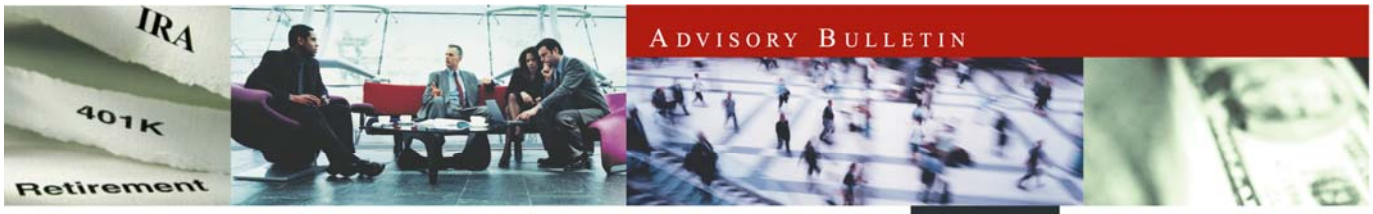

THOMPSON HINE

August 2006

PENSION PROTECTION ACT OF 2006

On August 17, 2006, the President signed into law the Pension Protection Act of 2006 (the "Act") encompassing pension funding reform, new cash balance requirements, participant investment enhancements, retirement savings provisions and other important benefit plan law changes. The following portion of this Advisory Bulletin highlights **certain** important law changes from the Act. For further information, please contact any member of the Thompson Hine Employee Benefits and Executive Compensation Group listed at the end of this Advisory Bulletin.

PENSION FUNDING REFORM

Executive Summary: The Act requires full funding over seven years, beginning in 2008. However, special phase-in and contribution rules dramatically impact this seven year funding and create certain incentives to "pre-fund" plans to certain levels, both before and after 2008.

- **New Seven Year Funding.** Beginning in 2008, an employer must fund 100% of the liability of a single employer defined benefit pension plan over seven years. The employer must make a "shortfall" contribution each year to eliminate the plan's funding shortfall. The plan's liability is determined using a new three-segment "yield curve" interest rate structure based on corporate bond rates averaged over 24 months (and subject to 1/3 phase-in percentages for 2008 and 2009) and a new mortality table to be prescribed by the IRS. The plan's assets are averaged over two years and reduced by credit balances (*see* below). After 2008, the funding shortfall is recalculated each year and any incremental shortfall is contributed to the plan over a new seven-year period. (Each year, an employer also must fund the plan's "normal cost", *i.e.,* benefits accrued in that year, with exceptions for certain excess funded plans.)

- **Full Funding Phase-In.** For 2008, 2009 and 2010, an employer need not make a shortfall contribution if the plan meets a minimum funding threshold of 92% for 2008, 94% for 2009 and 96% for 2010 (ignoring credit balances created pre-2008). If the threshold is not met for the year (and each preceding year), the shortfall contributions would begin over a seven-year period beginning with that year and, in any event, in 2011. A new plan or a plan making deficit reduction contributions for 2007 is ineligible for this phase-in rule.

- **Credit Balances Restricted.** For 2008 and thereafter, an employer with a plan in existence in 2007 can continue to use existing "credit balances" (*i.e.,* excess contributions from a pre-2008 year) to offset future required contributions under the new law (*i.e.,* normal cost and shortfall contributions), subject to important restrictions. First, no restriction applies to a plan for which a shortfall contribution is not required for the 2008, 2009 or 2010 plan year (*see* above). Second, if a shortfall contribution is required for any such year but the plan is at least 80% funded for the preceding year (reduced by credit balances created after 2007), the employer can use the credit balances to offset required contributions for the year. However, if a plan is less than 80% funded, the employer cannot use credit balances to offset the required contributions. In both cases, the credit balance is subtracted from assets (as noted), resulting in a higher funding shortfall and contribution.

- **Accelerated "At Risk" Contributions.** Beginning in 2008, a plan that is less than 80% funded will be subject to accelerated "at risk" contributions, if the plan is also less than 70% funded using "at risk" actuarial assumptions (which assume accelerated distribution of benefits and in some cases additional loading factors). The 80% limit is phased-in over three years, at 65% for 2008, 70% for 2009 and 75% for 2010, with the 80% limit applying effective in 2011. The foregoing funded percentages are determined for the preceding year and reduced by credit balances. However, an employer may waive credit balances to increase the plan's funded percentages to avoid "at risk" contributions, but the credit balances cannot be used to offset required contributions. Plans with fewer than 500 participants are exempt from "at risk" contributions.

- **Benefit Limitations.** Beginning in 2008, the Act restricts plan amendments that would increase benefits if, after the amendment, the plan would be less than 80% funded. Next, a plan that is between 60% and 80% funded can provide lump sum payments, but limited generally to 50%. Further, a plan less than 60% funded must be frozen and cannot pay lump sum payments or shutdown or similar benefits. Finally, a plan of a bankrupt employer cannot pay lump sum payments, unless the plan is 100% funded. The lump sum payment restrictions are not applicable to a plan that was frozen before September 1, 2005. The foregoing funded percentages are determined for the current year and reduced by credit

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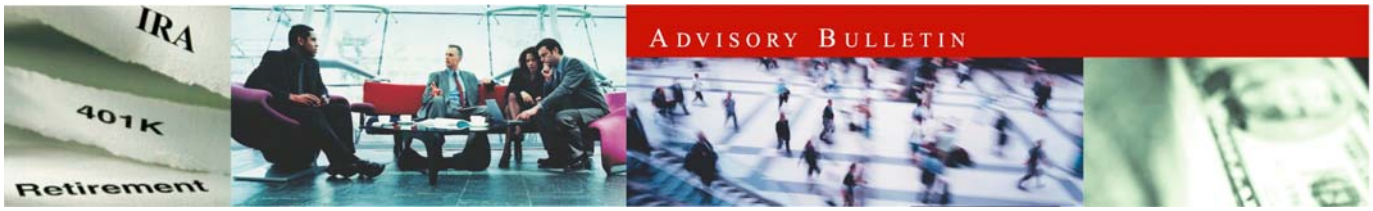

balances. However, an employer may waive credit balances to increase the plan's funded percentages to avoid these benefit limitations, but the credit balances cannot be used to offset required contributions. Also, an employer may post security to the plan to increase the funded percentages and avoid the benefit limitations.

• **Lump Sum Payments.** Beginning in 2008, a lump sum payment will be calculated using the new three-segment "yield curve" interest rate structure based on corporate bond rates (subject to 20% phase-in percentages for 2008, 2009, 2010 and 2011) and the same new mortality table to be prescribed by the IRS for funding purposes.

• **Nonqualified Deferred Compensation Funding Restrictions.** Effective after August 17, 2006, amounts an employer transfers to a rabbi trust to provide nonqualified deferred compensation benefits to its key executives (or amounts subject to a transfer or restrictive provision) will be taxable to the key executives (to the extent vested) and subject to a 20% penalty, if the transfers are made during (or the provision is tied to) a "restricted period". A "restricted period" exists (i) while a pension plan is subject to "at risk" contributions (beginning in 2008), (ii) if the employer of a pension plan is in bankruptcy or (iii) during the 12-month period that begins on the date which is six months before the termination date of an employer's underfunded pension plan.

Action Items: An employer should begin to review the funding status of its plans under the new law as soon as practicable and determine whether to "pre-fund" the plans to various thresholds to (i) minimize future contributions to the plans, (ii) preserve flexibility to increase benefits and (iii) if applicable, preserve ability to make full lump sum payments from the plans.

CASH BALANCE PLANS

Executive Summary: The Act provides that cash balance and other hybrid plans are not inherently age discriminatory if certain plan design requirements are met beginning generally on June 29, 2005. Further, the conversion of a pension plan to a cash balance or hybrid plan must avoid "wearaway," effective for conversions after June 29, 2005.

• **No Age Discrimination.** Beginning generally on June 29, 2005, a cash balance or other hybrid plan is not inherently age discriminatory if the plan provides (i) three year vesting (*see* below) and (ii) interest credits of not more than a market rate (*see* below). However, a plan in existence on June 29, 2005 need not comply with these requirements until years beginning after December 31, 2007. Also, the cash balance formula may be expressed as a hypothetical account balance or current value of the accumulated percentage of the employee's final average pay ("hybrid formula").

• **Three Year Vesting.** The plan must provide three year vesting for any participant whose benefit is determined as a cash balance or hybrid formula.

• **Market Rate Interest Credits.** The plan must provide interest credits (or equivalent) on the hypothetical account or hybrid formula at a rate not less than zero and not greater than a market rate of return. A plan may provide a reasonable minimum guaranteed rate or a rate that is equal to the greater of a fixed or variable rate of return.

• **Conversion Wearaway Prohibition.** The Act prohibits "wearaway" for plans that, after June 29, 2005, convert from a traditional defined benefit plan to a cash balance or hybrid plan. A participant's benefit may not be less than "A+B" where "A" is the accrued benefit before conversion and "B" is accruals after the conversion. A participant's hypothetical account is credited with any early retirement subsidy for which the participant is eligible at retirement.

• **No Whipsaw Calculation.** Effective for distributions after August 17, 2006, a plan may make a single sum distribution which equals the participant's hypothetical account balance or hybrid formula accumulation.

• **Retrospective Relief Unresolved.** The Act states that no inference is to be drawn regarding age discrimination or the calculation of single sum distributions before its applicable effective date.

Action Items: An employer should review its cash balance and hybrid plans to determine the design changes necessary or desirable under the new law, including calculation of lump sum distributions and retroactive compliance for certain prior plan conversions.

PARTICIPANT INVESTMENT

Executive Summary: The Act mandates diversification for employer securities. Further, the Act creates protections from liability for employers who wish to offer investment advice and establish default investment options. Finally, the Act requires additional participant disclosures and information regarding their investment options.

• **Employer Security Diversification.** Beginning in 2007, defined contribution plans must be amended to provide for immediate investment diversification with respect to employer securities attributable to employee elective and after-tax contributions. For matching and nonelective contributions, diversification is required for participants with three years of service. Plan sponsors must notify participants of their diversification right and provide at least three diversified investment option alternatives. Diversification for existing accounts may be phased-in. The new rules do not apply to stand-alone ESOPs, privately held companies and one-participant plans.

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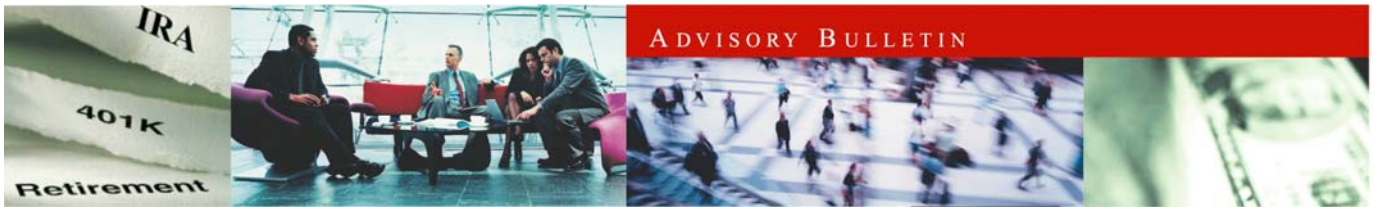

• **Investment Advice.** Beginning in 2007, plan sponsors can select investment advisers to provide advisory services to plan participants. An eligible investment adviser is permitted to advise plan participants for a fee, provided either that the fee is fixed (*i.e.,* not contingent upon the investments selected by the participant) or that the investment advice is generated from a computer model. Arrangements with investment advisers will need to be structured to meet certain requirements and must be audited annually.

• **Default Investments.** The Act relieves plan fiduciaries of liability if they select a default investment option that complies with soon-to-be-issued Department of Labor regulations and provide timely notice to plan participants about their right to make investment elections and how contributions will be invested in the absence of such election.

• **Mapping Investments.** Beginning in 2008, the Act provides fiduciary liability relief to a plan fiduciary who makes a qualified change in investment options, whereby amounts that a participant has directed be allocated to an investment option are reallocated to a different investment option with similar characteristics and timely notice of the change is provided to plan participants.

• **Benefit Statements.** Beginning in 2007, plan sponsors must provide quarterly benefit statements for defined contribution plans with participant-directed investments and annual statements for plans with only company-directed investments. For defined benefit plans, plan sponsors must provide a benefit statement every three years or notify participants annually of the availability of a benefits statement.

Action Items: An employer should immediately determine whether its plans are affected by the new employer security diversification requirement and make necessary plan design changes to comply with the new law by 2007. Further, an employer should consider whether to arrange for investment advisory services for plan participants. Finally, an employer should review its default investments, participant notices and benefit statements for compliance with the new law.

RETIREMENT SAVINGS

Executive Summary: The Act encourages retirement savings by adopting an ADP/ACP testing safe harbor for automatic enrollment, making EGTRRA provisions, which were set to expire in 2011, permanent and improving portability. The Act also requires accelerated vesting for non-elective contributions.

• **Automatic Enrollment.** Effective in 2008, the Act creates a safe harbor from nondiscrimination testing to encourage employers to offer automatic enrollment in 401(k) and 403(b) plans. The safe harbor requires a minimum automatic deferral amount of 3% and either a matching contribution of 100% of the first 1% and 50% of the next 5% **or** a 3% nonelective contribution. Full vesting is required at two years of service. Effective August 17, 2006, the Act also preempts state payroll withholding laws.

• **EGTRRA Changes Permanent.** The Act makes permanent the EGTRRA provisions, *e.g.*, the current $15,000 increased limit on elective deferrals, $5,000 age 50 catch up contributions, $4,000 IRA contribution limit, Roth 401(k) contributions, increased contribution, benefit, compensation and deduction limits, expanded rollover options, and the Saver's Credit.

• **Faster Vesting of Nonelective Contributions.** Effective in 2007, the Act changes the vesting rule for employer nonelective contributions made after 2006--full vesting after three years of service or a two-six year vesting schedule with 20% vesting each year. Special effective dates apply for collectively bargained plans and certain ESOPs.

• **Non-Spouse Rollover Permitted.** Beginning in 2007, a non-spouse beneficiary now can rollover retirement plan balances upon the death of a participant to the non-spouse beneficiary's IRA. However the IRA is still treated as an inherited IRA for purposes of minimum required distributions.

Action Items: An employer should consider whether to adopt the automatic enrollment safe harbor design, particularly if the plan currently provides for automatic enrollment or is a safe harbor plan. Further, an employer should consider whether a change to the vesting schedule is required and, if so, whether to make the change prospective for future contributions only or retroactive for all contributions.

OTHER LAW CHANGES

• **Prohibited Transactions.** Effective August, 17, 2006, the Act excludes governmental, church, and foreign plans from benefit plan investors considered in determining whether partnership and LLC investment vehicles hold “plan assets” for purposes of ERISA and Code prohibited transaction rules. The Act also modifies the definition of “amount involved" for purposes of calculating the excise tax for certain transactions, creates a self-correction period for certain security transactions and creates or modifies prohibited transaction exemptions for securities transactions involving cross trading, block trades, blind transactions made through an electronic communication network, service providers and foreign exchange transactions. Finally, the Act creates a bonding exception for certain brokers and dealers.

• **IRA Charitable Contribution.** Solely for 2006 and 2007, the Act allows an individual age 70-1/2 to make charitable contributions from an IRA up to $100,000.

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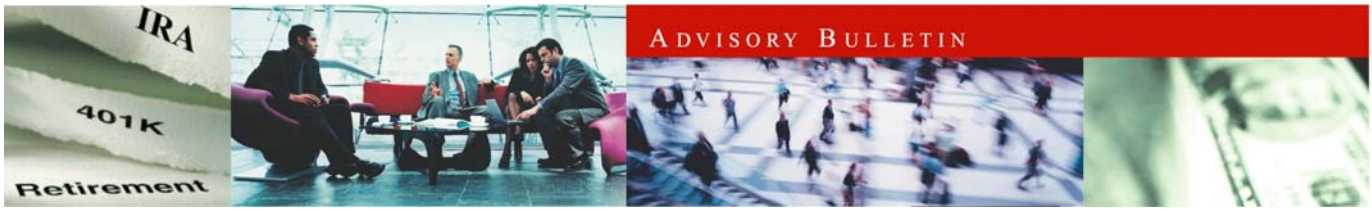

CASH BALANCE DECISIONS

On August 7, 2006, the Seventh Circuit in *Cooper v. IBM* ruled in favor of IBM, holding that IBM's cash balance plan did not violate age discrimination laws.

- **Cooper v. IBM Decision.** In the first appellate decision to address the legality of cash-balance plans under the pre-Act age discrimination provisions, the Seventh Circuit in *Cooper v. IBM* ruled on August 7, 2006 that IBM's cash balance plan satisfies ERISA's age neutrality requirements because covered employees annually received the same pay and interest credits without consideration of their age.

- **Equitable, FleetBoston Decisions.** The Seventh Circuit's *IBM* decision followed a similar July 20, 2006 decision, *Hirt v. Equitable Retirement Plan*, in which a New York district court, rejecting an earlier 2006 Connecticut district court's analysis in *Richards v. FleetBoston Financial Corp.*, held that cash balance plans did not violate ERISA's age neutrality requirements because they provided for the payment of "actuarial equivalents" in the form of lump sums or annuities. The issue is pending before the Third Circuit in the fully briefed appeal in *Register v. PNC Financial Services Group*, in which the district court had ruled for the employer (like the Seventh Circuit in *IBM*).

- **US Supreme Court.** Due to the absence of a split in the appellate courts, the Supreme Court is unlikely to hear the *IBM* case and finally settle the issue. As a result, while employers who adopted cash balance plans prior to enactment of the Act can take considerable solace from *IBM*, some ongoing risk remains.

FOR MORE INFORMATION

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