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Memorandum

TO: Board of Trustees
Industry and Local 338 Pension Fund

CC: Alicia Cochran
Debbie Dubbs
Mary Ann Dunleavy

FROM: Elizabeth O'Leary

DATE: May 31, 2018

RE: Withdrawal Liability Issues

This memo describes two pending court cases challenging the use of what is commonly called "the Segal Blend" in calculating withdrawal liability. Although Segal is no longer the actuary for the Industry and Local 338 Pension Fund (the "Fund"), Horizon Actuarial Services, LLC ("Horizon") continues to use the Segal Blend in calculating the Fund's withdrawal liability. Although the Fund continues to collect scheduled withdrawal liability payments from previously withdrawn employers, the deadline for those withdrawn employers to challenge the Segal Blend is long expired. Fortunately, there have been no recent withdrawals so this issue is not pertinent to the Fund at this time. However, we wanted to provide a report on these developments for informational purposes.

Withdrawal liability is calculated based on a number of actuarial assumptions. ERISA requires that in determining an employer's withdrawal liability, the actuary shall use "actuarial assumptions and methods which, in the aggregate, are reasonable (taking into account the experience of the plan and reasonable expectations) and which, in combination, offer the actuary's best estimate of anticipated experience under the plan." One of the actuarial assumptions that Segal uses in calculating withdrawal liability is known as the "Segal Blend." What this meant for the Fund is that Segal used the Fund's 7.50% investment return assumption and discount rate to value liabilities ***for funding purposes*** but it used different assumptions – i.e., the Segal Blend assumptions – to value liabilities ***for withdrawal liability purposes***. As Horizon reported after it became the actuary for the Fund, Horizon determined that it would continue to use the assumptions used by Segal for determining and assessing withdrawal liability.

The use of the Segal Blend is described in withdrawal liability reports. For instance, an estimated withdrawal liability report for the Fund during the July 1, 2016 through June 30, 2017 Plan Year included the following description of Horizon's interest rate assumption:

a) Interest Rate

> For liabilities up to the market value of assets, valued using PBGC interest rates as of June, 2016 of 2.77% and 2.86% (for 20 years and thereafter, respectively).
>
> For liabilities in excess of the market value of assets, valued using 7.5% for all years.

When the Segal Blend was initially adopted shortly after ERISA's withdrawal provisions were enacted in 1980, it produced lower withdrawal liability assessments than the use of funding assumptions. Under recent economic circumstances (lower interest rates), the reverse is true. Note that other major actuarial firms employ the Segal Blend or some variation of this methodology.

Segal's standard response to employers' challenges to the Segal Blend is the following:

> Some withdrawing employers claim that the Segal Blend is unreasonable because the long-term funding discount rate assumption is higher than the withdrawal liability discount rate assumption. The funding assumption is higher, in part, because it assumes investments in equities and perhaps other "risky" investments. If one were to use the funding assumption for withdrawal liability, one would be giving the withdrawing employer the reward for taking the risk without actually requiring that employer to take the risk. The continuing employers are entitled to the reward (if it develops) because they are taking the risk. Those withdrawing employers suggest that they should get the equity premium (the reward), but if the market declines the continuing employers should pay their share of the losses. Whether or not the Trustees choose to take additional risks in hopes of a later reward, the withdrawing employer's obligations should logically be discounted at the "risk-free" market rate – the rate that would be used if an insurance company assumed the obligation.
>
> Of course, Segal does not simply use the adjusted PBGC rates to determine withdrawal liability – we use the Segal Blend. The logic behind a blend of market and funding rates as follows. A full market value settlement would be appropriate if the withdrawal liability were required to be paid in a single sum, as is required for a standard termination of a single employer defined benefit pension plan. However, ERISA provides that the payments of withdrawal liability will be due over a period of up to twenty years. The foundation of the blend is that the portion that is already funded should be valued at market (because that portion could actually be

> settled), whereas the unfunded portion that will be funded over a period of years into the future should be valued on funding assumptions. A simple illustration will show how this is accomplished.

(1)	Assets at market (per audited financial statements)	80
(2)	Vested benefits at market (i.e., using adjusted PBGC assumptions)	100
(3)	Vested benefits – funding basis (i.e., using the assumptions used for determining minimum funding of the plan)	90
(4)	% funded at market = (1)/(2)	80%
(5)	Vested benefits for withdrawal liability = 80% of (2) + 20% of (3)	98
(6)	Unfunded vested benefits for withdrawal liability = (5) – (1)	18

Note that the unfunded vested benefits at market, (2) – (1) = 20, are higher that the unfunded vested benefits for withdrawal liability, (5) – (1) = 18. That is, under the economic circumstances applicable currently, the blending process lowers a withdrawing employer's assessment compared to a full market value assessment.

Recent Employer Challenges to the Segal Blend

Although employers have frequently raised challenges to the use of the Segal Blend throughout the years, those challenges have been unsuccessful until very recently.

Specifically, the law firm of Jones Day is representing two employers in pending withdrawal liability cases. One of the cases, which was filed in the United States District Court for the Southern District of New York, involves the New York Times Company and the Newspaper and Mail Deliverers'-Publishers' Pension Fund. The second case involves Manhattan Ford Lincoln Inc. and the United Autoworkers Local 259 Pension Fund and is pending in the United States District Court for the District of New Jersey.

The New York Times Case

In the *New York Times* case, Judge Sweet issued a 73-page opinion on March 26, 2018 on the parties' motions for summary judgment which included a number of rulings, some of which were favorable to the employer and some of which were favorable to the pension fund. Some of the issues in that case were very fact-specific and are beyond the scope of this memo. However, one issue that has been the subject of considerable attention pertains to Judge Sweet's resolution of the employer's challenges to the Segal Blend. In that case, the Segal actuary used a discount rate of 6.5% to calculate the employer's withdrawal liability. The court stated:

> Specifically, [the actuary] used a discount rate of 6.5%, known in the industry as the Segal Blend, which was calculated by blending the Fund's investment-return rate of 7.5% with lower, risk-free rates published by the PBGC. This rate was different than what the Fund used when calculating the Times' minimum funding requirements. As such, the

> parties dispute whether the asymmetrical application of the Segal Blend was legally permissible.

Judge Sweet rejected the employer's arguments that the use of the Segal Blend was prohibited as a matter of law and that actuaries *must* use the same discount rate for minimum funding and withdrawal liability purposes. However, Judge Sweet determined that the application of the Segal Blend in this particular case was problematic, and the court directed that the employer's withdrawal liability be recalculated using the 7.5% assumption. ("Egan's testimony before the Arbitrator was that a 7.5% assumption was her 'best estimate of how the Pension Fund's assets . . . will on average perform over the long term.' If 7.5% was the Fund actuary's 'best estimate,' it strains reason to see how the Segal Blend, a 6.5% rate derived by blending that 7.5% 'best estimate' assumption with lower, no-risk PBGC bond rates, can be accepted as the anticipated plan experience. This is especially when the blend includes interest rates for assets not included in the Fund's portfolio. The Segal Blend's applicability is further undermined by Egan's acknowledgment that she had used the Segal Blend as her 'best estimate' when calculating withdraw[al] liability 'regardless of the particular pension plan's actual portfolio of assets.'").

Judge Sweet's order is being appealed to the Second Circuit, and we understand that Segal will be filing a friend of the court brief seeking to have this portion of the decision reversed.

The Manhattan Ford Lincoln Case

The second case in which the employer is also represented by Jones Day is pending in the District Court of New Jersey. The sole dispute in that case is the Segal Blend. The arbitrator in that case (like the arbitrator in the *New York Times* case) ruled for the pension fund on this issue, and a summary judgment motion seeking to vacate the arbitrator's award is pending before Judge McNulty. In the *Manhattan Ford Lincoln* case, the fund was fully funded (with a 111.7% funded percentage) and had the fund's 7.5% investment return rate (rather than the Segal Blend rate) been applied to calculate the withdrawal liability, the employer would have owed nothing. Based on the Segal Blend, the withdrawal liability was $2.55 million.

Conclusion

Prior to Judge Sweet's recent decision in the *New York Times* case, challenges to the Segal Blend were generally dismissed as frivolous. As a result of this decision, there is now uncertainty in this area of the law and we can expect to see more employer challenges to the Segal Blend, at least until the Second Circuit rules on the appeal of Judge Sweet's decision.

We will monitor the developments in this area and provide updates as available.