

Solemn Promise or Past Sin?
Implications of Pension Terminations

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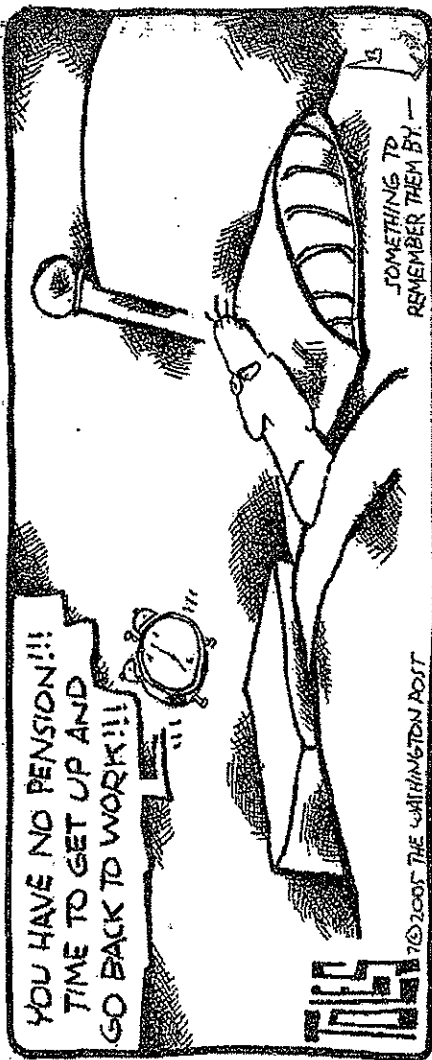
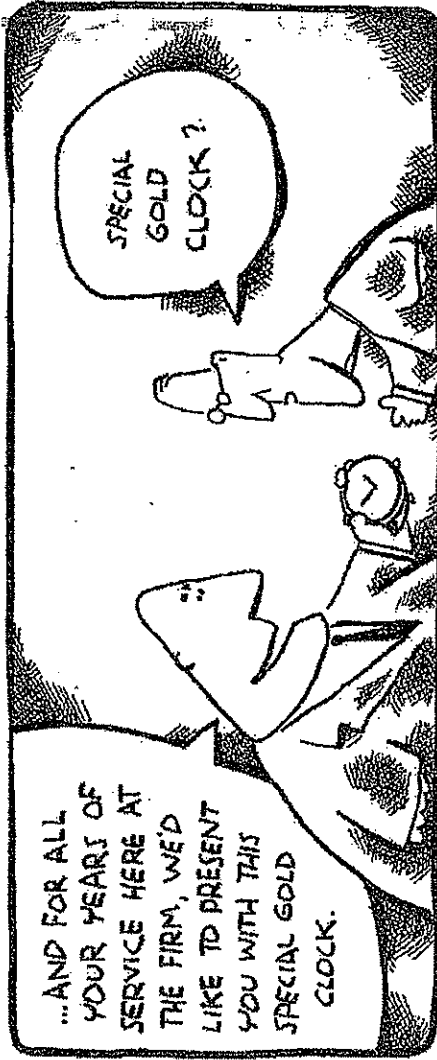


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I. Background: Plans, Players, Procedures and Claims.

A. Types of Plans and Characteristics

1. Defined Contribution Plans (401K Plans, Profit-Sharing Plans, Etc.)
2. Defined Benefit Plans
 - a. Definitely determinable benefit usually based on age, length of service and compensation levels
 - b. Funded on group basis using actuarial assumptions
3. Multi-employer plans (a/k/a Taft Hartley plans)
 - a. Generally industry group plans (e.g., trucking, mining and construction)
 - b. Withdrawal liability issues

B. Governing Law/PBGC

1. Employee Retirement Income Security Act of 1974 As Amended ("ERISA") (29 U.S.C. § 1001 et. seq.) (other significant provisions in Internal Revenue Code)
 - a. ERISA sets uniform minimum standards for pension plans.
 - b. Title IV of ERISA
 - i. Sets forth complex funding rules
 - ii. Does not apply to defined contribution plans
 - iii. Provides mandatory government insurance to protect defined benefits. These are administered by the Pension Benefit Guaranty Corporation (the "PBGC")

2. PBGC
 - a. Oversees Title IV of ERISA.
 - b. A governmental “insurance company”
 - c. Not funded by general tax revenues but by employer premiums, collections on employer liability claims, investment returns
 - d. Takes very active role in bankruptcy cases (where a lot of ERISA law is made)
 - e. Missions include making sure pension benefits are not interrupted
 - i. Make sure that defined benefit plans are funded sufficiently
 - ii. Oversee plan termination process
 - iii. Recover premiums and bankruptcy claims
3. Funding of Defined Benefit Plans
 - a. ERISA establishes a minimum funding standard
 - b. Funding must always be sufficient to cover an “accumulated funding deficiency”
 - i. “Normal costs” (i.e. current costs associated with provided benefit for active participants)
 - ii. Amount necessary to amortize unfunded past service
 - c. The Deficit Reduction Contribution
 - i. Exceptionally onerous funding requirement

ii. If assets fall below 90% of liabilities and were less than 90% for two consecutive years of the last three or if assets fall below 80% of plan liabilities in any given year, the plan sponsor must 100% fund the plan over the next three to five years

d. Funding limitations

i. During good times, ERISA does not let you over fund

ii. 10% excise tax on “excess contributions”

e. The “Perfect Storm”

i. Late 90’s - Could have saved for the future, but funding limitations may have prevented that (role of actuarial assumptions?)

ii. Recent economic conditions. Recent drop in interest rates and declining markets, as well as other old line industry problems, made underfunding a major issue (see Part IV of these materials)

C. Defined Benefit Plans Outside of Bankruptcy

1. “Anti-cutback rule.” The Internal Revenue Code flatly prohibits employers from:

a. decreasing benefits that participants have already earned

b. delaying eligibility for accrued early retirement benefits

c. retroactively eliminating already accrued benefits, rights or other features

2. Assuming a Collective Bargaining Agreement (“CBA”) is not violated, can amend going forward but cannot amend in any way that impairs rights to earned and accrued benefits - even with agreement of employees
3. Can freeze and replace (assuming no CBA violation)
4. As National Labor Relation Board makes pensions the mandatory subject of collective bargaining, defined benefit plans are usually going to be required by CBA if there is one
5. General rule outside of bankruptcy is that an employer cannot voluntarily terminate an under funded plan

D. Defined Benefit Plans in Bankruptcy

1. Additional tools bankruptcy provides
 - a. Distress termination
 - b. Rejection of collective bargaining agreements
 - c. Potential suspension of contributions
 - d. Reduction in PBGC claims
2. Distress Termination (more on this in Part II of these materials)
 - a. ERISA says only available in four situations
 - i. Liquidation in bankruptcy
 - ii. Reorganization in bankruptcy
 - iii. Inability to pay debts when due

- iv. Unreasonably costly and burdensome pension plan
 - b. Reorganization in bankruptcy is most commonly invoked
 - 3. Distress termination or pension plan is often necessarily linked to rejection of a collective bargaining agreement under Section 1113
 - 4. The Debtor often attempts to suspend minimum funding contributions while in bankruptcy
 - a. What portion of minimum funding contributions can be suspended?
 - b. What portion is entitled to administrative priority?
 - 5. PBGC Claims in Bankruptcy
 - a. Unfunded benefit liability claim (the claim for difference between value of plan assets at the time of termination and amount of plan obligations)
 - i. Issues regarding priority of claim (secured, administrative, unsecured)
 - ii. Calculation of claim. ERISA mandated rate or prudent investor rule?
 - b. Unpaid minimum funding claims
 - c. Claims for premiums

II. The Distress Termination Process

- A. Underfunded pension plans may be terminated through a process denominated as a “voluntary distress termination.” 29 U.S.C. § 1341(c)
- B. A voluntary distress termination requires approval by the PBGC and the Bankruptcy Court
- C. Plan Administrator must give the PBGC and participants 60 days written notice
- D. Termination must not violate the terms of a collective bargaining agreement.
- E. Title IV of ERISA sets out a four-part test (called “reorganization distress test”) for a voluntary distress termination for a Chapter 11 debtor: 29 U.S.C. § 1341 (c)(2)(B)(ii) and 29 C.F.R. § 4041.41(c)(2)
 - 1. The filing of petitions for relief under Chapter 11; the Chapter 11 cases have not been dismissed;
 - 2. The debtors have timely submitted to the PBGC a copy of their request to the Bankruptcy Court to terminate the pension plan; and
 - 3. The Bankruptcy Court has determined that:
 - a. Unless the plan is terminated, the debtors
 - (i) will be unable to pay all of their debts pursuant to a plan of reorganization and
 - (ii) will be unable to continue in business outside the reorganization process (i.e., the “financial necessity test”); and
 - b. The Bankruptcy Court approves the termination.

- F. The plan sponsor simultaneously must file a motion with the Bankruptcy Court seeking a determination that the standards for a voluntary distress termination have been met
- G. The PBGC makes the ultimate decision regarding the sufficiency of the distress showing, the adequacy of the debtor's disclosures and the liability of any controlled group parties for the unfunded benefits liability upon termination of the pension plans
- H. Although the Bankruptcy Court plays an essential role in the process, it is ultimately the PBGC that makes the final determination as to whether or not the reorganization distress test has been satisfied
- I. The PBGC generally will request that the Bankruptcy Court, when making a financial necessity determination, also make certain findings for purposes of the termination, and then the PBGC agrees to be bound by them. This prevents the possibility of a conflict between the findings of the Bankruptcy Court and the PBGC.
- J. If a collective bargaining agreement provides for establishment and/or maintenance of a pension plan, the sponsor must obtain the union's consent to implement the termination or alternatively reject the CBA through the Section 1113 process. The PBGC will not terminate a pension plan if to do so would violate the terms of a CBA
- K. Legal Standards for Voluntary Distress Termination
 - 1. Only a few bankruptcy cases have discussed in detail the standard for a voluntary distress termination and have utilized the two-part financial necessity test to examine the debtor's financial picture as a whole and evaluate relevant factors to determine whether the test is satisfied
 - 2. Factors include:

- The debtor's projected cash flows and ability to make upcoming pension contributions;
- Whether anything can be done to improve liquidity;
- The amount of the upcoming pension payments;
- Whether exit lenders would finance a debtor's plan of reorganization in light of expected plan contributions;
- Whether the debtor can obtain any debt or equity financing to obtain confirmation of a plan;
- Factors leading to the underfunding of the pension plan;
- Whether uncertainty of the debtor's liability to the pension plan would prevent exit financing and/or an equity investment;
- Whether the debtor could afford to fund the pension plan even if its plan of reorganization paid nothing to unsecured creditors;
- Whether management has reduced its own compensation; and
- Steps taken by management to improve the debtor's financial condition and operations

L. There are similarities between the factors considered in evaluating whether the financial necessity determination is satisfied for a distress termination and the feasibility standard for plan confirmation under Section 1129(a)(11)

1. In re Wire Rope Corp. of America, Inc., 287 B.R. 771, 777 (Bankr. W.D. Mo. 2002) (initial threshold question is “[c]an the [d]ebtor obtain confirmation of *any* plan of

reorganization without the termination of the [r]etirement [p]lans”);

2. In re Eastmet Corp. v. United Steelworkers of America, No. 86-B-0035, Slip. Op. at 2-3 (Bankr. D. Md. Sept. 29, 1986) (the debtor must show that “it has taken every means within its power to fund the plan according to the current terms embodied in the agreement between the company and the union”)

III. Interplay of Distress Termination Process with Section 1113 of Bankruptcy Code

- A. Many CBA’s provide for the continued maintenance of a plan. ERISA provides that a distress termination cannot be completed if it would violate a CBA. 29 U.S.C. § 1341(a)(3). This is known as the “contract bar”
- B. Consequently, the debtor will often try to get the union to drop this contract bar either through negotiation or litigation as part of the Section 1113 process
- C. The debtor has a strategic option of simultaneously moving to reject the CBA and for a distress termination, or first moving to eliminate the contract bar and then moving for distress termination
- D. In either event, the standards are very similar, and therefore if PBGC is opposing the distress termination, it may participate in the 1113 process to protect its position if the process is bifurcated
- E. Varying Standards of “Necessity” Under Section 1113
 1. In order to reject a CBA, the debtor must show that its proposed modifications “provide for those modifications in the employees benefits and protections that are necessary to permit the reorganization of the debtor” Section 1113(b)(1)(A)

2. The case law is divergent on the meaning of “necessity”
3. The Third Circuit has adopted a “but for” standard -- a debtor may propose only those modifications necessary to prevent its liquidation. Wheeling-Pittsburgh Steel Corp. v. United Steel Workers of America, 791 F.2d 1074 (3d Cir. 1986)
4. The Second Circuit has adopted a less stringent standard of “necessity,” i.e., whether the proposed changes “will enable the debtor to complete the reorganization process successfully” by a showing that there is “a greater probability of successful reorganization than if the contract were allowed to stay in force.” Truck Drivers Local 807 v. Carey Transportation, Inc., 816 F.2d 82 (2d Cir. 1987). See also In re Mile Hi Metal Systems, Inc., 899 F.2d 887 (10th Cir. 1990)

IV. PBGC Claims

- A. PBGC typically has multiple claims against multiple estates
 1. PBGC’s claims are, by statute, joint and several against all members of the plan sponsor’s “controlled group” (oversimplified, this generally means all entities 80% of more commonly owned). Thus, PBGC will file claims against multiple debtors under common control.
 2. The claim for the shortfall in an underfunded plan is simply stated as the difference between the plan’s assets and the plan’s obligations as of the date of plan termination. It is defined in ERISA as “the total amount of the unfunded benefit liabilities (as of the termination date) to all participants and beneficiaries under the plan, together with interest (at a reasonable rate) calculated in accordance with regulations prescribed by [PBGC].” 29 U.S.C. § 1361(b).
 3. The term “unfunded benefits liabilities,” in turn, is defined as the excess of “the value of the benefit

liabilities under the plan (determined ... on the basis of assumptions prescribed by [PBGC] ... over the current value of the assets of the plan).” 29 U.S.C. § 1302(a)(18). PBGC typically files a contingent claim for this liability, which matures only upon the termination of the plan.

4. Calculation of PBGC unfunded benefit claim in Chapter 11 Cases

- Prior to December 2003, courts consistently used the “prudent investor rate” to calculate the present value of the PBGC underfunded benefit claim
- SDNY Chief Bankruptcy Judge Lifland ruled in Chateaugay Corp., 126 B.R. 165 (Bankr. SDNY 1991) that the prudent investor rate is that achieved by a reasonable, prudent long-term return while preserving capital and minimizing risk
- Investor would be an average investor earning average returns, now considered an index fund investor
- A later settlement caused the District Court to vacate its opinion, and order the Bankruptcy Court opinion withdrawn. See Chateaugay Corp., 1993 U.S. Dist. LEXIS 21409, 1993 WL 388809 (SDNY 1993)
- Both Circuit Courts of Appeal that have ruled held that PBGC should not use the discount rate set forth in ERISA under its valuation regulations; but the underfunded benefit liability should be calculated using a prudent investor rate
- This is based on Section 502(b)’s requirement that all claims be brought to present value, and Section 1123(a)(4)’s requirement for the same treatment of claims in the same class

- In re CF&I Fabricators of Utah, Inc., 150 F.3d 1293 (10th Cir. 1998) The Tenth Circuit ruled that the discount rate is to be established using Bankruptcy Code consideration, not by PBGC using ERISA Title IV principles
- ERISA regulation began “for purposes of this subchapter, the term...” Thus, the ERISA rate is inapplicable in Chapter 11
- Using a prudent investor rate promotes Congress’ intent to provide for fair and uniform distribution of assets among creditors under the bankruptcy Code
- The Tenth Circuit affirmed the District Court’s holding which reversed the Bankruptcy Court’s holding
- The lower court in CF&I Fabricators determined the prudent investor rate was 12.3% resulting in a \$124 million claim. The ERISA valuation regulation would have resulted in a \$223 million claim
- The Sixth Circuit, in In re CSC Industries, Inc., 232 F.3d 505 (6th Cir. 2000), also held the prudent investor rate should be used
- The issue before the court was whether to apply the ERISA discount rate or the prudent investor rate, and not to determine the prudent investor rate
- PBGC had stipulated to a 10% interest rate as the prudent investor rate for valuing pension claims if that was the correct standard
- The ERISA valuation rate would have resulted in a \$49.7 million claim. The prudent investor rate,

based on a 10% discount rate, would have resulted in a \$1.8 million claim

- Notwithstanding these two appellate decisions, Judge Mitchell, in a Fourth Circuit Bankruptcy case, In re USAirwaysGroup Inc., 303 B.R. 784 (Bankr. E.D. Va. 2003), ruled the prudent investor rate was inappropriate for determining the PBGC's claim for unfunded benefit liabilities
- PBGC argued that because ERISA defines an employer's liability in terms of the valuation regulation the regulation should control for purposes of determining the amount of the claim
- PBGC had filed a \$2 billion claim, based on the regulation's use of the 1983 General Annuity Mortality table, a 5.1% discount rate for the first 20 years and a 5.25% discount rate after that, with a projected retirement age of 56
- The debtors argued, citing the two appellate cases on point, that the court is not legally bound by the valuation regulation and is free to make its own findings as to the appropriate interest rate to be used
- The debtors suggested using a 1994 mortality table, an 8% discount rate, and a projected retirement age of 60, resulting in an \$894 million claim
- The Court agreed with PBGC, stating that non-bankruptcy law determines both the validity and the value of a claim. Thus, all claims are calculated under non-bankruptcy law so there is no disparate treatment problem
- Court relied on Raleigh v. Illinois Dept. of Revenue, 530 U.S. 15 (2000) to hold that the claim "in the first

instance” is calculated under non-bankruptcy law. The right source of law is the valuation regulation

- Court stated that the prudent investor rate impermissibly shifts risk to the retirees for adverse stock market performance
5. PBGC also has a claim for any missed minimum funding contributions due the plan. 29 U.S.C. § 1362(c). Again this claim is typically filed as a contingent claim.
 6. PBGC also files claims for any missed insurance premiums due under 29 U.S.C. § 1307
 7. In some cases, PBGC may also have a perfected secured claim, sometimes as a result of the debtor having obtained a waiver of required minimum funding from the IRS, conditioned on the posting of collateral acceptable to PBGC. 26 U.S.C. § 412(f)(3); sometimes because of PBGC having perfected pre-petition liens pursuant to 26 U.S.C. § 412(n), or sometimes as a result of a consensual lien being perfected prior to bankruptcy.

B. Priority of PBGC Claims

1. Unfunded Benefit Liability Claim: PBGC asserts all or part of its claim for the shortfall is entitled to priority under Section 507(a)(1) and (8) of the Bankruptcy Code as a result of the provisions of Section 4068 of ERISA, which provides for a lien in PBGC’s favor and provides that in a bankruptcy case, the lien imposed by that section shall be treated as a tax due and owing to the United States. Although PBGC succeeded on this theory in years past, see, e.g., In re Washington Group, 8 Employee Benefits Cases (BNA) 1351 (M.D.N.C. 1987), the more recent trend has been adverse to PBGC. See, e.g., In re Bayly Corp., 163 F.3d 1205 (10th Cir. 1998).
2. Priority of Minimum Funding Claims: PBGC asserts “cascading” priority under Section 507(a)(1), (4) and (8)

for certain pre- and post-petition missed minimum funding payments pursuant to various theories. The assertion that post-petition contributions required by federal law are entitled to priority status has had little recent success. Compare In re Columbia Packing Co. v. PBGC, 81 B.R. 205 (D. Mass. 1988) (holding that employer contributions are entitled to first priority) with In re Sunarhauserman, Inc., 126 F.3d 811 (6th Cir. 1997) (post-petition minimum funding contributions not entitled to priority under “benefit to the estate theory except for the portion attributable to post-petition labor). In 1987, ERISA and the Internal Revenue Code were amended to provide PBGC with a lien for missed minimum funding payments in excess of \$1 million. Because of the automatic stay, the lien cannot be perfected post-petition, but PBGC asserts tax priority status for the amount with respect to which the lien is imposed, even if not perfected. The Sixth and Tenth Circuits have ruled adversely to PBGC on this issue. In re CF&I Fabricators of Utah, 150 F.3d 1293 (10th Cir. 1998); In re CSC Industries, 232 F.3d 505 (6th Cir. 2000).