Pension and Retiree Claims in U.S. Insolvencies

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Overview issues

- Companies in so-called legacy U.S. industries such as transportation, steel and other manufacturing often have pension and retiree health claims in the billions of dollars
- These and other labor costs have been a major focus of many reorganizations
  - In recent airline and steel reorganizations, labor and benefit costs have been major issues
- The PBGC, the federal corporation that insures “qualified” defined benefit pension plans, has taken an increasingly interventionist approach in these cases
- An understanding of the rights and remedies of debtors and of claimants is increasingly critical to navigating the path and outcome of many reorganizations
- Different benefit entitlements have **very** different rights and remedies. The nuances need to be understood to analyze the issues appropriately
- The Bankruptcy Code is procedurally and substantively protective of contractual rights under collective bargaining agreements and of certain retiree medical benefits
- Depending on the jurisdiction, the law varies ***substantially*** on several of the central relevant issues
  - Having advisors experienced in these areas is especially important

What are the major categories of claims at issue?

- There are various types of employee and retiree benefit entitlements – with very different rights both in and out of chapter 11. Some of the major categories include:
  - “Qualified” pension claims
    - Arising under a collective bargaining agreement (“CBA”)
    - Not arising under a CBA
      - Both types generate ongoing funding and “termination liability” obligations
  - Non-qualified pension benefits
    - Arising under a CBA (not common)
    - Not arising under a CBA
  - Contractually entitled retiree health claims
  - Amendable at will retiree health claims

Qualified "DB" pension plans

- The two primary types of "qualified" pension plans are **defined benefit plans** and **defined contribution** plans
  - Defined benefit ("DB") plans usually provide for a monthly payment for life, often calculated based on final earnings and years of employment
  - Under defined contribution plans (401(k)s, HR-10s, etc.), a fixed amount of money is periodically contributed to an individual account and invested. There is no fixed or guaranteed benefit amount at retirement – whatever the employee's balance is, it is
    - Qualified defined contribution plans (and the amounts funded into them) are **not** property of a debtor's estate, rarely give rise to claims against debtors and do not implicate the PBGC.
- What makes a DB plan "qualified" is that it meets a variety of tests under the Internal Revenue Code including funding and nondiscrimination rules, and can be administered as a tax exempt trust
- A qualified plan (which has substantial tax advantages to employers and workers) is a separate legal entity whose assets are generally beyond the reach of a debtor's estate and creditors

Qualified "DB" pension plans (cont.)

- Under ERISA, employer sponsors (herein, the debtor) are required periodically to make minimum funding contributions as calculated by actuaries based on complex formulae
  - The funding obligations are typically a combination of "normal costs" (based on benefits earned by labor in the current period) and "past service costs" which consist of unfunded liabilities from past service benefits, experience gains and losses, and changes in actuarial assumptions
    - These technical distinctions matter a great deal in bankruptcy
    - Contracting workforces or declining industries can lead to substantial underfunding
  - Complex rules govern the timing, amount and currency of funding obligations – ***which are different from GAAP accounting***
    - Upcoming funding obligations are not disclosed on and *cannot* be derived from financial statements
  - Further legislative reform in this area is likely, possibly in the near term

Qualified "DB" pension plans (cont.)

- Outside of bankruptcy, if a debtor misses minimum funding obligations in excess of $1 million, a lien arises in favor of the PBGC on <u>all</u> the assets of the debtor's "controlled group" for the missed payment amounts
  - The controlled group generally includes all entities (debtor and non-debtor) that (at an 80% level) own, are owned by, or are under common ownership with, the plan sponsor
- The automatic stay that arises upon a chapter 11 filing bars the PBGC from perfecting a lien against the debtors
- Major corporate entities almost never miss the requisite minimum funding payments and suffer the actual imposition of a blanket lien in favor of the PBGC
  - Some debtors time their bankruptcy filing to avoid having to make a financially burdensome funding payment
- The PBGC and others will argue in the bankruptcy court (under various theories) that **all** minimum funding contributions must timely be made, even if based entirely on pre-petition services
- They have lost in the vast majority of cases litigated
  - The majority rule is that (unless a lien arose and was perfected pre-petition) "pre is pre and post is post" and chapter 11 debtors need only pay as an administrative claim the contribution amounts actually attributable to post-petition labor
  - IRS excise tax claims for missed funding payments will also not generally be afforded any type of priority

Qualified DB plan terminations

- A chapter 11 debtor can move under ERISA voluntarily to terminate a qualified DB plan ("a distress termination")
  - Where a CBA requires the maintenance of the plan, a debtor must obtain relief from the CBA obligation through negotiation or 1113 relief
- The *PBGC* can initiate an involuntary termination irrespective of 1113 or the provisions of a CBA
- The ERISA standard for distress termination by a debtor is very strict
  - The debtor must obtain a finding from the bankruptcy court that but for termination, the debtor will be unable to pay its debts pursuant to a plan of reorganization and will be unable to continue in business outside of chapter 11
  - Once the debtor secures that ruling, the PBGC must make additional findings and set a termination date
- When a qualified DB plan is terminated, the PBGC usually becomes plan trustee, and it (not the plan nor the beneficiaries) succeeds to termination liability and other claims against the debtor under the plan
- Subsequent to plan termination, there is often litigation over both the size and priority of PBGC claims
  - One fight centers on whether the PBGC is allowed to use its regulatory (very conservative) present value methodology as opposed to the "prudent investor rate" generally used by bankruptcy courts in calculating creditor claims
    - The PBGC, after several failures on this issue, prevailed in USAirways I. As a result, its claim increased by $1.35 billion
  - The PBGC has made different arguments in support of its request to be treated as a secured, priority tax, other priority or administrative claimant
    - Except for arguments based upon post-petition services, or contributions entitled to priority under §507(a)(5), these arguments have not been successful
- These issues are complex and vary greatly by circuit. Competent professionals should be consulted

What is the role of the PBGC?

- The PBGC is a federal corporation that was created under ERISA in 1974. It guarantees certain benefits to participants in qualified defined benefit pension plans that are terminated and turned over to the PBGC
- The PBGC is neither funded by tax revenues nor backed by the federal government. It is funded by:
  - Insurance premiums from employers that sponsor insured plans
  - The assets of plans it takes over and recoveries on claims against sponsors
  - The investment return on its assets
- The PBGC's involvement in the termination of covered plans includes:
  - The right to initiate the involuntary termination of a plan
  - The ultimate approval of an employer's attempt to effectuate a distress plan termination
  - Termination liability and other claims against the employer and its controlled group
- The PBGC guarantee of benefits (independent of plan assets) is capped at $47,659.00 a year for workers who retired at 65
  - Highly compensated workers (such as pilots and management) are only partially covered
  - Workers who retire before 65 are capped at lower amounts on a sliding scale
  - Eligible participants may receive a greater level of benefits depending on the funded status of the plan

What is the role of the PBGC (cont.)?

- As of September 30, 2005, the PBGC reported a $**23 billion deficit** and more than 1 million workers dependent on it for their pensions. This is a substantial increase from prior years
  - 5 of the 10 largest claims in PBGC history are from airlines, equaling 20% of claims but <2% of covered workers
- The PBGC has become more active in bankruptcy cases and otherwise. It:
  - Is pushing hard for wide-ranging and material legislative reform
  - Frequently serves on creditors' committees
  - Is willing to litigate extensively where its institutional interests are involved
  - Has defended its rights to recover from **all** members of the employer's controlled group as expressly provided by statute
    - Under ERISA, all members of the controlled group are jointly and severally liable for the PBGC's claims
    - In Enron and other cases, the PBGC has objected to asset sale orders that sought to release nondebtor affiliates from PBGC liability, and the orders obligated the debtors to escrow the sale proceeds to secure the PBGC's claims
    - The PBGC has also gotten more involved in the M&A context generally to try and exert leverage
  - Guards against "abusive follow on plans," where the debtor, through a new plan supplementing a terminated plan taken over by the PBGC, tries to recreate what would have been substantially the same package of benefits originally contemplated by the terminated plan

Non-qualified pension benefits

- For more highly compensated employees, “non-qualified” supplemental pension benefits are put in place to provide the balance of the promised pension benefits that cannot be paid by the qualified plans due to IRS limitations
- Non-qualified plans are not funded through separate legal entities with title to their own assets in the way that qualified plans are
- Rather, with some exceptions, these benefits are often paid out of the general assets of the company, and claimants’ rights may be limited to a general unsecured claim against the debtor for unpaid non-qualified benefits that are on account of pre-petition labor
  - This continues to be the case even if the company sets up a “Rabbi Trust”
- Occasionally, companies seek to protect senior management by prefunding or securing (through escrows or “secular trusts”) non-qualified benefits
  - While intended to be protective of senior management and retentive in nature, these efforts have been subject to criticism, including by labor and other stakeholders and even forced senior management resignations at several major corporations
- In some cases, debtors move to assume or honor these programs as part of executive retention/severance motions or even under the employee wages first day motion

Collective bargaining agreements and section 1113

- As a general rule, debtors can "assume" or "reject" executory contracts in their "business judgment" – a very deferential standard of review
  - Rejection damages are pre-petition claims
- Congress enacted section 1113 in response to a 1984 Supreme Court decision that included CBAs within that general rule, allowed a debtor to reject a CBA, and held that a CBA is not enforceable upon the filing of a petition
- 1113 sets forth both procedural and substantive requirements that must be met before a debtor can reject (modify) a CBA. They include:
  - Making a proposal to the unions based on "complete and reliable information"
  - Providing the unions all relevant information necessary to evaluate the proposal
  - Meeting at reasonable times and conferring in good faith to try to reach agreement
  - Having the proposal contain (only) modifications "necessary to permit the reorganization of the debtor and assure[] that all creditors, the debtors and all of the affected parties are treated fairly and equitably"
    - There is a difference of opinion in the circuit courts over the standard for examining whether requested changes are "necessary to permit the reorganization of the debtor"
      - The Third Circuit (Delaware) has ruled that the standard is stringent and that the proposed modifications must be essential to the short term goal of preventing liquidation
      - The Second Circuit (New York) has set forth the clear majority rule, that the proposal must contain necessary, but not absolutely minimal, changes that will enable the completion of a successful reorganization
    - Most courts have followed the less stringent interpretation

Collective bargaining agreements and section 1113 (cont.)

- Under section 1113(f), a debtor cannot “unilaterally modify” any provisions of a CBA absent compliance with the section 1113 procedures
- Because CBAs often include obligations to maintain or fund pensions and other retiree benefits, section 1113 is often implicated where a debtor seeks changes in these benefits. Among other things:
  - A debtor cannot seek a distress termination of a qualified pension plan maintained under a CBA unless it secures relief from the CBA obligation through negotiation or otherwise under section 1113
  - Unions and others have argued that a debtor’s failure to pay ongoing pension and benefit claims – even if based on pre-petition service – is a breach of 1113
    - There is a circuit split on this issue. The majority view is that section 1113 does **not** take precedence over the claims’ priority provisions of the bankruptcy code, and does not require the payment of pre-petition claims
- 1114, not 1113, governs retiree health claims, even if they are covered by a CBA
- In addition to the circuit splits on several critical issues, there are still important unanswered questions under 1113
  - Courts have held that a union with a CBA governed by the National Labor Relations Act **can** strike subsequent to 1113 rejection
  - No court has ruled whether a union whose CBA is governed by the Railway Labor Act (airlines and railroads) can strike if its contract is rejected under 1113
  - There is also a split over whether an 1113 rejection gives rise to a damage claim and on whether a one year cap on damages applies to CBA rejection damages

Retiree medical claims and section 1114

- Retiree medical costs are huge and growing
  - GM spends more annually on medical benefits – $5.2 billion or $1,400 per car – than it does on steel
- Fundamentally, they break down into two categories (as determined by governing documents and non-bankruptcy law):
  - Contractually entitled retiree medical claims
  - Amendable at will retiree medical claims
- Section 1114 of the Bankruptcy Code contains procedural and substantive requirements for a debtor's modification of "retiree benefits," which include health, accident, disability and death benefits
  - All benefits, whether incurred pre- or post-petition, must "timely" be paid and may not be modified until relief is granted by the court
    - Any unpaid amounts have the status of administrative expenses
  - The debtor must negotiate with an "authorized representative" of retirees over possible changes to these benefits
    - If the union declines to serve as such (and some decline), an 1114 committee will be appointed (with advisors) paid for by the estate
    - There are good faith and other procedural requirements for this negotiation similar to the requirements under section 1113
  - The court will only approve changes that
    - Are necessary to the reorganization
    - Assure that all creditors, the debtor and all affected parties are treated "fairly and equitably"
    - Are "clearly favored by the balance of the equities"
- The majority of cases have held that 1114 applies only to contractually entitled benefits.

Fiduciary Issues

- Insolvency can present difficult fiduciary issues for management and board members of corporations in respect of these issues
  - They often simultaneously serve as fiduciaries for the pension plans
  - There can be suits for breach of fiduciary duty against the individual fiduciaries
  - It is **very** important that an appropriately structured fiduciary policy be in place
    - There may be advantages to coverage through a stand-alone policy (as opposed to a component of the general D&O policy)
  - To address these issues, some companies have attempted to appoint independent fiduciaries or to have the "company as a whole" and not named individuals, be plan fiduciaries