Benefits Law Group.

Jane Francis
jfrancis@hollandhart.com
(303) 295-8599
Denver

Irene Gallagher
igallagher@hollandhart.com
(303) 295-8270
Denver
(208) 383-3957
Boise

Rebecca Hudson
rhudson@hollandhart.com
(303) 295-8005
Denver

Elizabeth Nedrow
enedrow@hollandhart.com
(406) 252-2166
Billings

Sheldon Smith
ssmith@hollandhart.com
(303) 295-8540
Denver

Leslie Thomson
lthomson@hollandhart.com
(406) 252-2166
Billings

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Beth Nedrow, Holland & Hart LLP, 401 North 31st Street, Suite 1500, Billings MT 59101
Phone: 406-252-2166 | enedrow@hollandhart.com