

**THE PENSION BENEFIT GUARANTY  
CORPORATION’S VALUATION REGULATION IN  
BANKRUPTCY: ENTITLED TO *CHEVRON*  
DEFERENCE OR ARBITRARY AND CAPRICIOUS?**

James L. Bromley, Matthew M. Karlan, and Esther Lifshitz\*

INTRODUCTION .....	248
I. BACKGROUND: THE ROLE OF THE VALUATION REGULATION UNDER ERISA.....	254
A. ERISA’s Insurance Program .....	254
B. UBL Claims under ERISA .....	257
C. The Valuation Regulation.....	258
II. TWO CONFLICTING LINES OF CASES .....	259
A. The Tenth and Sixth Circuits Have Concluded That the Prudent Investor Rate Applies in Bankruptcy .....	260
B. Following U.S. Airways, Bankruptcy Courts Have Concluded That the Valuation Regulation Controls in Bankruptcy .....	263
III. THE PBGC’S ANNUITY-BASED VALUATION REGULATION IS INCONSISTENT WITH ITS STATED RATIONALE, AND IS THEREFORE ARBITRARY AND CAPRICIOUS .....	267
A. Legal Framework: Arbitrary-and-Capricious Review Requires Courts to Consider a Regulation’s Purpose and Rationale.....	268
B. Rationale for the Valuation Regulation: The Discount Rate	

---

\* James L. Bromley is a partner, and Matthew M. Karlan is a current associate, at Cleary Gottlieb Steen & Hamilton LLP. Esther Lifshitz was formerly an associate at Cleary Gottlieb and is currently a law clerk to the Honorable Eric Vitaliano of the U.S. District Court for the Eastern District of New York. Cleary Gottlieb served as counsel to Nortel Networks Inc. and certain of its affiliates in *In re Nortel Networks Inc., et al.*, No. 09-10138 (Bankr. D. Del.), in which some of the issues discussed in this Article arose, but were not decided by the Bankruptcy Court. The authors would like to thank co-counsel to Nortel, Harold J. Ashner of Keightley & Ashner LLP, and also David C. Smith, Professor of Commerce at the University of Virginia, for their input on these issues during the Nortel proceedings. The views expressed in this Article are solely those of the Authors, and do not necessarily reflect the views of Cleary Gottlieb or its clients.

## 248 U. OF PENNSYLVANIA JOURNAL OF BUSINESS LAW [Vol. 20.2

	Should Reflect the PBGC’s Actual Costs.....	270
	C. The Valuation Regulation Overstates the PBGC’s UBL Claim and Does Not Reflect the PBGC’s Actual Costs .	273
IV.	THE PBGC’S <i>POST HOC</i> JUSTIFICATIONS FOR THE VALUATION REGULATION DO NOT SUPPORT IT .....	275
	A. Annuity Pricing Is Not Necessary to Avoid Any “Moral Hazard” .....	276
	B. The Annuity Interest Factors Do Not Reflect a “Market Price” for the PBGC’s Insurance Coverage.....	278
	CONCLUSION.....	284

## INTRODUCTION

Imagine you represent a corporate debtor in a United States chapter 11 proceeding. A creditor files a large claim, one of the largest in the case. The claim calls for payments to be made far into the future. The court concludes the debtor is liable and instructs the parties to brief the appropriate measure of damages. Finance 101 tells you that the quantum of damages for future payments will depend on the discount rate, *i.e.* the assumed rate of interest applied to discount the future payments to present value. Indeed, bankruptcy courts are regularly called upon to determine discount rates for future cash flows.<sup>1</sup> You advocate for a reasonable discount rate, one that accurately reflects market conditions and properly captures the harm claimed. You might point to treasury yields or average stock market returns, but you focus on the actual damage suffered and how to best calculate the value of that damage over time. Your adversary, however, claims the unilateral right to define its own discount rate, and, moreover, states flatly that this rate need not be supported by any evidence, is beyond debate, and cannot be questioned by the court. Imagine further that your opponent proposes a discount rate that yields a claim that is twice, three times, or even *25 times* the amount that would be calculated using a discount rate implied by actual market conditions – leading to a claim far in excess of the damage actually suffered by the creditor. Finally, suspend disbelief and assume that the court agrees with your adversary. Your debtor faces an outsized claim, and other creditors holding admitted claims – creditors whose claims have been determined in the traditional fashion focusing on the damage actually

---

1. See generally Gregory M. Gordon et. al., *Present Value Discounting of Claims in Bankruptcy*, 17 NORTON J. BANKR. L. & PRAC. 33 (2008) (citing as examples, in addition to claims by the PBGC, claims under unexpired leases and executory contracts and for rejection damages or prepetition breaches, claims by employees and retirees, claims under long-term debt instruments and related guaranties, and mass tort claims).

suffered – have their recoveries substantially diluted.

This is not a far-fetched hypothetical. This real-life scenario regularly confronts debtors facing claims filed by the Pension Benefit Guaranty Corporation (“*PBGC*”), the federal agency charged with administering the insurance program for U.S. private-sector, defined-benefit pension plans protected under the Employee Retirement Income Security Act of 1974 (“*ERISA*”).<sup>2</sup> In the event of a termination of such a pension plan, the PBGC takes control of the pension plan’s assets and is responsible to make payments to the pensioners covered by the plan subject to a statutory cap.<sup>3</sup> As a result, the PBGC is empowered by statute to bring a claim against the sponsor of the terminated pension plan for any shortfall between the value of the plan assets transferred to the PBGC and the expected future benefit payments payable to pensioners, known as unfunded benefit liabilities (“*UBL*”) under ERISA.<sup>4</sup> Since pension benefits are by their nature paid out over time and are contingent on factors such as mortality and retirement, the PBGC’s UBL claim must be estimated in order to be recovered, and, once estimated, an interest rate must be applied to those future payments to discount them to present value. Unlike other creditors seeking recovery for future payment streams, however, the PBGC maintains that it has the right to set its own discount rate. In 1975, the PBGC adopted a regulation pursuant to which it calculates the amount of its claims, prescribing assumptions as to mortality and retirement, as well as the discount rate to be applied (the “*Valuation Regulation*”).<sup>5</sup> For over 40 years, the PBGC has used the Valuation Regulation to calculate claims in U.S. bankruptcies.

The PBGC’s methodology involves a survey of insurance company annuity prices that the PBGC uses, in conjunction with its own assumptions as to mortality and retirement, to “solve” for the interest factors that it applies to discount future payments (for purposes of this Article, the “*Annuity Interest Factors*,” though that term is not used by the PBGC). Annuity contracts are contracts between an investor and an insurance company in which the investor gives a lump sum to the insurance company in exchange for a stream of periodic payments in the future. These are by definition low (near zero) risk investments, offered only by well-capitalized financial

---

2. Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 (1974), 29 U.S.C. §§ 1001 – 1461.

3. The statutory limit is beyond the scope of this Article. For simplicity, we assume here that the full amount of benefits is guaranteed, though this is not necessarily true in every situation.

4. The transfer of the pension plan assets and the related commencement of payment by the PBGC of pension obligations may in practice post-date plan termination.

5. 29 C.F.R. §§ 4044.41-75. The Valuation Regulation allows for the use of more than one discount rate depending on the time period involved, though each discount rate would be based on the Annuity Interest Factors described *infra*.

institutions, and typically imply a low discount rate. In theory, the PBGC's use of the Annuity Interest Factors could make sense if the PBGC purchased annuity contracts to lock in a low risk instrument that would fund the required payments over time. If the PBGC purchased annuity contracts, there would be a perfect match between the damage suffered by the PBGC and the cost incurred by the PBGC in remedying that damage.<sup>6</sup>

There is a hitch, however. The PBGC does not buy annuity contracts. Instead, it employs a sophisticated and diversified investment strategy that over time has yielded average returns of about 8%,<sup>7</sup> significantly higher than the returns that would be obtained through the purchase of annuities. The difference between the discount rate implied by the Annuity Interest Factors and the actual rate of return on the PBGC's investment portfolio means that by using the Valuation Regulation, the PBGC claims the right to collect more money than it needs to meet future pension obligations for any given terminated plan. The difference can be dramatic: In one reported case, the difference between the PBGC's UBL claim based on the Valuation Regulation and the amount of the claim based on an assumed rate of return based on a diversified portfolio (at times referred to as the "prudent investor rate") was over \$47 million – a difference of some 95%.<sup>8</sup> At the same time, the PBGC, which unlike insurance companies suffers from a significant deficit,<sup>9</sup> is unable to provide the certainty of an annuity. In other words, the PBGC effectively charges sponsors of terminating plans for a level of certainty that it cannot in fact provide to plan participants once it assumes

---

6. This approach is used in the United Kingdom under the Pensions Act 1995, c. 26 § 74 (UK), whereby upon the termination of the covered pension plan, the plan trustees will purchase an annuity to provide for payment of their equivalent of UBL. Also, in the United Kingdom, the plan assets of unrelated terminated plans are not co-mingled in a single pool as is the case in the U.S.

7. See Table 1 and accompanying discussion, *infra*.

8. *PBGC v. Belfance (In re CSC Indus., Inc.)*, 232 F.3d 505, 507-08 (6th Cir. 2000), *cert. denied*, 534 U.S. 819 (2001). The PBGC's UBL claim based on the Valuation Regulation was \$49,658,702.19, while the amount of the claim based on a prudent investor rate was \$1,822,075.19. *Id.*

9. The PBGC's 2016 annual report indicates a deficit of \$20.6 billion for the single-employer program and \$58.8 billion for the multiemployer program. 2016 PENSION BENEFIT GUAR. CORP. ANN. REP. 10. The Government Accountability Office has been highlighting the financial difficulties and chronic underfunding of the PBGC for decades, stating, for example, in a 1989 report that "[s]ince its inception, the program's losses and administrative costs have exceeded premiums collected." U.S. GOV'T. ACCOUNTABILITY OFFICE, GAO/AFMD-90-11, FEDERAL CREDIT AND INSURANCE: PROGRAMS MAY REQUIRE INCREASED FEDERAL ASSISTANCE IN THE FUTURE 32 (1989), *available at* <http://www.gao.gov/products/AFMD-90-11> [<https://perma.cc/DE38-RL3N>]. After this Article was prepared, the PBGC released its 2017 Annual Report, indicating a \$10.9 billion deficit for the single-employer program and a \$65.1 billion deficit for the multiemployer program. 2017 PENSION BENEFIT GUAR. CORP. ANN. REP. 10.

responsibility for the benefits at issue.

Since the PBGC's UBL claim only comes into play when a pension plan is terminated – and since under current law a plan sponsor can only voluntarily terminate an underfunded plan when it meets one of several statutory tests for financial distress – issues surrounding the PBGC's Valuation Regulation to date have only been litigated in the bankruptcy courts.<sup>10</sup> In this context, the PBGC's unilateral selection of a discount rate affects not only the debtors, but other *pari passu* unsecured creditors as well, all of whom must seek recovery from the same limited pool of assets, but none of whom enjoy comparable license to dictate the discount rate applicable to future payments.<sup>11</sup> Litigants have therefore argued – sometimes successfully, sometimes not – that a bankruptcy court should disregard the Valuation Regulation when it leads to an overstatement of the PBGC's UBL claim (*i.e.*, when it overstates the amount by which the plan is actually underfunded), and instead make its own estimation of the amount the PBGC will likely need to satisfy future pension obligations, just as a bankruptcy court would estimate similar claims for future cash flows when brought by non-PBGC creditors. To do otherwise, the argument goes, would provide the PBGC with an unearned “windfall” in excess of the amount it likely needs to meet the terminated plan's future pension obligations. Indeed, the significant – sometimes massive – disparity between the size of the PBGC's UBL claim under the Valuation Regulation and the prudent investor rate is so substantial that it has an *in terrorem* effect on settlement dynamics, not unlike the pressure put on criminal defendants under the Federal Sentencing

---

10. ERISA provides two ways for a plan sponsor to voluntarily terminate a pension plan: standard and distress. First, in a “standard” termination, the plan contains sufficient assets to meet the benefits owed or promised to participants, and so the *employer* distributes the assets to the participants through the purchase of annuities from private insurance companies or through payment of an upfront lump sum to participants. 29 U.S.C. § 1341(b). In this situation, the PBGC has no liability to pay and does not pay benefits to participants in the terminated plan. Second, in a “distress” termination, the plan is underfunded and the employer may only terminate if it satisfies one of four statutory distress tests. 29 U.S.C. § 1341(c). In a distress termination, the PBGC takes over the plan and assumes both the assets and the responsibility for paying benefits. ERISA also provides a means for involuntary termination instituted by the PBGC. 29 U.S.C. § 1342. In an involuntary termination, the PBGC also takes over the plan and assumes both the assets and the responsibility for paying benefits.

11. While this Article looks at the harm to *pari passu* creditors arising from the PBGC's policy, there are likely harms to plan participants as well, since the PBGC uses the same Valuation Regulation to determine the allocation of plan benefits upon termination. See AMERICAN RETIREES EDUC. FOUND., PENSION GUARANTEES THAT WORK FOR RETIREES: A PROPOSAL FOR COMMONSENSE PBGC REFORMS 13-20 (February 1, 2017), available at <http://www.nrln.org/flyin%20whthpr/WP.%20PBGC%20Rules%20Reform.pdf> [<https://perma.cc/L8NF-UGBK>] (discussing the consequences of PBGC's interest rate assumptions for American retirees).

### Guidelines.

The “windfall” argument against the Valuation Regulation has had mixed results. Both the Tenth and Sixth Circuits have held that the Valuation Regulation does not control in bankruptcy when it comes into conflict with the central bankruptcy principle that all similarly situated creditors be treated alike, and have instead applied a prudent investor rate.<sup>12</sup> In 2003, however, the bankruptcy court overseeing the U.S. Airways chapter 11 proceedings broke with these precedents and held that it was bound by the Valuation Regulation, explicitly disagreeing with the Sixth and Tenth Circuits.<sup>13</sup> Relying on the Supreme Court’s decision in *Raleigh v. Illinois Department of Revenue*,<sup>14</sup> the *U.S. Airways* court held that the substantive non-bankruptcy law that gave rise to the PBGC’s UBL claim – ERISA and the PBGC’s implementing regulations – applied in bankruptcy, regardless of the effect on other creditors.<sup>15</sup> Since then, no circuit court has addressed the issue, but every bankruptcy court to do so has followed *U.S. Airways*, albeit with little or no independent analysis.<sup>16</sup> The PBGC has made no secret of the importance of these decisions to its strategy in pursuing outsized bankruptcy claims and how that strategy aids the agency in its efforts to climb out of its multi-billion dollar deficit. As it stated in 2013, “[t]hese decisions have given PBGC significant leverage in enforcing its underfunding claims at a time when the agency faces a \$23 billion deficit,” and “[i]ndeed, PBGC has not had a claims objection litigated to decision since the above cases were decided.”<sup>17</sup>

Whether bankruptcy courts are in fact bound to apply the Valuation Regulation is a question that implicates thorny and conflicting issues of bankruptcy, ERISA, and administrative law. For one thing, the holding in *Raleigh* arguably should not apply to this fact pattern, as the prudent investor issue is, in practice, primarily litigated in bankruptcy. Moreover, application of the Valuation Regulation, which increases the PBGC’s UBL claim beyond any reasonable estimate of the PBGC’s own costs of providing the pension benefits, clashes directly with the fundamental principle of bankruptcy law that similarly situated creditors be treated alike, with none being entitled to

---

12. *PBGC v. Belfance (In re CSC Indus., Inc.)*, 232 F.3d 505 (6th Cir. 2000), *cert. denied*, 534 U.S. 819 (2001); *PBGC v. CF&I Fabricators of Utah, Inc. (In re CF&I Fabricators of Utah, Inc.)*, 150 F. 3d 1293 (10th Cir. 1998), *cert. denied* 526 U.S. 1145 (1999).

13. *In re U.S. Airways Grp., Inc.*, 303 B.R. 784 (Bankr. E.D. Va. 2003).

14. 530 U.S. 15 (2000).

15. *U.S. Airways*, 303 B.R. at 793.

16. See *infra* notes 100-102 and accompanying text.

17. U.S. PENSION BENEFIT GUAR. CORP., DERIVATION OF INTEREST FACTORS IN PBGC’S LIABILITY VALUATION METHODOLOGY 12 (Sept. 6, 2013), available at <https://www.pbgc.gov/documents/LiabilityValuation-20130906.pdf>. [<https://perma.cc/2FMY-JSUG>] [hereinafter the “WHITE PAPER”].

a claim in an amount greater than what it is owed. At the same time, however, any challenge to the validity of the Valuation Regulation must confront principles of administrative law, including deference to reasonable agency interpretations of the statutes they administer under the Administrative Procedure Act (“APA”)<sup>18</sup> and the *Chevron*<sup>19</sup> doctrine, which provides that broad, but not unlimited, deference be given to federal agency determinations.

This Article proposes a different path through this legal thicket.<sup>20</sup> Sidestepping the *Raleigh* question, this Article argues that the PBGC’s current Valuation Regulation is invalid – both in bankruptcy and outside bankruptcy – because it leads to an overstatement of the PBGC’s claim that is directly contradictory to the PBGC’s own rationale for the Valuation Regulation put forward in the Federal Register during the notice-and-comment rulemaking process. As stated by the PBGC as early as 1975 and as recently as 1993, the rationale for the Valuation Regulation is that the amount of the PBGC’s claim should be based on the PBGC’s own costs in providing the pension benefits. This traditional definition of a damages claim makes sense, as the only purpose of the PBGC’s right to collect a UBL claim is to allow it to pay out future pension benefits. The problem, however, is that the Annuity Interest Factors currently used in the Valuation Regulation significantly overstate the cost to the PBGC of providing the pension benefits, thus resulting in an artificially low discount rate, which in turn results in an artificially high UBL claim.

Under well-established Supreme Court precedent, the “arbitrary and capricious” standard requires that an agency examine the relevant data and articulate a satisfactory explanation for its action, including a “rational connection between the facts found and the choice made.”<sup>21</sup> Even if the

---

18. Administrative Procedure Act, 5 U.S.C. §§ 551-559 (2011).

19. See *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*, 467 U.S. 837 (1984) (discussing deference to administrative agencies’ interpretations of the statutes they administer).

20. While a few articles discuss the PBGC’s Valuation Regulation and the conflict that arises when that regulation is applied in bankruptcy, none has conducted the analysis presented here. See, e.g., Gregory M. Gordon et. al., *Present Value Discounting of Claims in Bankruptcy*, 17 NORTON J. BANKR. L. & PRAC. 33 (2008) (discussing the differences between the prudent investor rate and the PBGC’s regulatory discount rate); John H. Rains IV, Note, *Searching for Fairness in All the Wrong Places: Valuing the Pension Benefit Guaranty Corporation’s Unsecured Claim in Bankruptcy*, 58 FLA. L. REV. 1107 (2006) (arguing that Congress should adopt the valuation method promulgated by the PBGC in order to increase the PBGC’s recovery in bankruptcy); Debra A. Riley, *The Questionable Future of the Prudent-Investor Rate: Will ERISA Claims Dilute-Further-the Dividends for Trade Creditors?*, AM. BANKR. INST. J. (July/Aug. 2004) (discussing potential impact of *U.S. Airways* decision).

21. *Encino Motorcars, LLC v. Navarro*, 136 S. Ct. 2117, 2125 (2016) (citing *Motor*

agency can articulate a legitimate reason for a given policy choice, its method of effectuating this policy choice must be rational – if there is no relationship between an agency’s policy objective and its approach, then the approach must be struck down as arbitrary and capricious.<sup>22</sup> Despite paying lip service to *Chevron* and the APA in passing,<sup>23</sup> litigants to date have not truly pursued this issue, and the courts have never squarely addressed it. This Article proposes that courts should engage in the careful analysis required by the Supreme Court’s instruction to assess whether an agency rule is consistent with the facts before the agency and the agency’s stated rationale in adopting the regulation in light of those facts.

This Article is divided into four Parts. Part I provides a brief overview of the role of the PBGC and UBL claims in the context of the private-sector, defined-benefit insurance program established under ERISA. Part II examines the split of authority between courts that have enforced the Valuation Regulation in bankruptcy and those that have concluded that it is not binding when it overstates the PBGC’s UBL claims. Part III argues that the Valuation Regulation’s use of Annuity Interest Factors is arbitrary and capricious because it fails to reflect the PBGC’s actual cost of providing the pension benefits, and is therefore inconsistent with the PBGC’s own stated rationale for the regulation, if not the statute itself. Part IV demonstrates that the PBGC’s attempts at *post hoc* rationalizations for the Annuity Interest Factors – including the PBGC’s arguments that the Valuation Regulation reflects a “market price” for the insurance it offers to plan participants and avoids a purported “moral hazard” that would otherwise exist – do not justify their use. The Conclusion offers suggestions for reform.

## I. BACKGROUND: THE ROLE OF THE VALUATION REGULATION UNDER ERISA

### A. *ERISA’s Insurance Program*

In 1974, Congress enacted ERISA, a federal statute designed to protect certain private sector workers’ pension benefits.<sup>24</sup> The legislation

---

Vehicle Mfrs. Ass’n. of U.S., Inc. v. State Farm Mut. Auto. Ins. Co., 463 U.S. 29, 43 (1983)).

22. See *Judulang v. Holder*, 565 U.S. 42, 55-64 (2011) (holding that courts must reject an agency rule “unmoored from the purposes and concerns” of the relevant statute and that an agency must effectuate its policy choice in “some rational way” and “based on non-arbitrary, relevant factors” (internal citations omitted)).

23. See *infra* notes 94-102 and accompanying text.

24. At the time of its enactment, the defined benefit pension plan was the typical pension plan for American workers with pension benefits. PAUL J. SCHNEIDER & BRIAN M. PINHEIRO, *ERISA: A COMPREHENSIVE GUIDE* § 3.03 (4th ed. 2016 Supp.). Defined contribution pension plans, typified by plans qualifying under Section 401(k) of the Internal Revenue Code, I.R.C.



established minimum standards for participation, vesting, and funding, requirements for reporting and disclosure, and obligations for fiduciaries, all aimed at safeguarding the integrity of private pension plans and ensuring that plans would have sufficient assets to pay benefits when due.<sup>25</sup>

A key component of the comprehensive reform Congress undertook with ERISA was the establishment of an insurance program, administered by the PBGC, “to protect employees against the loss of vested benefits in the event of plan termination.”<sup>26</sup> The PBGC is “a wholly owned, self-financing government corporation,” within the Department of Labor, “charged with guaranteeing the payment of certain benefits in terminated” defined-benefit plans up to certain legal limits.<sup>27</sup> The PBGC insures private, defined-benefit pension plans under two separate programs, a single-employer program and a multiemployer program,<sup>28</sup> which are operated and financed separately.<sup>29</sup> The single-employer program insures approximately 30 million participants in more than 22,000 pension plans,<sup>30</sup> while the multiemployer program covers over 10 million participants in approximately 1,400 pension plans.<sup>31</sup> According to the PBGC, since its creation in 1974, it has “become responsible for more than 1.5 million people in over 4,800 failed single-employer and multiemployer plans.”<sup>32</sup> This Article focuses on the single-employer program, as this is the context in which the discount rate question has been litigated.

The PBGC funds its insurance programs through four sources. First, the PBGC collects premiums paid by plan sponsors covered under the program.<sup>33</sup> Second, when the PBGC becomes the trustee for a terminated

---

§ 401(k), were not introduced until 1978 by the Revenue Act of 1978, Pub. L. No. 95-600, § 135, 92 Stat. 2763, 2785 (1978). ERISA does not purport to cover defined benefit pension plans offered to public employees. Those employees relied, and continue to rely, on the taxing power of the public-sector sponsor, a structure which sets the stage for its own looming crisis.

25. PAUL J. SCHNEIDER & BRIAN M. PINHEIRO, ERISA: A COMPREHENSIVE GUIDE §§ 1.01, 1.02, 1.04. The stated purposes of ERISA included encouraging participation in retirement plans and addressing concerns over perceived abuses in the private pension system. H.R. REP. NO. 93-807 (1974), *as reprinted in* U.S.C.C.A.N. 4670, 4671, 4676-81.

26. H.R. REP. NO. 93-1280 (1974) (Conf. Rep.), *as reprinted in* U.S.C.C.A.N. 5038, 5184.

27. H.R. REP. NO. 99-300, at 278 (1985), *as reprinted in* 1986 U.S.C.C.A.N. 756, 929; U.S. GOV'T ACCOUNTABILITY OFFICE, GAO-11-271, REP. TO CONG. REQUESTERS, PENSION BENEFIT GUAR. CORP.: ASSET MANAGEMENT NEEDS BETTER STEWARDSHIP 3 (June 2011), *available at* <http://www.gao.gov/assets/330/320643.pdf> [<https://perma.cc/J7V2-9SFP>] [hereinafter “GAO-11-271 REPORT”].

28. 29 U.S.C. §§ 1301 – 1311.

29. 2016 PENSION BENEFIT GUAR. CORP. ANN. REP. 1.

30. *Id.* at 3.

31. *Id.*

32. *Id.* at 2.

33. GAO-11-271 REPORT, *supra* note 27, at 3. In the 2010 fiscal year, for example, the

pension plan, it takes possession of the assets of the terminated plan.<sup>34</sup> Third, after the termination of a plan and the assumption of that plan's assets, the PBGC may assert a claim (typically in bankruptcy) against each plan sponsor (or any member of its "controlled group") for the amount of unfunded benefit liabilities.<sup>35</sup> Finally, the PBGC engages professional asset management firms to invest its assets and earns investment income from the returns on total assets held.<sup>36</sup> The PBGC receives no federal taxpayer funding and the federal government is not required to financially assist the PBGC in meeting its obligations.<sup>37</sup>

The PBGC holds its investment assets in two funds: the revolving fund and the trust fund.<sup>38</sup> The revolving fund contains the PBGC's premium revenues and is invested in Treasury securities.<sup>39</sup> Revolving fund investments totaled approximately \$26 billion as of September 30, 2016.<sup>40</sup> The trust fund contains the assets recovered from trustee plans and their sponsors and related investment income.<sup>41</sup> Total trust fund investments amounted to approximately \$65.6 billion, as of September 30, 2016.<sup>42</sup>

The PBGC uses private investment management firms to administer its investment assets, in accordance with an investment policy statement.<sup>43</sup> Under the investment policy, the PBGC's goal has long been to "prudently maximize investment returns"<sup>44</sup> through investments mainly in equities and fixed-income securities; it does not buy annuities.<sup>45</sup> According to its 2016 Annual Report, the PBGC manages approximately \$100 billion in total

---

PBGC collected approximately \$2.3 billion in premiums.

34. GAO-11-271 REPORT, *supra* note 27, at 3. In the 2010 fiscal year, the PBGC assumed approximately \$1.8 billion in assets from 147 terminated defined-benefit plans.

35. GAO-11-271 REPORT, *supra* note 27, at 3. 29 U.S.C. § 1362(b).

36. GAO-11-271 REPORT, *supra* note 27, at 3. For example, in the fiscal year 2010, the PBGC earned \$7.8 billion from its investment portfolio. *Id.*

37. PENSION BENEFIT GUAR. CORP., INVESTMENT POLICY STATEMENT 1, Sep. 2016.

38. 2016 PENSION BENEFIT GUAR. CORP. ANN. REP. 41.

39. The PBGC is required by statute, 29 U.S.C. § 1305(b)(3), to invest a portion of the revolving fund assets in government debt securities. While it has discretion to invest a portion of this fund in other non-governmental debt products, the PBGC's current policy is to only invest in Treasury securities. 2016 PENSION BENEFIT GUAR. CORP. ANN. REP. 41.

40. *Id.*

41. *Id.*

42. *Id.*

43. *Id.* at 11.

44. 2008 PENSION BENEFIT GUAR. CORP. ANN. REP. 18; *see* 2016 PENSION BENEFIT GUAR. CORP. ANN. REP. 42 (stating that "[t]he objective of PBGC's investment policy is to maximize funded status within a prudent risk framework that is informed by PBGC's fixed obligations and asset composition of potential trustee plans," and noting that "[t]he investment policy establishes a 30 percent target asset allocation for equities and other non-fixed income assets, and a 70 percent asset allocation for fixed income").

45. 2016 PENSION BENEFIT GUAR. CORP. ANN. REP. 68.

assets.<sup>46</sup> Through this strategy, the PBGC achieves average returns on its total assets in the range of 8 to 9 percent.<sup>47</sup>

### B. *UBL Claims under ERISA*

As referenced above, one source of the PBGC's funding is its recovery on claims in respect of a terminated plan's unfunded benefit liabilities. Specifically, ERISA provides that the PBGC is entitled to recover "the total amount of the unfunded benefit liabilities (as of the termination date) [owed] to all participants and beneficiaries under the plan, together with interest (at a reasonable rate) calculated from the termination date in accordance with regulations prescribed by the corporation [*i.e.*, the PBGC]."<sup>48</sup> As amended, ERISA defines the "amount of unfunded benefit liabilities" to mean, "as of any date, the excess (if any) of – (A) the value of the benefit liabilities under the plan (determined as of such date on the basis of assumptions prescribed by the corporation for purposes of section 1344 of this title), over (B) the current value (as of such date) of the assets of the plan."<sup>49</sup>

Congress also granted the PBGC a unique collection advantage over other creditors – an advantage particularly valuable in the context of a bankruptcy filing. ERISA effectively pierces the corporate veil of each member of a corporate group, making all members jointly and severally liable to the PBGC for the UBL claim (as well as certain other claims the PBGC may be able to assert), regardless of whether any particular member was the plan sponsor or benefited in any way from the work performed by the pension plan participants. Specifically, the statute provides that the PBGC is permitted to recover from any member of the plan sponsor's "controlled group" – defined to mean, "in connection with any person, a

---

46. 2016 PENSION BENEFIT GUAR. CORP. ANN. REP. 11.

47. See Table 1 and accompanying discussion, *infra* (listing the annual and average five-year returns reported by the PBGC).

48. 29 U.S.C. § 1362(b)(1)(A).

49. 29 U.S.C. § 1301(a)(18). For simplicity, this Article uses the term "unfunded benefit liability" to refer to the PBGC's claim regardless of time period, even though that term was first defined by Congress in 1987. Omnibus Budget Reconciliation Act of 1987 (OBRA), Pub. L. No. 100–203, § 9313, 101 Stat 1330 (1987). In the House Report on the amendment, the Committee on Education and Labor "recognize[d] that valuing benefit liabilities for purposes of determining an employer's liability to participants and beneficiaries may be difficult," and that "in a distress or involuntary termination, such valuation results in inherent tension between the PBGC and the persons responsible for asserting and collecting the claims for unfunded benefit liabilities and for paying such liability to plan participants, because the PBGC and those persons are competing for the same employer dollars." H.R. REP. NO. 100-391, at 124 (1987), as reprinted in 1987 U.S.C.C.A.N. 2313-1, 2313-99. The Committee therefore explained that it "expect[ed] that the PBGC will develop standards for valuing benefit liabilities that are as objective as possible." *Id.*

group consisting of such person and all other persons under common control with such person” – each of which is jointly and severally liable for the UBL claim.<sup>50</sup>

### C. *The Valuation Regulation*

The PBGC first promulgated the Valuation Regulation in a rule proposed in 1975, adopted on an interim basis in 1976 and finalized in 1981 following a notice-and-comment procedure.<sup>51</sup> The PBGC has used this Valuation Regulation ever since as its framework for calculating the present value of its bankruptcy claim, with periodic adjustments to the underlying assumptions used in the calculus.<sup>52</sup>

As is relevant here, the current Valuation Regulation states as follows:

The plan administrator shall value all benefits as of the valuation date by – (a) Using the mortality assumptions prescribed by §4044.53 and the interest assumptions prescribed in appendix B to this part; (b) Using interpolation methods, where necessary, at least as accurate as linear interpolation; (c) Using valuation formulas that accord with generally accepted actuarial principles and practices; and (d) Adjusting the values to reflect loading expenses in accordance with appendix C to this part.<sup>53</sup>

The “interest assumptions prescribed in appendix B” provide the discount rates used to generate the PBGC’s UBL claims asserted in any bankruptcy proceeding. Tellingly, the Valuation Regulation itself omits any explanation of how the PBGC derived the interest rates contained in appendix B. Rather, appendix B simply consists of a table titled “Interest Rates Used To Value Benefits,” which lists only the applicable interest rate for a given period, nothing more.<sup>54</sup> Thus, while a general description of the

---

50. 29 U.S.C. § 1301(a)(14) (defining “controlled group”); 29 U.S.C. § 1362(a) (“In any case in which a single-employer plan is terminated in a distress termination under section 1341(c) of this title or a termination otherwise instituted by the corporation under section 1342 of this title, any person who is, on the termination date, a contributing sponsor of the plan or a member of such a contributing sponsor’s controlled group shall incur liability under this section. The liability under this section of all such persons shall be joint and several.”). The ability of the PBGC to assert claims against all members of a corporate group, including, arguably, members located outside of the United States, means that the PBGC cannot suffer from structural subordination. No other pre-filing unsecured creditor is granted this sort of priority treatment. 11 U.S.C. § 507. Only post-filing lenders providing debtor-in-possession financing may be granted superior treatment by the bankruptcy court, but such treatment is limited expressly by the amount of the financing provided. 11 U.S.C. § 364(c), (d).

51. See *infra* notes 118-128 and accompanying text.

52. See 29 C.F.R. §§ 4044.41-75 (setting out the current Valuation Regulation).

53. 29 C.F.R. § 4044.52.

54. 29 C.F.R. Part 4044, Appendix B.

survey-based methodology for determining the Annuity Interest Factors has been included in various Federal Register publications,<sup>55</sup> the actual codified regulation contains only the numbers to be used as interest factors, without further explanation.

Elsewhere, however, the PBGC has explained its methodology for deriving the Annuity Interest Factors in greater detail. According to the explanation published by the PBGC on its website, the Annuity Interest Factors are derived from a survey (the “*Survey*”) performed by the American Council of Life Insurers (the “*ACLI*”), which inquires of private insurance companies the price that they would charge for group annuities contracts as of the termination date.<sup>56</sup> According to the PBGC, the Annuity Interest Factors are meant to estimate “the approximate cost of purchasing equivalent annuities from an insurance company in the private sector.”<sup>57</sup> The participants in each Survey consist of a group of life insurers, but are otherwise anonymous to the PBGC. The ACLI asks for the annuity prices the insurers would charge on hypothetical pension streams paying \$10 a month to individuals starting at a given age, over various age profiles. The PBGC then uses these prices to infer a new annuity pricing schedule based on PBGC mortality tables. The resulting interest factors are the rates that best set the PBGC assumed pension payments equal to their inferred prices.<sup>58</sup>

## II. TWO CONFLICTING LINES OF CASES

Whether the Valuation Regulation is controlling in bankruptcy remains unsettled. The only two Courts of Appeals to address the issue, the Sixth and the Tenth Circuits, have concluded that the Valuation Regulation leads to an overstatement of the PBGC’s claim that is inconsistent with bankruptcy law and have therefore held that, at least in bankruptcy, the Valuation

---

55. 41 Fed. Reg. 48484, 48485 (Nov. 3, 1976) (“The initial interest rates used are derived from annuity price data obtained by PBGC from the private insurance industry. The PBGC’s interest assumptions have been designed so that, when coupled with the mortality assumptions found in the regulation, the benefit values obtained for immediate and deferred annuities are in line with industry annuity prices.”); *see also* 45 Fed. Reg. 38415, 38416 (June 9, 1980); 58 Fed. Reg. 50812 (Sept. 28, 1993); 70 Fed. Reg. 12429, 12430 (Mar. 14, 2005) (providing general descriptions of the methodology for determining Annuity Interest Factors).

56. WHITE PAPER, *supra* note 17, at 1.

57. *Id.*

58. This Article does not address the problems with the PBGC’s Survey-based methodology for determining the Annuity Interest Factors used in the Valuation Regulation. Rather, without endorsing the PBGC’s methodology, the Article assumes that the Annuity Interest Factors accurately reflect the prices that private life insurance companies would charge to offer group annuities of the sort as to which pricing is sought by the PBGC. Others have noted, however, that the Survey methodology appears to be far from perfect. *See infra* note 98.

Regulation is not controlling and that a prudent investor rate should be applied to calculate the PBGC's UBL claims.<sup>59</sup> Since *In re U.S. Airways Grp., Inc.*<sup>60</sup> in 2003, however, every bankruptcy court to address the issue has held that it was bound by the Valuation Regulation. None of these bankruptcy decisions has been appealed to a Court of Appeals, and as such, to date, no Court of Appeals has adopted the view put forward in *U.S. Airways*, and the Supreme Court has never addressed the issue.<sup>61</sup>

A. *The Tenth and Sixth Circuits Have Concluded That the Prudent Investor Rate Applies in Bankruptcy*

The Tenth Circuit addressed the issue first in 1998, in *PBGC v. CF&I Fabricators of Utah, Inc. (In re CF&I Fabricators of Utah, Inc.)*.<sup>62</sup> As framed by the court in that case, “[t]he major controversy between the parties [was] whether the ERISA provisions carry over into bankruptcy or whether PBGC comes to Chapter 11 like any other unsecured creditor.”<sup>63</sup> The PBGC, the Tenth Circuit concluded, “is not entitled to special rights in bankruptcy and its ERISA powers and rights do not give it priority over the other unsecured creditors of CF&I’s estate.”<sup>64</sup>

The Tenth Circuit began by observing that “[i]nasmuch as those liabilities [*i.e.*, the PBGC’s UBL claims] are for beneficiaries’ payments that extend into the future, the amount of the liability must be reduced to present value so the debt can be dealt with under the reorganization plan.”<sup>65</sup> Indeed,

---

59. *PBGC v. Belfance (In re CSC Indus., Inc.)*, 232 F.3d 505 (6th Cir. 2000), *cert. denied*, 534 U.S. 819 (2001); *PBGC v. CF&I Fabricators of Utah, Inc. (In re CF&I Fabricators of Utah, Inc.)*, 150 F. 3d 1293 (10th Cir. 1998), *cert. denied* 526 U.S. 1145 (1999).

60. 303 B.R. 784 (Bankr. E.D. Va. 2003).

61. The lack of appeals is consistent with the deal-centric philosophy that characterizes most large chapter 11 proceedings. Very often, a resolution with the PBGC is a condition for a company to emerge from chapter 11, as was the case with *U.S. Airways*, thus creating a situation where parties may choose to litigate the PBGC claim issue before the bankruptcy court on a timeline that is roughly coincident with the timeline for plan confirmation, but are highly incentivized to avoid lengthy appeals. Although certain claims issues can be reserved for final determination post-confirmation, in most large chapter 11 cases, the size of the PBGC’s claims prevents post-confirmation resolution. The fact that the PBGC’s claims are, by virtue of their joint-and-several nature, filed against all debtors in a multi-debtor setting (where the PBGC’s claims can often represent all or nearly all of the claims against certain debtors) nearly always requires resolution of the PBGC’s claims prior to, and thus as a condition to, confirmation.

62. 150 F.3d 1293 (10th Cir. 1998), *cert. denied* 526 U.S. 1145 (1999).

63. *Id.* at 1295.

64. *Id.* at 1295. The decision in *CF&I* also addressed questions concerning the tax and priority treatment of the PBGC’s claims, which are beyond the scope of this Article and therefore not addressed here.

65. *Id.* at 1300.

the parties in *CF&I* agreed that 11 U.S.C. § 502(b), which provides that the court “shall determine the amount” of claims “as of the date of the filing of the petition,” mandated that the PBGC’s claim be discounted to present value, disagreeing only on the methodology for doing so.<sup>66</sup> As the court noted, “[t]he dispute is significant because the proffered methods produce marked differences of \$222,866,000 if PBGC’s approach is utilized or \$124,441,000 if CF&I prevails.”<sup>67</sup> In other words, the PBGC claimed an entitlement to nearly twice the sum calculated by CF&I based on the different assumptions in discounting.

In holding that a prudent investor rate applied in bankruptcy, the Tenth Circuit rejected the PBGC’s argument that the Valuation Regulation was controlling under *Chevron*, concluding that “[a]lthough valid in other contexts, we do not believe these principles are applicable here” for two reasons.<sup>68</sup> First, the Tenth Circuit noted that ERISA’s definition of “unfunded benefit liabilities” in 29 U.S.C. § 1301(a)(18) is expressly limited to defining that term “for purposes of this title [ERISA]” and therefore, in the court’s view, “cannot extend to bankruptcy.”<sup>69</sup> Second, the court held that the ERISA definition of unfunded benefit liabilities “conflicts with provisions of the Bankruptcy Code,” and that the Bankruptcy Code “controlled.”<sup>70</sup> Citing bankruptcy’s “cardinal rule that all claims within the same class must be treated alike” under 11 U.S.C. § 1123(a)(4), the court held that “[t]hat principle would be violated here if PBGC’s interpretation of § 1301(a)(18) were adopted because PBGC’s discount rate would apply only to it and not any other general unsecured creditor.”<sup>71</sup> Congress, the court concluded, had made clear under 29 U.S.C. § 1144(d) that “when ERISA conflicts with another provision of federal law, ERISA must be subordinated.”<sup>72</sup> In short, the Tenth Circuit concluded that “[n]othing in the ERISA sections relied upon by PBGC implies a carry-over into the realm of bankruptcy to allow PBGC to set its own valuation methodology.”<sup>73</sup>

Two years later, in *PBGC v. Belfance (In re CSC Indus., Inc.)*,<sup>74</sup> the Sixth Circuit was confronted with the same issue. The PBGC had argued below that the value of its UBL claim was \$49,658,702.19, based on an investment return rate premised on the Valuation Regulation of “6.4% for

---

66. *Id.*

67. *Id.*

68. *Id.* at 1301.

69. *Id.*

70. *Id.*

71. *Id.*

72. *Id.*

73. *Id.*

74. 232 F.3d 505 (6th Cir. 2000), *cert. denied*, 534 U.S. 819 (2001).

the first 20 years and 5.75% thereafter.”<sup>75</sup> After the bankruptcy court held that the Valuation Regulation assumptions used in determining that amount would give the PBGC an unearned “windfall,” and ruled that a prudent investor rate should apply, the parties stipulated that “a ‘prudent investor’ rate would be a 10% return,” which resulted in a claim of \$1,822,075.19 – less than five percent of the amount generated by the Valuation Regulation.<sup>76</sup>

While not adopting all aspects of the Tenth Circuit’s analysis,<sup>77</sup> the Sixth Circuit largely agreed with its conclusion, holding that “the bankruptcy court’s authority under 11 U.S.C. §§ 502(b) and 1123(a)(4) to determine the amount of claims in bankruptcy proceedings and treat creditors in the same class equally gives it the authority to value unfunded benefit liabilities claims using a ‘prudent investor rate.’”<sup>78</sup>

The Sixth Circuit also considered, but rejected, the argument that the Supreme Court’s decision in *Raleigh v. Illinois Department of Revenue*,<sup>79</sup> which had come down after the Tenth Circuit decided *CF&I*, mandated a different outcome. In *Raleigh*, the Supreme Court held that “bankruptcy does not alter the burden imposed by the substantive law” otherwise governing a state-law tax claim, reaffirming the general principles that “the validity of a claim is generally a function of underlying substantive law,” and that while “Congress of course may do what it likes with entitlements in bankruptcy,” courts will only presume Congress did so when it makes a clear indication.<sup>80</sup> In its analysis, the Supreme Court had distinguished the burden of proof, which it considered a question of the claim’s “validity” – and therefore governed by non-bankruptcy law – from questions of claim “allowance,” which are governed by bankruptcy law.<sup>81</sup> In the Sixth Circuit’s view, under *Raleigh*, “[w]hile the *validity* of a claim might be a matter for nonbankruptcy law, bankruptcy courts have the statutory authority to determine the *allowability* and *amount* of the claim.”<sup>82</sup> The applicable discount rate, the Sixth Circuit concluded, was not a question of validity and therefore fell within the bankruptcy court’s purview.

---

75. *Id.* at 507-08.

76. *Id.* at 508.

77. In particular, the *CSC Indus.* court stated: “We are not entirely persuaded that the district and *CF&I* courts were correct in concluding that 29 U.S.C. § 1144(d), which provides that ‘[n]othing in this subchapter shall be construed to alter, amend, modify, invalidate, impair, or supersede any law of the United States,’ requires that the ERISA provision, 29 U.S.C. § 1301(a)(18), be subordinated to the Bankruptcy Code. Section 1144(d), on its face, applies only to subchapter I of ERISA, whereas the definition of unfunded benefit liabilities, section 1301(a)(18), is found in subchapter III of ERISA.” *Id.* at 509.

78. *Id.*

79. 530 U.S. 15 (2000).

80. *Id.* at 17, 21, 25.

81. *Id.* at 22-24.

82. *CSC Indus.*, 232 F.3d at 509.



Thus, the Sixth Circuit concluded, like the Tenth Circuit, that “[t]he PBGC’s authority to promulgate regulations governing the valuation of unfunded benefit liabilities does not extend so far as to subordinate the authority of the bankruptcy courts to value claims in bankruptcy proceedings,” and “the PBGC should be treated like any other unsecured creditor in the bankruptcy reorganization; therefore, the use of the ‘prudent investor rate’ to value the PBGC’s claim was appropriate.”<sup>83</sup>

B. *Following U.S. Airways, Bankruptcy Courts Have Concluded That the Valuation Regulation Controls in Bankruptcy*

Three years after the *CSC Indus.* decision, the bankruptcy court overseeing the U.S. Airways bankruptcy<sup>84</sup> broke with the Sixth and Tenth Circuits. There, the PBGC asserted a UBL claim of approximately \$2.219 billion,<sup>85</sup> based on “a discount rate of 5.1% for the first 20 years and 5.25% thereafter.”<sup>86</sup> U.S. Airways objected to the PBGC’s UBL claim. Using a discount rate of 8%, as well as more up to date mortality figures and different retirement assumptions, U.S. Airways calculated a UBL amount of only \$894 million – roughly one third the size of the UBL claim determined under the Valuation Regulation.<sup>87</sup>

The *U.S. Airways* court “respectfully disagree[d]” with the Sixth and Tenth Circuits, concluding that under the Supreme Court’s decision in *Raleigh*, it was bound to apply the Valuation Regulation.<sup>88</sup> Even while recognizing that bankruptcy courts are courts of equity, empowered under the Bankruptcy Code in certain circumstances to alter legal rights as they exist outside of bankruptcy, the bankruptcy court rejected any distinction between the “validity” and the “amount” of the claim under *Raleigh*, concluding that both were governed by non-bankruptcy law.<sup>89</sup>

---

83. *Id.* at 509. Prior to the *CF&I* and *CSC Indus.* decisions, the Bankruptcy Court in the Southern District of New York had held that the PBGC is not entitled to deference because it has no inherent expertise in determining the present value of projected future payments. *LTV Corp. v. PBGC (In re Chateaugay Corp.)*, 115 B.R. 760, 773 (Bankr. S.D.N.Y. 1990), *aff’d* 130 B.R. 690 (S.D.N.Y. 1991), *vacated, withdrawn*, 17 E.B.C. 1102 (S.D.N.Y. 1993). Although this decision was ultimately withdrawn by consent order after the parties settled, courts have continued to cite it as persuasive authority. *See, e.g., In re Loewen Grp. Int’l Inc.*, B.R. 427, 435 (Bankr. D. De. 2002).

84. The U.S. Airways bankruptcy took place in the U.S. Bankruptcy Court for the Northern District of Virginia, which is located in the Fourth Circuit.

85. 303 B.R. at 787.

86. *Id.*

87. *Id.* at 788.

88. *Id.* at 792.

89. *Id.* at 793. Interestingly, the bankruptcy court opined that “if the PBGC held merely a common-law indemnity claim for future benefits owed to the pilots, there can be little doubt

Despite concluding that the Valuation Regulation was controlling under *Raleigh*, the court went on to consider whether that regulation materially overstated the PBGC's UBL claim. In doing so, the court acknowledged that the PBGC invests its trust fund assets "in a mixture of equities and bonds similar to those of most pension plans" and as a result "has done pretty well over the long haul," such that "returns on the PBGC's trust fund assets over the 18-year period from 1985 through 2002 are approximately 10% on an annual basis."<sup>90</sup> Nevertheless, the court reasoned that "[t]he real issue is one of risk."<sup>91</sup> It concluded that since "no one can predict with certainty what returns the stock market will produce over the next 50 years," and "[g]iven the strong societal interest in protecting pension benefits, a risk-free or nearly risk-free rate to value the pension liability is more appropriate than a rate based on optimistic projections (even if those projections are widely-shared by fund managers) as to the stock market's future long-term performance."<sup>92</sup> Thus, it said, "the court is unable to conclude that use of a 'prudent investor' rate is necessary to avoid overstating the actual loss resulting from the distress termination."<sup>93</sup>

Although the record does not indicate that any party made detailed arguments concerning the Valuation Regulation's validity under the APA or *Chevron*,<sup>94</sup> the bankruptcy court referenced both in concluding that the

---

that this court would have full authority to determine an appropriate discount rate as well as related assumptions as to mortality and expected retirement age," and that, "[i]n this connection, 8% would hardly be an unreasonable choice for a discount rate." *Id.* It concluded, however, that "the court is not simply valuing a contingent future loss," but "[r]ather, Congress, by statute, has expressly given the PBGC a *present* right to recover an amount determined in accordance with the valuation regulation." *Id.*

90. *Id.* at 795.

91. *Id.*

92. *Id.* at 796.

93. *Id.* The *U.S. Airways* court apparently discounted the concern of a "windfall" to the PBGC, stating that such "'windfall' rhetoric must be taken with a large grain of salt" because, in that case, "claims are being paid with stock having an estimated value equal to less than two cents for each dollar in allowed claims, [such that] full allowance of the PBGC's claim could never result in the PBGC receiving more than the amount of its actual loss." *Id.* at 791 n.6. This analysis overlooks, however, that regardless of whether claims were being paid in stock, worth pennies on the dollar, or in 100 cent dollars, in both cases the PBGC receives more than its fair share of the pool of assets if it is given an oversized claim. Where recoveries are such that creditors do not receive payment in full, other creditors suffer from the PBGC's outsized claim. Where recoveries to creditors are sufficient to pay all similarly situated creditors in full, given the absolute priority rule embodied in Section 1129(b)(2)(B)(ii) of the Bankruptcy Code, junior or subordinated creditors, or even preferred or common equity, suffer from the PBGC's outsized claims. There is no harmless error if the PBGC's outsized claims are permitted.

94. Indeed, in attempting to avoid discovery in the *U.S. Airways* dispute, the PBGC made a point of the fact that "[n]owhere in their objection to the PBGC Proof of Claim do the Reorganized Debtors purport to challenge the Valuation Regulation under the Administrative

regulation was valid. Citing the *Chevron* doctrine, the court concluded that “considerable deference must be given to the PBGC, as the agency responsible for carrying out a legislatively-delegated function, for determining how best to implement the statutory mandate.”<sup>95</sup> Similarly, as to the APA, the court concluded that “[g]iven the presumption of validity that must be accorded the PBGC regulation, the debtor has simply not presented sufficient evidence for the court to find that the survey is an irrational or arbitrary means for the PBGC to measure the close-out liability of a terminated pension plan.”<sup>96</sup>

Critically, as to both conclusions, the *U.S. Airways* court assumed that the use of annuity pricing was relevant to the claims calculation: “The stated goal of the regulation is to determine a value for the unfunded benefit liabilities that approximates the cost of purchasing an annuity contract from a commercial insurer that would pay the same benefits.”<sup>97</sup> Though candidly acknowledging that the ACLI “survey has serious limitations,”<sup>98</sup> the court

---

Procedure[] Act, 5 U.S.C. § 706, (the ‘APA’) as arbitrary, capricious, an abuse of discretion or otherwise not in accordance with law.” The Pension Benefit Guaranty Corporation’s Motion to Quash or, in the Alternative, for a Protective Order at 11, In re US Airways Group, Inc., No. 02-83984-SSM, D.I. 4182 (Bankr. E.D. Va. Oct. 6, 2003).

95. 303 B.R. at 797.

96. *Id.* at 798.

97. *Id.* at 797. The *U.S. Airways* court stated this twice, the first time citing a notice in the Federal Register from 1993. *See id.* at 788 (“The stated goal of the regulation is to generate a value which will ‘accurately approximate the cost of [single-premium] group annuity contracts’ that would pay the benefits promised under the terminated plan.” (quoting 58 Fed. Reg. 5128)). As discussed in the next section of this Article, however, this statement of the Valuation Regulation’s purpose is incorrect, and indeed is contradicted by the very same Federal Register publication.

98. *Id.* at 797. The court stated:

That the survey has serious limitations is hardly to be questioned. Because of the anonymous manner in which the survey is conducted, the PBGC has no way of knowing whether it is receiving responses from market leaders or small players, nor does it have any way of independently verifying that the values reported on the survey forms accurately reflect what the responding company is actually charging for the annuity policies it sells. Indeed, because it does not itself send out the survey forms, the PBGC does not even know the specific universe of companies to which the forms were sent. As the General Accounting Office has recently observed in a report to Congress, the anonymous nature of the survey necessarily creates “ambiguity about the extent to which the PBGC interest rate factors reflect the current broad market for group annuities.” These limitations are an unavoidable consequence of the unwillingness of commercial insurance companies to release sensitive pricing information (or at least, to release it in such a form that specific prices can be identified with specific companies). Short of Congress enacting a statute permitting the PBGC to subpoena the information, it is difficult to see how the PBGC could overcome the inherent limitations of the present survey.

*Id.* (footnotes omitted).

reasoned that “the issue is not whether the survey could be improved” but “whether, notwithstanding its limitations, the survey is nevertheless a rational way for the PBGC to implement the stated goal of determining a value that approximates the cost of a commercial annuity.”<sup>99</sup> Nowhere did the *U.S. Airways* court consider whether the use of annuity pricing was consistent with the rationale for the regulation, or otherwise an appropriate methodology for calculating UBL damages.

Notwithstanding the limitations of the *U.S. Airways* decision, in the more than ten years since it was issued, several additional bankruptcy courts have held that the Valuation Regulation controls in bankruptcy.<sup>100</sup> These decisions, however, have contained minimal, if any, analysis.<sup>101</sup> Most importantly, the question whether the Valuation Regulation is arbitrary and capricious under the APA or *Chevron*<sup>102</sup> is not addressed in any of these

---

99. *Id.* The *U.S. Airways* court also attempted to bolster its conclusion by noting that “the statute defines ‘unfunded benefit liabilities’ as being the amount determined by reference to the PBGC valuation regulation” and “[t]hat regulation was already in effect when the statute was amended to its present form, and the court must therefore presume that Congress knew and approved of the PBGC’s general methodology.” *Id.* at 796. This argument merely begs the question, however, of what, if anything, Congress intended to ratify – the ACLI Survey-based methodology for determining the Annuity Interest factors (which factors are not part of the Valuation Regulation except to the extent the rates that use such factors without explanation appear in Appendix B to the regulation) or the objective of the Valuation Regulation stated repeatedly by the PBGC over many years (which, as addressed in the next section of this Article, is to approximate the PBGC’s own costs in providing pension benefits to beneficiaries under terminated plans).

100. *See, e.g.*, In re Durango Georgia Paper Co., No. 02-21669, 2017 WL 221785, at \*3 (Bankr. S.D. Ga. Jan. 18, 2017); In re Wolverine, Proctor & Schwartz, LLC, 436 B.R. 253, 262-63 (D. Mass. 2010); Dugan v. PBGC (In re Rhodes Inc.), 382 B.R. 550 (Bankr. N.D. Ga. 2008); United Air Lines, Inc. v. U.S. Bank Tr. Nat’l Ass’n (In re UAL Corp.), 346 B.R. 456 (Bankr. N.D. Ill. 2006); Order, In re High Voltage Eng’g Corp., No. 05-10787 (Bankr. D. Mass. July 27, 2006) [D.I. 2048]; In re UAL Corp., No. 02-48191 (Bankr. N.D. Ill. Dec. 30, 2005) (Order and Trans. Of Hearing, Dec. 16, 2005, at 32-33).

101. There are cases in which the discount-rate issue was mentioned, but only in the context of approving a settlement and therefore without reaching any determination on the underlying substantive issue. *See* In re Wolverine, Proctor & Schwartz, LLC, 436 B.R. 253, 262-63 (D. Mass. 2010) (discussing discount rate in the settlement context); In re Kaiser Aluminum Corp., 339 B.R. 91, 96 (D. Del. 2006) (noting in settlement context that “in the face of these complex and uncertain issues, it is difficult to envision who would succeed, but not difficult to envision complex, costly and time-consuming litigation”); *see also* In re Sea Containers, Ltd., No. 06-11156 (KJC), 2008 Bankr. LEXIS 2363, at \*23 n. 9 (Bankr. D. Del. Sept. 19, 2008).

102. In three of those decisions, the parties explicitly disclaimed any argument that the Valuation Regulation was invalid outside of bankruptcy and instead relied exclusively on the argument that a different rate should apply in bankruptcy as a matter of law. *See* Order and Trans. Of Hearing, Dec. 16, 2005 at 33, In re UAL Corp., No. 02-48191 (Bankr. N.D. Ill. Dec. 30, 2005) (nothing that “neither the committee nor ALPA have argued that the regulations are inapplicable or would not be used to determine the amount of United’s unfunded benefit liabilities under applicable nonbankruptcy law”); In re High Voltage Eng’g Corp., No. 05-

decisions. None of the subsequent decisions has considered, examined or even questioned the *U.S. Airways* court's assumption regarding the rationale for the Valuation Regulation.

### III. THE PBGC'S ANNUITY-BASED VALUATION REGULATION IS INCONSISTENT WITH ITS STATED RATIONALE, AND IS THEREFORE ARBITRARY AND CAPRICIOUS

While courts have mentioned briefly the APA and *Chevron* doctrine in discussing the Valuation Regulation, none has given thoughtful consideration to the analysis required under those rubrics. In particular, the decision in *U.S. Airways* – and therefore the decisions following it – proceeds from a fundamental misapprehension regarding the Valuation Regulation's history and purpose.

Central to the *U.S. Airways* analysis upholding the application of the Valuation Regulation in bankruptcy was the court's determination that "[t]he stated goal of the regulation is to determine a value for the unfunded benefit liabilities that approximates the cost of purchasing an annuity contract from a commercial insurer that would pay the same benefits."<sup>103</sup> Though acknowledging the ACLI Survey's shortcomings, the court reasoned that "notwithstanding its limitations, the survey is nevertheless a rational way for the PBGC to implement the stated goal of determining a value that approximates the cost of a commercial annuity."<sup>104</sup> The cases following *U.S. Airways* have followed suit without questioning that premise.

As described more fully below, that basic premise is simply wrong: contrary to the PBGCs more recent litigation stance, the stated goal of the Valuation Regulation – as stated repeatedly in the Federal Register since 1975 – has never been to mirror annuity pricing for its own sake. Rather, since 1975, the PBGC has consistently stated in its notice-and-comment rulemakings that the rationale underlying (and thus purportedly justifying) the Valuation Regulation is that the amount of the PBGC's claim should reflect the actual cost to the PBGC of providing the pension benefits for

---

10787, slip op. at 1 (Bankr. D. Mass. July 26, 2006) (stating that "the parties agreed to narrow the initial issue for determination to whether this court should utilize the underlying substantive law, namely the PBGC's regulations, to determine the amount of its claim or whether the Court should utilize a prudent investor approach advocated by the Chapter 11 Trustee"); *Dugan v. PBGC (In re Rhodes, Inc.)*, 382 B.R. 550, 559 (Bankr. N.D. Ga. 2008) (stating that "[i]ndeed, the Liquidating Agent has not contended that outside of bankruptcy and without obtaining a judgment invalidating PBGC's regulations, Debtors could successfully challenge the amount of PBGC's claim solely on the ground that the claim is excessive due to PBGC's use of an inappropriate discount rate").

103. 303 B.R. at 797.

104. *Id.* at 797.

which it is assuming responsibility upon a plan's termination. While the cost to the PBGC of providing benefits could in theory mirror the cost of annuity contracts – if the PBGC in fact purchased annuities – the reality is that it does not do so. Even if the PBGC initially anticipated that it would buy annuities or engage in investment practices comparable to insurance companies, the PBGC has made no attempt to demonstrate why it would be the case that annuity contracts would accurately reflect its own costs given its now longstanding practice of investing in a diversified portfolio that does not include annuities. Courts, in assessing whether the Valuation Regulation applies in bankruptcy, have likewise failed to grapple with whether the current Valuation Regulation's use of annuity pricing bears any rational relationship to the stated purpose of the regulation.

A. *Legal Framework: Arbitrary-and-Capricious Review Requires Courts to Consider a Regulation's Purpose and Rationale*

The APA states, in relevant part, that a reviewing court must “hold unlawful and set aside agency action, findings, and conclusions found to be . . . arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law.”<sup>105</sup> The *Chevron* doctrine is a standard of statutory interpretation that grew out of the Supreme Court's decision in *Chevron, U.S.A., Inc. v. Natural Res. Def. Council, Inc.*<sup>106</sup> The doctrine provides that a court will defer to an agency's interpretation of a federal statute that the agency is charged with administering if the statute is silent or ambiguous on the question at issue and the agency's interpretation is reasonable.<sup>107</sup> The Court further explained that where Congress “has explicitly left a gap for the agency to fill” and has expressly delegated authority to that agency to legislate regulations accordingly, “[s]uch legislative regulations are given controlling weight unless they are arbitrary, capricious, or manifestly contrary to the statute.”<sup>108</sup> Thus, in practice, there is likely to be little difference between the analysis under *Chevron* versus the APA, as both call

---

105. 5 U.S.C. § 706(2).

106. 467 U.S. 837 (1984).

107. *Id.* at 842-43. The Supreme Court has stated that the PBGC is an agency eligible for *Chevron* deference when the PBGC's interpretation is reasonable. *See Pension Benefit Guar. Corp. v. LTV Corp.*, 496 U.S. 633, 650 (1990) (noting that “[h]aving determined that the PBGC's construction is not contrary to clear congressional intent, we still must ascertain whether the agency's policy is based upon a ‘permissible’ construction of the statute, that is, a construction that is ‘rational and consistent with the statute’”). There is an active jurisprudential debate concerning *Chevron* itself and whether the effective delegation of legislative authority to an agency under any circumstances is appropriate. This Article does not take a position on that debate and tests the Valuation Regulation assuming that *Chevron* remains good law.

108. *Chevron*, 467 U.S. at 843-44.

for an “arbitrary and capricious” standard of review where Congress has made an express delegation of rulemaking authority to the agency.<sup>109</sup>

The scope of review under the “arbitrary and capricious” standard requires that the agency examine the relevant data and articulate a satisfactory explanation for its action, including a “rational connection between the facts found and the choice made.”<sup>110</sup> The Supreme Court has held that, in reviewing that explanation, the court must “consider whether the decision was based on a consideration of the relevant factors and whether there has been a clear error of judgment.”<sup>111</sup> An agency rule will generally be found to be “arbitrary and capricious if the agency has relied on factors which Congress has not intended it to consider, entirely failed to consider an important aspect of the problem, offered an explanation for its decision that runs counter to the evidence before the agency, or is so implausible that it could not be ascribed to a difference in view or the product of agency expertise.”<sup>112</sup> Even if the agency can articulate a legitimate reason for a given policy choice, its method of effectuating this policy choice must be rational – if there is no rational relationship between an agency’s policy objective and its approach, then the approach must be struck down as arbitrary and capricious.<sup>113</sup>

In conducting this analysis, courts are generally limited to examining the administrative record. The APA explicitly instructs a reviewing court to look at the whole administrative record when deciding whether to set aside agency action,<sup>114</sup> and courts have consistently refused to consider an agency’s “post hoc rationalizations” and litigation positions.<sup>115</sup>

---

109. See *Judulang v. Holder*, 565 U.S. 42, 53 n.7 (2011) (noting that its analysis pursuant to the APA’s standard of judicial review would be the same if conducted under *Chevron* step two, “because under *Chevron* step two, we ask whether an agency interpretation is ‘arbitrary or capricious in substance’”).

110. *Encino Motorcars, LLC v. Navarro*, 136 S. Ct. 2117, 2125 (2016) (citing *Motor Vehicle Mfrs. Ass’n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983)).

111. *State Farm*, 463 U.S. at 43.

112. *Id.*; see also *Michigan v. E.P.A.*, 135 S. Ct. 2699, 2706 (2015) (holding the EPA’s interpretation unreasonable under *Chevron*, because it did not take cost into account when deciding whether it was appropriate to regulate power plants, and quoting *State Farm* for the proposition that “agency action is only lawful when it rests on a consideration of the relevant factors”).

113. See *Judulang v. Holder*, 565 U.S. 42, 55, 64 (2011) (holding that courts must reverse an agency rule “unmoored from the purposes and concerns” of the relevant statute and that an agency must effectuate its policy choice in “some rational way” and “based on non-arbitrary, relevant factors” (internal citations omitted)).

114. 5 U.S.C. § 706(2).

115. *Citizens to Preserve Overton Park, Inc. v. Volpe*, 401 U.S. 402, 420 (1971); see also *F.C.C. v. Fox Television Stations, Inc.*, 556 U.S. 502, 513–14 (2009) (noting that “we insist that an agency examine the relevant data and articulate a satisfactory explanation for its action”); *Pension Ben. Guar. Corp. v. LTV Corp.*, 496 U.S. 633, 654 (1990) (noting that

Of some relevance here given that the Valuation Regulation was originally promulgated in the 1970s, the Supreme Court has also explained that the passage of time alone will not insulate a regulation from review. Indeed, as the Court has explained, a “rule’s vintage” is a “slender reed to support a significant government policy,” as “[a]rbitrary agency action becomes no less so by simple dint of repetition.”<sup>116</sup> On the other hand, changes in agency policy also require justification.<sup>117</sup>

B. *Rationale for the Valuation Regulation: The Discount Rate Should Reflect the PBGC’s Actual Costs*

The PBGC’s original notice in the Federal Register regarding the proposed Valuation Regulation, which appeared on December 12, 1975, stated that the rationale for the proposed regulation was that the interest rate (and other assumptions) applied to the PBGC’s claim should reflect the actual cost to the PBGC of providing the pension benefits:

*General Approach.* The value of a benefit as of the date of termination is the *current value of the cost that the PBGC normally should incur* as of the date of termination, in providing the benefit under reasonable assumptions as to mortality, rates of retirement when early retirement is possible, administrative expenses that will be incurred, and *investment return assumptions reflecting current and longer term investment opportunities*. The PBGC’s assumptions will be adjusted from time to time to reflect changes in market conditions and mortality assumptions.<sup>118</sup>

---

“*Overton Park* suggests that § 706(2)(A) . . . imposes a general ‘procedural’ requirement of sorts by mandating that an agency take whatever steps it needs to provide an explanation that will enable the court to evaluate the agency’s rationale at the time of decision”); *Florida Power & Light Co. v. Lorion*, 470 U.S. 729, 743–44 (1985) (“If the record before the agency does not support the agency action, if the agency has not considered all relevant factors, or if the reviewing court simply cannot evaluate the challenged agency action on the basis of the record before it, the proper course, except in rare circumstances, is to remand to the agency for additional investigation or explanation.”).

116. *Judulang*, 565 U.S. at 61.

117. See *Encino Motorcars, LLC v. Navarro*, 136 S. Ct. 2117, 2126 (2016) (holding that “a reasoned explanation is needed for disregarding facts and circumstances that underlay or were engendered by the prior policy” and an “[u]nexplained inconsistency in agency policy is a reason for holding an interpretation to be an arbitrary and capricious change from agency practice” (citations and quotation marks omitted)).

118. 40 Fed. Reg. 57982, 57982 (Dec. 12, 1975) (emphasis added). The PBGC went on to add that “[t]he current value of plan benefits represents an estimate of *costs to the PBGC, not of costs to the plan sponsor*.” *Id.* (emphasis added). In fact, the PBGC anticipated that its cost of providing benefits would be lower – not higher – than the cost incurred by plan sponsors. *Id.* (“In general, because the PBGC can pool the assets and liabilities of many terminated plans for purposes of asset management, benefit administration and the purchase



The implication of this general approach for interest rates was clear: “To value benefits upon termination, *interest assumptions should reflect current market opportunities.*”<sup>119</sup> As of 1975, the PBGC apparently contemplated that those “market opportunities” in which it would invest would include the “purchase of annuities,” as stated in the preamble to the original proposed rule.<sup>120</sup> Indeed, when first announcing that it was using interest rates derived from annuity price data in 1976,<sup>121</sup> the PBGC explained that the rationale for using annuity-based rates was to estimate the PBGC’s actual costs: “the PBGC believes that the interest rate assumptions underlying quotations for the purchase of large blocks of annuities from private insurers provide *the most reliable basis for estimating PBGC’s expected investment experience.*”<sup>122</sup>

In 1978, the PBGC went even further, specifically staking out the position that the Annuity Interest Factors do not “overcharge” employers. For example, in the course of responding to a public comment in 1978 that the PBGC’s rates were “too low” relative to actual market conditions, *i.e.*, relative to “the higher rates of yield for Standard & Poors (‘S&P’) long-term government bonds and ‘AAA’ Industrial bonds,” the PBGC rejected the suggestion that its regulatory rates in fact did, or were intended to, produce a result materially different from the PBGC’s actual cost of providing the benefits following plan termination.<sup>123</sup> It stated:

*The PBGC does not believe that the rates being established . . . result in an “overcharge” to terminating plans. Section 4002(a)(1) of ERISA enjoins PBGC to carry out its functions under Title IV so as to encourage the continuation of private pension plans. To this end, the PBGC has sought to set rates that will not encourage plan terminations and/or PBGC trusteeships. On the other hand, the PBGC is also concerned that assessments for employer liability not be greater than what PBGC expects it will need to meet its guaranty liabilities for insufficient plans. Thus, PBGC has adopted what it believes is a balanced approach in setting its rates.*<sup>124</sup>

---

of annuities, the PBGC’s projected costs in providing plan benefits should generally be less than the costs that would be incurred by some individual plans themselves, especially very small plans, which are expected to constitute a majority of terminating plans.”)

119. *Id.* (emphasis added).

120. *Id.* (stating that “the PBGC can pool the assets and liabilities of many terminated plans for purposes of asset management, benefit administration and the purchase of annuities”).

121. 41 Fed. Reg. 48484, 48485 (Nov. 3, 1976).

122. 41 Fed. Reg. 48498, 48498 (Nov. 3, 1976) (emphasis added).

123. 43 Fed. Reg. 55240, 55240-41 (Nov. 27, 1978).

124. *Id.* at 55241.

Two years later, in the context of proposing a method for publishing its interest factors on a prospective rather than retrospective basis, the PBGC again reaffirmed its cost-based rationale for setting those rates. Once again, the PBGC made clear that “[t]he current value of a benefit as of a specific date is equal to the amount of money needed on that date in order to be able to pay the benefit over future years, taking into account reasonable and current expectations as to the mortality, administrative expenses and interest earnings (*i.e.*, the rate of return to be earned on the investment of the money).”<sup>125</sup> While acknowledging, consistent with this premise, that “[u]nder usual insurance practices, the interest rate assumption would be an estimate of the rate of return to be earned during a future interval of time on funds set aside to meet future benefit obligations,” the PBGC went on to say that it “believes that its relatively brief period of investment experience is neither sufficient nor necessarily an appropriate basis from which to project future earnings.”<sup>126</sup> In other words, the PBGC acknowledged and reaffirmed the principle that the interest factors should be tied to the PBGC’s actual costs, but stated that – as of 1980 – it lacked sufficient information to estimate what those rates would be.

While the PBGC has been open about its use of annuity pricing, it has never announced any change in this underlying cost-based rationale, and has repeatedly reaffirmed it over the course of several decades, including specifically restating that rationale verbatim in its 1993 rulemaking.<sup>127</sup> It has also consistently maintained its pledge to update the assumptions underlying the Valuation Regulation as needed to mirror market realities.<sup>128</sup>

---

125. 45 Fed. Reg. 38415, 38416 (June 9, 1980).

126. *Id.* The PBGC went on to add that, “[f]urther, the PBGC believes it would not be appropriate for it to set rates which produce benefit values (annuity prices) that are significantly different from the prices of annuities offered by private insurers. Accordingly, PBGC will continue its practice of setting its interest rate and factors so as to produce benefit values that are intended to be comparable to prices offered by private insurers.” *Id.*

127. 42 Fed. Reg. 2678, 2678 (Jan. 13, 1977) (“The valuation rates prescribed by the PBGC are designed to reflect PBGC’s cost of providing benefits in terminating plans.”); 45 Fed. Reg. 38415, 38416 (June 9, 1980) (“The current value of a benefit as of a specific date is equal to the amount of money needed on that date in order to be able to pay the benefit over future years, taking into account reasonable and current expectations as to the mortality, administrative expenses and interest earnings (*i.e.*, the rate of return to be earned on the investment of the money).”); 58 Fed. Reg. 5128, 5128 (Jan. 19, 1993) (quoting the rationale stated in the Dec. 12, 1975 proposed rulemaking). While PBGC has taken a more defensive tone in its more recent Federal Register discussions of the Annuity Interest Factors after they were successfully challenged in bankruptcy cases – stating in 2005 for example that the “derived interest factors are not market interest rates” and “it is never meaningful to compare PBGC’s interest factors to market interest rates,” 48 Fed. Reg. 12429, 12430 (Mar. 14, 2005), – it has never explicitly recanted its original cost-based rationale for the regulation, much less attempted to provide any official justification for doing so.

128. *See, e.g.*, 40 Fed. Reg. 57982, 57982 (Dec. 12, 1975) (“The PBGC’s assumptions

C. *The Valuation Regulation Overstates the PBGC's UBL Claim and Does Not Reflect the PBGC's Actual Costs*

As noted above, the PBGC has long embraced an investment strategy based on “prudent” risk taking, under the direction of professional money managers. The result of this approach has been annual returns that, on average, significantly outpace the rate of return implicit in the PBGC’s Annuity Interest Factors. In other words, since the PBGC uses a sophisticated investment strategy to maximize its returns on its assets, the Annuity Interest Factors do not reflect the PBGC’s actual cost in providing the pension benefits for a terminated plan.

This can be seen by examining the PBGC’s annual returns as reflected in its annual reports. As shown below in Table 1, the annual rates of return reported by the PBGC in the annual reports available on its website for the years 1995 through 2016 vary by year (including some negative returns during economic downturns) but average 8.23% when considering annual returns, or 8.35% when looking at the 5-year average return reported in each Annual Report during that period. Under either measure, the PBGC’s average rate of return is over 8%, and well in excess of the discount rates generally dictated by the Annuity Interest Factors, such as the 5.25% long-term discount rate the PBGC argued for in *U.S. Airways*. It is also important to note that the figures in Table 1 reflect the PBGC’s earnings from both its trust fund and its revolving fund assets. Looking at the trust fund assets alone, the returns are generally higher, owing to the lack of statutory constraints on investment approach. Indeed, the court in *U.S. Airways* found that “reported returns on the PBGC’s trust fund assets over the 18-year period from 1985 through 2002 are approximately 10% on an annual

---

will be adjusted from time to time to reflect changes in market conditions and mortality experience.”); *id.* at 58008 (“The interest rates and intervals of deferment contained in this Appendix will be amended by the PBGC from time to time to reflect changes in market conditions.”); 41 Fed. Reg. 48484, 48485 (Nov. 3, 1976) (“The PBGC intends to be monitoring the interest assumptions periodically, and will review the mortality assumptions when data is available. The assumptions will be changed when appropriate.”); 43 Fed. Reg. 55240, 55240 (Nov. 27, 1978) (“The interest rates and factors set forth in the regulation must be adjusted periodically to reflect changes in investment markets. . . . Because these rates and factors must be reflective of investment experience, it is necessary to update the rates and factors periodically.”); 44 Fed. Reg. 3971, 3971 (Jan. 19, 1979) (expressing the same); 45 Fed. Reg. 82172, 82172 (Dec. 15, 1980) (stating that “the interest rates and factors set forth in the regulation are adjusted periodically to reflect changes in financial and annuity markets”); 46 Fed. Reg. 26765, 26766 (May 15, 1981) (“The interest rates and factors set forth in Appendix B to Part 2610 are adjusted periodically to reflect changes in financial and annuity markets.”); 58 Fed. Reg. 5128, 5128 (Jan. 19, 1993) (quoting original 1975 statement that “[t]he PBGC’s assumptions will be adjusted from time to time to reflect changes in market conditions and mortality experience”).

basis.”<sup>129</sup>

*Table 1: Annual and Five-Year Average Returns Reported by the PBGC, 1995-2016*

<u>Year</u>	<u>Annual Return (Percentage)</u>	<u>Five-Year Average Return (Percentage)</u>
1995	24.1	15.5
1996	8.5	12.3
1997	21.9	14.4
1998	14.4	11.9
1999	3.6	14.2
2000	13.2	12.1
2001	-3.3	9.6
2002	2.1	5.8
2003	10.3	5.0
2004	8.0	5.9
2005	8.9	5.1
2006	4.2	6.7
2007	7.2	7.7
2008	-6.5	4.2
2009	13.2	5.2
2010	12.1	5.8
2011	5.1	6.0
2012	12.6	7.1
2013	2.6	9.0
2014	8.0	8.0
2015	0.1	5.6
2016	10.8	6.7
<i>Average</i>	8.23	8.35

129. In re U.S. Airways Grp., Inc., 303 B.R. 784, 795 (Bankr. E.D. Va. 2003). Note that while the analysis in this Article, and in Table 1 in particular, was performed and initially made public prior to the release of the PBGC’s 2017 Annual Report, the inclusion of data from the 2017 Annual Report would not materially alter the conclusions reached here. See 2017 PENSION BENEFIT GUAR. CORP. ANN. REP. 12 (reporting annual rate of return of 5.6%, or 5.4% over a five-year period).

#### IV. THE PBGC'S *Post Hoc* JUSTIFICATIONS FOR THE VALUATION REGULATION DO NOT SUPPORT IT

The foregoing demonstrates that the PBGC's current annuity-based Valuation Regulation cannot be squared with – much less justified by – the official cost-based rationale for the Valuation Regulation found in the Federal Register. Perhaps recognizing this disconnect between the regulation's rationale and the PBGC's desire to charge sponsors of terminating plans at an annuity rate, the PBGC has, in responding to legal challenges to the Valuation Regulation, attempted to recast the rationale for the Valuation Regulation.

This recasting is perhaps best summarized in a 2013 white paper published on the PBGC website, titled “Derivation of Interest Factors in PBGC's Liability Valuation Methodology” (the “White Paper”).<sup>130</sup> The White Paper, which has not been published in the Federal Register or made subject to official public commentary, states that its “purpose” “is to describe the *rationale* for the PBGC's liability valuation methodology and regulation particularly as it relates to the determination and application of interest factors.”<sup>131</sup> While the White Paper does not constitute the official rationale for the Valuation Regulation, which – as the Supreme Court has repeatedly explained<sup>132</sup> – is to be found solely in the official administrative record, it is worth considering the arguments raised by the PBGC in the White Paper, which mirror the position the PBGC has taken, and likely will continue to take, in litigation (and which position has been accepted by bankruptcy courts since 2003).<sup>133</sup>

In contrast to the official explanation found in the Federal Register, which was based on the cost to the PBGC, the White Paper asserts that “[f]rom the outset, the cornerstone of the PBGC regulatory approach has been to value a plan's benefit liabilities by approximating the fair market price of group annuities sold by private sector insurance companies.”<sup>134</sup> The White Paper states that the “rationale for valuing liabilities based on their market value is twofold”:

---

130. WHITE PAPER, *supra* note 17.

131. WHITE PAPER, *supra* note 17, at 1 (emphasis added).

132. See *supra* notes 114-115 and accompanying text (explaining that the official rationale for a regulation is found in the administrative record).

133. In its Pre-Trial Brief in *U.S. Airways*, the PBGC stated that it would “prove that its claim is the marketplace value of the Pilots Plan's liabilities, less the value of the Pilots Plan's assets,” on the basis that the “PBGC's determination of the unfunded benefit liabilities of the Pilots Plan is well within the range of what insurance companies would charge.” Pre-Trial Brief of the Pension Benefit Guaranty Corporation at 28, In re *U.S. Airways Group, Inc.*, No. 02-83984 (Bankr. E.D. Va. Oct. 17, 2003).

134. WHITE PAPER, *supra* note 17, at 2 (emphasis added).

First, this valuation approach minimizes the “moral hazard” inherent in the Title IV termination insurance program by ensuring that it is not less costly for an employer to terminate a pension plan in a distress termination with the PBGC than to terminate the plan in a standard termination in the private sector. Marking liabilities in PBGC-trusted plans to the annuity market matches those liabilities to the price that a plan sponsor would have to pay to terminate their plan in the open market. This avoids the moral hazard mentioned above as well as the clear impropriety of overpricing PBGC’s trusteeship of a sponsor’s pension plan.

Second, the regulation is premised on the rationale that valuing a liability based on the value a willing buyer and seller would exchange for that liability – i.e., a market value obtained in a competitive marketplace – is reasonable.<sup>135</sup>

Each of these arguments is addressed in turn below.

A. *Annuity Pricing Is Not Necessary to Avoid Any “Moral Hazard”*

The so-called “moral hazard” cited by the PBGC appears to be a reference to the fact that in a standard termination an employer “can complete the standard termination by distributing plan assets in the form of annuities purchased from a private insurer.”<sup>136</sup> Though not stated explicitly, the PBGC’s argument seems to be that, were it to use a higher discount rate reflecting its actual investment experience, plan sponsors would elect to engage in distress terminations rather than standard terminations. There are at least two flaws in this argument.

First, as a threshold matter, the PBGC’s focus on the purchase of annuities for a standard termination is misplaced, as a standard termination may, but need not be, accomplished by the purchase of annuities. Rather, by statute, a standard termination can also be accomplished by means of lump sum payments to participants,<sup>137</sup> which in general constitutes a cheaper alternative to the purchase of annuities since insurance companies that offer annuities must account for the risk they take on in selling those products, and is in fact the alternative taken by a large percentage of eligible retirees when

---

135. WHITE PAPER, *supra* note 17, at 2-3.

136. WHITE PAPER, *supra* note 17, at 8 (citing 29 U.S.C. § 1341(b)(3)(A)(i); 29 C.F.R. § 4041.28(c)(2)). Section 1341(b) provides under “Methods of final distribution of assets” in a standard termination that “[i]n distributing such assets, the plan administrator shall – (i) purchase irrevocable commitments from an insurer to provide all benefit liabilities under the plan, or (ii) in accordance with the provisions of the plan and any applicable regulations, otherwise fully provide all benefit liabilities under the plan. A transfer of assets to the corporation in accordance with section 1350 of this title on behalf of a missing participant shall satisfy this subparagraph with respect to such participant.”

137. 29 U.S.C. § 1341(b)(3).

given the option.<sup>138</sup>

Second, and more fundamentally, the purported choice between a standard and a distress termination that underlies the supposed “moral hazard” simply is not available. As the PBGC itself acknowledges in the White Paper, an employer may voluntarily terminate an “underfunded plan only if the employer and each member of the controlled group meet one of ERISA’s tests for financial ‘distress.’”<sup>139</sup> None of these tests involves or references annuities; rather, they turn on the financial health of the plan sponsor.<sup>140</sup> Thus, there is no clear “moral hazard” inherent in discounting UBL claims according to the PBGC’s rate of return on its investments, given that employers are not at liberty to select a distress termination merely because they believe it will be more advantageous than a standard termination or continuation of the plan.

Indeed, to the extent the PBGC was expressing a concern related to the ability of a plan sponsor to terminate a pension plan absent financial distress, this concern is no longer relevant since Congress amended ERISA in 1986 and 1987 to provide that an employer may only voluntarily terminate a plan where it can be shown that either the plan had sufficient assets to cover liabilities or where the employer met the standard for financial distress.<sup>141</sup> The amendments implemented in 1986-87 were designed to correct the perceived effect the then-existing system had of “encourag[ing] employers to terminate plans, evade their obligations to pay benefits and shift unfunded pension liabilities to the insurance program.”<sup>142</sup> Thus, the goal was “to increase the likelihood that participants will receive their full benefits, to

---

138. Testimony of Craig Rosenthal on Behalf of the American Benefits Council for the ERISA Advisory Council: Private-Sector De-Risking and Participant Protections at 4 (June 5, 2013), available at <https://www.americanbenefitscouncil.org/pub/?id=e6140ac6-f0b9-af44-18d0-471154b3b649> [<https://perma.cc/L49R-RAHV>] (stating “[a]nnuities come at a cost to the plan sponsor though, as the cost of purchasing an annuity is almost universally higher than the cost of offering lump sums” and that “[t]his increased cost is primarily the result of margins imposed by the insurer to cover potential adverse risks, profits, taxes and other expenses”). According to Rosenthal, onetime lump-sum offers, including offers in connection with a plan terminations, experience an election percentage for participants who have not yet commenced benefits in the range of 40 to 60%. *Id.* at 6.

139. WHITE PAPER, *supra* note 17, at 8-9 (emphasis added).

140. Under ERISA, an employer may voluntarily terminate a pension plan due to financial distress only if one of four tests is satisfied: (1) the employer is in liquidation proceedings, (2) the employer is in reorganization proceedings and termination is needed for the success of the reorganization, (3) without termination, an employer will be unable to meet obligations in order to continue in business, or (4) costs of the plan have become “unreasonably burdensome” due to declining workforce. 29 U.S.C. § 1341(c)(2)(B).

141. Single Employer Pension Plan Amendments Act of 1986, Pub. L. No. 99-272, 100 Stat. 237 (1986); Pension Protection Act, Pub. L. No. 100-203, 101 Stat. 1330 (1987) (part of Omnibus Budget Reconciliation Act of 1987).

142. H.R. REP. No. 99-300, at 312 (1985), as reprinted in 1986 U.S.C.C.A.N. 756, 963.

limit claims against the PBGC insurance system to instances of severe hardship and to assure that the program is prudently financed.”<sup>143</sup> Prior to the amendments, Congress determined that plan sponsors’ “lack of full statutory accountability to participants, beneficiaries, and the PBGC provides a disincentive for employers to fully fund their pension plans and can result in a funding shortfall that threatens both benefit security and the fiscal solvency of the PBGC.”<sup>144</sup> By enacting these changes, Congress hoped to create a situation where “[p]articipants and beneficiaries and the PBGC will incur losses from a plan termination only when the contributing sponsor and the other members of its controlled group are so financially distressed that they cannot pay the full liability that the bill would impose.”<sup>145</sup> Thus, Congress has already addressed the “moral hazard” issue and there is no credible argument that use of annuity pricing relates to, or can be justified by, a moral hazard risk.

B. *The Annuity Interest Factors Do Not Reflect a “Market Price” for the PBGC’s Insurance Coverage*

The PBGC also argues for the use of its Annuity Interest Factors based “on the rationale that valuing a liability based on the value a willing buyer and willing seller would exchange for that liability – i.e., a market value obtained in a competitive marketplace – is reasonable.”<sup>146</sup> This rationale sounds appealing superficially because it suggests that the PBGC is estimating how the market might value the coverage of the pension obligations provided by the PBGC. But the PBGC’s rationale mixes “apples with oranges” in the sense that what the market is pricing with the Annuity Interest Factors are annuities offered by life insurance companies (a product that the PBGC does not buy, nor can it provide), whereas *what is actually being provided* by the PBGC is a commitment to cover the future pension obligations using earnings generated from PBGC assets. The two are not the same. The PBGC would never find a willing buyer for its coverage at the “price” implied by the Annuity Interest Factors because the PBGC follows an investment strategy and has a capital position that are very different from life insurance companies.

When an actual annuity contract is sold by a private insurance company, the purchaser pays a lump-sum price for the contract in exchange for a promise from the insurance company, as seller, to pay a fixed amount of cash on a monthly basis to a set of beneficiaries over a given period; for example,

---

143. *Id.*

144. H.R. REP. No. 100-391, at 109 (1987), as reprinted in 1987 U.S.C.C.A.N. 2313-1.

145. *Id.* at 125.

146. WHITE PAPER, *supra* note 17, at 3.



until the death of each of the beneficiaries. Life insurance companies are well-capitalized financial institutions that invest the proceeds from their annuity sales in relatively low-risk, fixed income assets.<sup>147</sup> This is the reason that the implied discount rates from the insurance companies are so low: the assets used to pay the annuities over time are invested in low-risk assets with low rates of return.

In contrast, according to its own stated investment policy, the PBGC does not follow a low-risk/low return investment strategy. For instance, in its 2008 Annual Report, the PBGC stated that one of the objectives of its current investment policy was to “prudently maximize investment returns.”<sup>148</sup> PBGC director Charles Millard acknowledged the risk profile of the PBGC’s strategy, stating that “[t]he PBGC has the ability to accept some degree of short-term volatility to achieve our goal of enhancing assets to pay benefits.”<sup>149</sup> The PBGC, as well as other U.S. government agencies, have on multiple occasions recognized the risks inherent in the PBGC investment program. For example, the PBGC’s 2009 Annual Report declares that its financial health is subject to “market risk associated with interest rates and equity returns” because these factors affect the value of PBGC’s assets.<sup>150</sup> The Government Accountability Office (“GAO”) designated the PBGC single employer program as “high-risk” in July 2003 and added the multiemployer program in January 2009.<sup>151</sup> These programs still remain on the GAO’s high-risk list due to “long-term structural challenges relating to funding of defined benefit pension plans.”<sup>152</sup> Finally, the U.S. Government does not stand behind the PBGC’s obligations and funds from general tax revenues are not provided to the PBGC to carry out its mandate.<sup>153</sup>

The differences between the PBGC and life insurance companies become apparent when examining the asset holdings of the institutions. As

---

147. Robert McMenamin et al. *What Do U.S. Life Insurers Invest In?*, Chicago Fed Letter, No. 309, THE FED. RESERVE BANK OF CHICAGO, Apr. 2013.

148. 2008 PENSION BENEFIT GUAR. CORP. ANN. REP. 18. This objective has been repeated in subsequent investment policy statements. See PENSION BENEFIT GUAR. CORP., PBGC INVESTMENT POLICY STATEMENT, May 2011 (stating that “[p]rudent risk-taking is justifiable”); PENSION BENEFIT GUAR. CORP., PBGC INVESTMENT POLICY STATEMENT 4, Sep. 2016 (same).

149. PENSION BENEFIT GUAR. CORP., PBGC Announces New Investment Policy, Feb. 18, 2008, available at <https://www.pbgc.gov/news/press/releases/pr08-19> [<https://perma.cc/YVQ7-SB5Y>].

150. 2009 PENSION BENEFIT GUAR. CORP. ANN. REP. 22.

151. U.S. GOV’T ACCOUNTABILITY OFFICE, HIGH RISK SERIES, AN UPDATE 150, Feb. 2011.

152. 2016 PENSION BENEFIT GUAR. CORP. ANN. REP. 20-21.

153. PENSION BENEFIT GUAR. CORP., PBGC Announces New Investment Policy, Feb. 18, 2008, available at <https://www.pbgc.gov/news/press/releases/pr08-19> [<https://perma.cc/94KZ-VSPJ>].

stated in its 2016 Investment Policy Statement, the PBGC aims for a 70/30 ratio of fixed-income to equity assets.<sup>154</sup> As of 2016, the PBGC was roughly on track to meet this objective, with approximately 67.6% of its assets in fixed-income securities, 28.0% in equities, and the remainder in other investments such as real estate and private equity.<sup>155</sup> By contrast, insurance companies, which are constrained by state laws and regulations concerning their investments,<sup>156</sup> as well as the practical need to meet long-term obligations, invest primarily in fixed-income assets such as corporate bonds and mortgages.<sup>157</sup> As of year-end 2015, for example, 70.1% of life insurer general account assets were held in bonds, with corporate bonds alone constituting nearly half of all assets, while only 2.2% of assets were in stocks and 10.3 in mortgages (the remainder was comprised of real estate, and other investments).<sup>158</sup> Thus, compared to the life insurers, the PBGC holds a much larger proportion of its investments in relatively risky equities and a smaller proportion in lower risk fixed-income and other debt securities. While the large weight of the PBGC's allocation in equities generates higher average returns for the PBGC, it comes with a commensurate level of risk not embraced by insurance companies.

The PBGC and insurance companies also differ in their capital positions, *i.e.*, the difference between the value of assets and liabilities. As noted in its 2016 Annual Report, for FY 2016 the PBGC's Single Employer Program reported approximately \$97.3 million in assets and \$117.9 million in liabilities, for a deficit of approximately \$20.6 billion (*i.e.*, roughly 17%

---

154. PENSION BENEFIT GUAR. CORP., PBGC INVESTMENT POLICY STATEMENT 5, Sept. 2016.

155. 2016 PENSION BENEFIT GUAR. CORP. ANN. REP 68 (reporting \$57,292 million in fixed maturity securities, \$23,684 million in equity securities, and \$84,732 million in total assets, in each case by market value).

156. NAT'L ORG. OF LIFE AND HEALTH INS. GUAR. ASS'NS., CONSUMER PROTECTION COMPARISON: THE FEDERAL PENSION SYSTEM AND THE STATE INSURANCE SYSTEM 17, May 22, 2016 (noting that "state insurance commissioners heavily regulate and closely monitor life insurer investments," which must generally be made up of "highly rated, investment grade debt obligations" and that "life insurers are generally restricted from investing in the aggregate more than 20% of their admitted assets in equities listed on a qualified exchange, or more than 5% in the aggregate in equities of unaffiliated entities not listed on a qualified exchange").

157. See Robert McMenamin et al. *What Do U.S. Life Insurers Invest In?*, Chicago Fed Letter, No. 309, THE FED. RESERVE BANK OF CHICAGO, Apr. 2013 (noting that "fixed-income assets like bonds and mortgages constituted the largest share of invested assets, at 75.5% and 9.6%, respectively," with corporate bonds alone making up "the largest share of general-account assets" at 46.0%," while equities constituted only 2.3%).

158. AM. COUNCIL OF LIFE INSURERS, LIFE INSURERS FACT BOOK 2016 11. Note that these figures exclude assets held in separate accounts for liabilities associated with investment risk pass-through products, such as variable annuities or variable life insurance, *id.* at 7, 11, which are not the focus here.

of liabilities).<sup>159</sup> By comparison, insurance companies are required, subject to regulatory oversight, to maintain assets in excess of insurance obligations.<sup>160</sup> As of 2015, the vast majority of insurance companies had a risk-based capital ratio – the excess of assets over the minimum amount needed to avoid triggering regulatory action – of 200% or greater, with an average ratio of 486%.<sup>161</sup> In other words, insurance companies generally carry well in excess of twice the required level of assets. The positive capital positions of the life insurers provide them with an extra “equity cushion” against any losses on their assets.

There are other important differences, too. As noted by the GAO, the PBGC differs from insurance companies in that (1) it is unable to set the level of premiums that it receives from plan sponsors to insure their plans, and (2) it must take on new participants, irrespective of the financial health of the terminated plans.<sup>162</sup>

Given the PBGC’s stated investment goals of prudent risk-taking, as well as its portfolio holdings and capital position, which together imply an explicitly higher risk and return strategy, the PBGC cannot duplicate the low risk and return profile implied by annuity contracts offered by life insurance companies. The only “market” rate that the PBGC could use to discount pension obligations would have to be higher than the Annuity Interest Factors in order to reflect the realities of the PBGC’s investment strategy and capital position. Therefore, when the PBGC uses its Annuity Interest Factors to discount pension obligations, it *understates* the discount rate, which leads the present value of the obligations to be *overstated*.

Moreover, even when the PBGC is permitted to collect an oversized claim based on its Annuity Interest Factors, it is still unable to offer a risk-

---

159. See 2016 PENSION BENEFIT GUAR. CORP. ANN. REP. 28. As noted, *supra* note 9, the PBGC again reported substantial deficits in 2017. See 2017 PENSION BENEFIT GUAR. CORP. ANN. REP. 10 (reporting \$10.9 billion deficit for the single-employer program and \$65.1 billion deficit for the multiemployer program). Although there is arguably some circularity in assessing the PBGC’s deficit on the basis of its Annual Reports, which similarly use artificially low discount rates, there is little disputing that the PBGC is poorly capitalized relative to most insurance companies.

160. See generally NAT’L ORG. OF LIFE AND HEALTH INS. GUAR. ASS’NS., CONSUMER PROTECTION COMPARISON: THE FEDERAL PENSION SYSTEM AND THE STATE INSURANCE SYSTEM 16-17, May 22, 2016.

161. AM. COUNCIL OF LIFE INSURERS, LIFE INSURERS FACT BOOK 2016 25, 30. To provide another metric, in 2015, the aggregate capital ratio of U.S. life insurers (defined as surplus funds plus capital stock plus asset valuation reserve as a percentage of general account assets) was 10.7%. *Id.* at 24.

162. GAO-11-271 REPORT, *supra* note 27, at 7. The GAO also noted that although the PBGC has adjusted its investment policy several times over the years, these “frequent changes in policy have had a moderate impact on PBGC’s actual allocation of assets since 1976 because there were no allocation targets in place prior to 1990 and the policy targets after that time were rarely ever met.”

free benefit given its asset allocation practices and capital position. Any amount the PBGC recovers through its UBL claim, together with the earnings from the plan assets that the PBGC inherits, is invested according to the PBGC's investment policy and alongside the PBGC's other assets as part of the total mix of assets available to the PBGC to meet obligations for all trustee plans. As a result, a higher claim amount does not guarantee (or nearly guarantee) that all the pension obligations will be paid when they come due; the overstated amounts are still subject to the same risks inherent in PBGC's aggregate investment portfolio.<sup>163</sup>

To be sure, if the PBGC starts with an overstated amount with which to invest, the expected dollar return on those amounts will more than cover the pension obligations for a given pension plan in isolation. Indeed, the PBGC would expect to earn a *surplus* above what is owed on the pension obligations. This surplus would benefit the PBGC by potentially strengthening its financial position, albeit at the cost of reducing the claim amounts available to other creditors. But even providing the PBGC with an overstated claim would not be sufficient to guarantee the pension obligations it has taken on for any given plan. In order for the PBGC to provide terminated pension plans with the same level of certainty of future benefit payments that private insurance companies can provide, it would need to fundamentally alter how it operates. In theory, the PBGC could buy annuities from private insurance companies for plan participants.<sup>164</sup> The PBGC could also change its investment allocation practices to be consistent with private sector insurance companies. To date, neither of these steps has been taken, however, nor has the PBGC indicated any intention to make such changes, to the extent it could do so. Therefore, the PBGC cannot provide trustee plans with the certainty offered by private insurance companies and implied in the Annuity Interest Factors. The PBGC may wish to charge plan sponsors for offering that level of certainty, but it simply cannot offer it. It currently charges for something that it does not provide, and cannot provide.

In light of the forgoing, it becomes clear that the more appropriate rate for discounting UBL claims is the expected return on the PBGC portfolio. Only by discounting the pension obligations at the expected return on the PBGC portfolio can one appropriately match "apples to apples" – using the PBGC's expected investment return as a discount rate that reflects the ability of the PBGC to generate a return *based on its own investment risk and return*

---

163. Given its capital position, the only way for the PBGC to provide a (nearly) risk-free benefit is to invest in (nearly) risk-free assets.

164. In theory, Congress could set premiums charged to non-terminated pension plans such that the revenue would pay for the difference between the cost of the annuities purchased and the amount of assets recovered from terminated pension plans and their plan sponsors. Congress has not done so.

*profile* to meet the payments under the pension obligations.

While it may have made some sense initially for the PBGC to use Annuity Interest Factors to estimate the cost that the PBGC would incur in providing benefits – indeed, the PBGC may have envisioned that it would in fact purchase annuities – that is no longer the case. As discussed above, it appears that the PBGC initially used annuity contracts to estimate PBGC investment returns because, through September 1976, the PBGC maintained an asset mix that was similar to insurance companies.<sup>165</sup> However, beginning in late 1976 and thereafter, the PBGC deviated from the low-risk and low-return profile of life insurance companies by increasing its investment in equities.<sup>166</sup> But the PBGC failed to divorce itself from the use of annuity prices to calculate its discount rates. By 1980, the PBGC defended its continued use of life annuities to infer discount rates in place of its actual investment returns by suggesting that it did not yet have sufficient investment return information to switch to a different discount rate.<sup>167</sup> The PBGC also began to argue that discounting at rates higher than those implied by life annuity contracts – even if the higher rates more accurately reflected the PBGC’s investment profile – could provide incentives for on-going plans to terminate,<sup>168</sup> a purported concern that is no longer relevant in light of subsequent amendments to ERISA providing that plan sponsors may not voluntarily terminate defined-benefit pension plans absent financial distress.<sup>169</sup> The PBGC no doubt came to appreciate over time the fact that its continued use of Annuity Interest Factors is hugely beneficial to its bottom line, effectively allowing it to pursue claims that yield recoveries far in excess of recoveries that would be generated by claims premised on a cost-based damages approach. Thus, while the PBGC rulemaking originally

---

165. In November 1976, the PBGC wrote that it “believes that the interest rate assumptions underlying quotations for the purchase of large blocks of annuities from private insurers provide the most reliable basis for estimating PBGC’s expected investment experience.” 41 Fed. Reg. 48498 (Nov. 3, 1976). Meanwhile, “[t]he PBGC Total Fund allocation in September 1976 (the beginning of the historical sample period) was similar to that found among life insurance companies,” GAO-11-271 REPORT, *supra* note 27, at 54.

166. The “period (September 1976 to August 1987) was characterized by a trend of allocation away from bonds into equities such that the allocation altered from 15 percent equities, 84 percent bonds in September 1976 to 64 percent equities, 31 percent bonds by August 1987.” GAO-11-271 REPORT, *supra* note 27, at 53.

167. “Under usual insurance practices, the interest rate assumption would be an estimate of the rate of return to be earned during a future interval of time on funds set aside to meet future benefit obligations. The PBGC believes that its relatively brief period of investment experience is neither sufficient nor necessarily an appropriate basis from which to project future earnings.” 45 Fed. Reg. 38415, 38416 (June 9, 1980).

168. “To this end, the PBGC has sought to set rates that will not encourage plan terminations and/or PBGC trusteeships.” 43 Fed. Reg. 55240, 55241 (Nov. 27, 1978).

169. See *supra* notes 139-145 and accompanying text.

intended that future benefit obligations be discounted at rates that reflected the PBGC's investment performance, the PBGC froze in place its use of annuity contracts to infer discount rates, thus defaulting on its commitment to update the assumptions as necessary to reflect the PBGC's actual costs.

#### CONCLUSION

The current state of the law with respect to the Valuation Regulation is untenable. The Valuation Regulation is in conflict with its own rationale, and is also in significant tension with the bedrock principles of bankruptcy law that form the context in which the PBGC's UBL claims are litigated. As argued herein, the conflict between the PBGC's Valuation Regulation and its own rationale should lead courts to the conclusion that the regulation is arbitrary and capricious, and not entitled to any deference in determining the appropriate discount rate for the PBGC's UBL claims – in bankruptcy or otherwise.

There are two basic roads to reform. First, the PBGC can revise its methodology for devising the discount rates used in the Valuation Regulation. This would not require a major overhaul of the regulation itself, which only uses the Annuity Interest Factors as one of several components in determining the UBL claim amount. Indeed, the PBGC has repeatedly stated that the assumptions underlying the computation of its UBL claim amount will be updated in the future as necessary to more accurately reflect market conditions. As demonstrated herein, the time for the PBGC to make such an amendment to its interest factors is long overdue.

Second, if the PBGC is not prepared to revise the Valuation Regulation, Congress should act. If it were truly Congress's intention that the PBGC be granted an outsized claim in bankruptcy to the detriment of other unsecured creditors, so be it. But Congress has never so indicated, notwithstanding the PBGC's insistence that Congress has "ratified" the current Valuation Regulation. If, on the other hand, Congress did not intend for the PBGC to exercise advantages over other similarly situated creditors in bankruptcy – besides those it expressly granted to the PBGC in providing that it could recover from any member of a plan sponsor's controlled group – then a clarifying amendment to ERISA mandating a cost-based approach to discounting the PBGC's UBL claim would have a salutary effect, bringing both greater clarity and fairness to bankruptcy proceedings to which the PBGC is a party.

Finally, if neither road to reform is pursued, courts have ample basis today to reject UBL claims based on the PBGC's annuity-pricing-derived discount rates. Congress provided the PBGC with enormous benefits through joint-and-several controlled group liability. It did not provide the

2017] VALUATION REGULATION IN BANKRUPTCY 285

PBGC with authorization to use an arbitrary and capricious discount rate to outsize its UBL claims.