

ABI CENTRAL STATES CONFERENCE
TRAVERSE CITY, MICHIGAN
JUNE 14-17, 2007

PENSION AND LEGACY: NEW LAWS AND OLD OBLIGATIONS

HONORABLE J. PHILIP KLINGEBERGER, U.S. BANKRUPTCY COURT
FOR THE NORTHERN DISTRICT OF INDIANA

MARK A. BERKOFF, DLA PIPER US LLP

GARY W. BURNS, WALKER NELL CONSULTANTS, INC.

SHAWN M. RILEY, McDONALD HOPKINS LLC

PENSION AND LEGACY: NEW LAWS AND OLD OBLIGATIONS

As a result of recent changes in both bankruptcy and pension laws, companies in financial distress now confront an altered landscape as they attempt to address legacy obligations—including pension benefits, workers’ compensation benefits and other retiree benefits. In an effort to relieve the financial burden placed on the Pension Benefit Guaranty Corporation (the “PBGC”), Congress amended the bankruptcy and pension laws so that a greater burden is now placed upon a bankrupt plan sponsor. Similarly, changes in other laws, as well as interpretation of priority rules, have altered the landscape with respect to workers’ compensation insurance and other benefit plans. Termination of pension and legacy benefits has become more challenging and often more costly for debtors, while parties in interest seek to maximize their leverage.

Pension Obligations

Prior to the enactment of the recent changes to the pension laws, if an insolvent plan sponsor could not fund its pension plan, and was unable to continue its business without inevitable termination of the plan, it could apply for a “distressed termination” of the plan and a parallel termination of the plan obligations. If the court (typically a bankruptcy court) found sufficient grounds for such plan termination, the PBGC became obligated for the plan as the trustee and paid benefits under the plan from plan assets and other PBGC funds. Recent large plan terminations have shifted billions of dollars of obligations to the PBGC, resulting in its financial distress.

The Pension Protection Act of 2006¹ (the “PPA”) and the Deficit Reduction Act of 2005² (the “DRA,” and together with the PPA, the “Acts”) attempt to offer financial

¹ Pub. L. 109-280 (August 17, 2006).

² Pub. L. 109-171 (February 8, 2006).

relief to the PBGC in two ways. First, the Acts raise revenue by charging premiums and raising premium rates for the PBGC's benefit. Second, the Acts attempt to deter the termination of under-funded pension plans by imposing certain monetary obligations upon the debtor.

Pension Protection Act

The PPA includes a number of bankruptcy-related changes to ERISA³ and the Internal Revenue Code (the "I.R.C.")⁴. The changes will have a significant impact on distressed companies that sponsor defined benefit plans. The changes are outlined below.

- (i) *Prohibition of Lump Sum and Similar Payments Under Single Employer Defined Benefit Plan*—The PPA reformed ERISA so that a single-employer defined benefit plan is no longer permitted to make lump sum and certain other prohibited payments.⁵ Prior to the PPA, single-employer plans were permitted to make accelerated distributions such as lump sum and certain other prohibited payments without limitation.
- (ii) *Determination of PBGC Guaranteed Benefits as of the Petition Date*—The PPA amended ERISA such that PBGC guarantees now are frozen as of the petition date.⁶ Prior to the enactment of the PPA, the PBGC determined the maximum amount of its benefit guarantee as of the termination date of the plan when the plan was terminated after an employer's bankruptcy.
- (iii) *Determination of Plan Assets Allocated to Category 3 as of Petition Date*—The PPA amended ERISA so that benefits payable as an annuity to

³ 29 U.S.C. §§ 1001 *et seq.* ("ERISA")

⁴ 26 U.S.C. §§ 1 *et seq.*

⁵ ERISA § 206(g)(3)(E); I.R.C. § 436(d)(5).

⁶ ERISA § 4022; PPA §§ 404(a), (c).

retired participants (so-called Category 3 benefits) are now determined as of the date of the bankruptcy petition rather than as of the termination date of the plan.⁷ All other allocations to pay benefits under the plan (among the five other priority categories) are determined as of the termination date of the plan.

- (iv) *Additional Tax on Certain Asset Transfers Related to Nonqualified Deferred Compensation*—The PPA amended the I.R.C. so that during a bankruptcy proceeding, if assets are set aside, reserved in a trust, or transferred to a trust for paying the deferred compensation of “an applicable covered employee” (e.g. top five officers and individuals subject to section 16(a) of the Securities Exchange Act of 1934) under a nonqualified deferred compensation plan, then those assets are treated as property transferred in connection with the performance of services under section 83 of the I.R.C.⁸ Therefore, the benefits paid to employees are included as part of their gross income and are also subject to a 20% excise tax, plus interest.⁹
- (v) *Additional Catch-up Contributions to IRAs in Connection with Certain Employer Bankruptcies*—The PPA amended the I.R.C. so that employees of certain bankrupt companies who have participated in the employers’ 401(k) plan and who have received at least 50% matching contributions made in employer stock may make up to \$3,000 in catch-up contributions

⁷ ERISA § 4044(a); PPA § 404(b)

⁸ I.R.C. § 409(A)(b)(3); PPA § 831(a).

⁹ I.R.C. § 409(A)(b)(5).

to their IRAs in 2007, 2008, and 2009.¹⁰ Prior to this change, the annual catch-up contribution limit for IRAs for 2006 was \$1,000, with no special provision for the bankruptcy of an employer.

(vi) *Prohibition of Payment of Unpredictable Contingent Events Benefits*—The PPA added language to the I.R.C. and ERISA so that, if a plan provides for plant shutdown benefits, and, when taking into account the effect of the plant’s shutdown, the plan’s funded status falls below 60% of the plan’s adjusted funding target attainment percentage, then the plan may not pay the plant shutdown benefits.¹¹ There was no similar provision in the I.R.C. or under ERISA prior to the enactment of these provisions.

(vii) *Phase-in of PBGC Guarantee for Unpredictable Contingent Event Benefits*—The PPA amended ERISA to provide that if an employer files for bankruptcy protection within a year after a shutdown, none of the benefits triggered by the shutdown will be guaranteed by the PBGC. The rationale is that no portion of the benefit is guaranteed until the first anniversary of the shutdown, and the freeze on the PBGC’s guarantee at the time of the bankruptcy filing will prevent any additional phase-in if the plan is terminated during bankruptcy.¹² Prior to this amendment, the five-year phase-in applied to plan amendments and began on the date of the plan amendment.

(viii) *Additional PBGC Premium for Plan Termination During Bankruptcy*—

The DRA added a new premium of \$1,250 per plan participant where

¹⁰ I.R.C. § 219(b)(5)(C); PPA § 831.

¹¹ I.R.C. § 436(b); ERISA § 206(g); PPA § 113(a)(1)(B).

¹² ERISA § 4022(b)(8); PPA § 403.

employers terminate a plan during a bankruptcy proceeding.¹³ The termination premium becomes due the first month after the debtor is “discharged” from bankruptcy and must be paid for three consecutive years after termination of the plan. The premium applies only in cases in which a debtor successfully reorganizes; it does not apply to a bankruptcy proceeding in which the debtor exits bankruptcy by way of an asset sale or a liquidation. The sunset provision provided by the DRA was repealed by the PPA.

- (ix) *Minimum Funding Rules*—The PPA added language to the I.R.C. and ERISA to include new minimum funding standards for plan years after 2007.¹⁴ Beginning in 2008, employers are required to fully fund the present value of all benefits earned or accrued under a plan as of the beginning of the year. Liabilities are calculated using interest rates derived from a three-year segment yield curve based on yields of high grade corporate bonds averaged over two years. Any increase in a funding shortfall is amortized over seven years.
- (x) *Information Available to Participants in Terminated Plans*—The PPA adds a section to ERISA which states that participants in a plan terminated in a distress termination are entitled to see information submitted by the plan administrator to the PBGC with respect to the termination within fifteen days of the request.¹⁵ Further, the PPA added a section to ERISA that gives participants in plans involuntarily terminated by the PBGC the

¹³ ERISA § 4006(a)(7); DRA § 8201(b).

¹⁴ I.R.C. § 430; ERISA § 303; PPA §§ 102(a), 112(a).

¹⁵ ERISA § 4041(c)(2)(D); PPA § 506(a)(1).

right to see the PBGC's administrative record regarding the termination within fifteen days of a request.¹⁶ Confidential information is protected from disclosure in both situations.

Workers' Compensation Benefits

The failure to fund or under-funding of workers' compensation benefits also raises significant issues regarding the size and priority of claims. The United States Supreme Court recently weighed in on the priority issue, holding that claims for unpaid premiums on a policy purchased by an employer to cover its workers' compensation liability were not entitled to priority under section 507(a)(5) of chapter 11 of title 11 of the United States Code (the "Bankruptcy Code").¹⁷ In reaching its decision, the Court recognized that the overall intent and purpose of the Bankruptcy Code is to provide equal (pro rata) treatment of all creditors, and courts are not permitted to give priority to a creditor's claim unless Congress has clearly authorized it.

In *Howard Delivery Serv. v. Zurich American Ins. Co.*, the debtor operated and employed workers in approximately twelve different states, all of which required the employer to provide workers' compensation coverage for on-the-job injuries sustained by its employees. Such coverage was provided to the debtor's employees in ten of the states in which the debtor operated. Upon the debtor's filing for chapter 11 protection, the workers' compensation provider filed a proof of claim for \$400,000 of unpaid workers' compensation insurance premiums, seeking priority under section 507(a)(5) of the Bankruptcy Code. The bankruptcy court denied the provider's claim priority status,

¹⁶ ERISA § 4042(c)(3); PPA § 606(b)(3).

¹⁷ See *Howard Delivery Serv. v. Zurich Am. Ins. Co.*, 126 S. Ct. 2105 (2006).

reasoning that workers' compensation benefits are not bargained-for. The provider appealed, and the district court affirmed.

The Fourth Circuit reversed in a 2-1 decision, with the two judges in the majority reaching their respective decisions on different grounds. The first determined that section 507(a)(5) unambiguously included workers' compensation premiums. The second found that although section 507(a)(5) was ambiguous, the statute's history supported the provider's position that priority be afforded to unpaid workers' compensation premiums. The dissenting judge took the view that the priority provided pursuant to section 507(a)(5) unambiguously excluded workers' compensation premiums.

In general, section 507(a)(5) gives priority to "allowed unsecured claims for contributions to an employee benefit plan." The Bankruptcy Act of 1898 gave priority to unpaid wages, but did not afford priority to unpaid contributions to benefit plans.¹⁸ When Congress amended the Bankruptcy Act in 1978, it added what is now section 507(a)(5). In so doing, Congress gave unpaid fringe benefits their own priority apart from unpaid wages. The Supreme Court noted, "the current [Bankruptcy] Code's juxtaposition of the wages and employee benefit plan priorities manifests Congress' comprehension that fringe benefits generally complement, or substitute for, hourly pay."¹⁹ This substitution of pay for a benefit is key in the Court's distinguishing between unpaid workers' compensation premiums and unpaid fringe benefits because, with respect to workers' compensation benefits, no substitution is ever bargained for by the employee. Instead, workers' compensation coverage is mandated by law and must be provided by the employer.

¹⁸ See United States v. Embassy Restaurant, Inc., 359 U.S. 29 (1959).

¹⁹ Howard Delivery Serv., 126 S. Ct. at 2111.

The provider argued that the term “employee benefit plan” was not a defined term under the Bankruptcy Code, and the definition provided by ERISA should apply. ERISA defines “employee benefit plan” as “an employee welfare benefit plan or an employee pension benefit plan or a plan which is both an employee welfare benefit plan and employee pension benefit plan.”²⁰ Further an “employee welfare benefit plan” is defined by ERISA as “any plan, fund, or program [that provides] its participants or their beneficiaries, through the purchase of insurance or otherwise,...benefits in the event of sickness, accident, disability, death or unemployment.”²¹

The Court resisted applying ERISA’s definitions and noted that workers’ compensation benefits imposed by state regulations are exempt from ERISA’s definition of any such plans. Instead, the Court focused on the fact that:

unlike pension provisions or group life, health, and disability insurance plans—negotiated or granted as pay supplements or substitutes—workers’ compensation prescriptions have a dominant employer-oriented thrust: they modify, or substitute for, the common-law tort liability to which employers were exposed for work-related accidents...[whereas] employer-sponsored pension plans, and group health or life insurance plans characteristically insure the employee (or his survivor) only.²²

Although not determinative to its decision, the Court also referenced that fact that most (though not all) states mandate workers’ compensation coverage, where other employee benefits, such as group health and life insurance, are usually voluntarily provided by the employer. The Court did not address the issue of priority afforded by some circuits to workers’ compensation premiums owed to a state fund as unpaid taxes pursuant to section 507(a)(8)(E) of the Bankruptcy Code.

²⁰ ERISA § 1002 (1).

²¹ ERISA § 1002 (3).

²² Howard Delivery Serv., 126 S. Ct. at 2113.

Retiree Benefits

The Bankruptcy Code has, for a number of years, provided certain protections to retirees upon a debtor-employer's chapter 11 filing. Section 1114 of the Bankruptcy Code prohibits a chapter 11 debtor from modifying retiree health benefits unless it complies with a negotiation process akin to collective bargaining and demonstrates to the court that the modifications are: (a) necessary to permit the reorganization to succeed; and (b) treat retirees equitably as compared to all other parties in interest in the case. Case law is split as to whether this provision prevents modification of a retiree plan that, by its terms, permits unilateral modifications by the employer. Some courts hold that section 1114 will not allow the unilateral modification provision of the retiree plan, while others hold that unilateral modification in accordance with the terms of the plan is permissible.

Although BAPCPA did not directly address this issue, it contains language limiting a debtor's ability to rely upon a unilateral modification clause to make prepetition modifications to retiree benefits. Revised section 1114(l) of the Bankruptcy Code requires the court, on motion of a party in interest and after notice and a hearing, to unwind any modification to a retiree health plan made within 180 days before the petition date if the debtor was insolvent at the time of the modification "unless the court finds that the balance of the equities clearly favors such modification."²³ Thus, a debtor's retiree benefit burden can be increased through a rescission of otherwise lawful modifications made within 180 days of the petition date.

BAPCPA did not address the ability of the reorganized debtor to make modifications to a retiree plan after the effective date of a chapter 11 plan. Therefore, unless a court has authorized modifications of retiree benefits under section 1114 during

²³ 11 U.S.C. § 1114(l).

the case, the retiree plan will continue with the unilateral modification provision in place, unaffected by the debtor's bankruptcy, so long as the plan provides for the continuation of benefits in accordance with section 1129(a)(13).

BAPCPA did increase the protection to employee contributions to benefit plans. BAPCPA increased the section 507(a) cap on wage and employee benefit claims entitled to priority from \$4,650 to \$10,000. This priority applies to wages or benefits earned up to 180 days prior to a bankruptcy filing. Prior to BAPCPA, only wages and benefits earned 90 days prior to a filing were given such priority. BAPCPA also modified the definition of "property of the estate" to clarify that funds withheld by an employer as employee contributions for benefits, annuities, and health insurance plans are not property of the estate.²⁴

Conclusion

Recent changes to pension and bankruptcy laws, while providing relief to the PBGC and to beneficiaries of employer-sponsored benefit plans, have resulted in a shifting of more of the financial burden back to the debtor/plan sponsor. The overwhelming costs of these plans, however, may have been a part of the reason for the financial distress and bankruptcy filing. The unintended consequence may be that companies faced with such burdens simply avoid the chapter 11 process, or, if in chapter 11, opt for an asset sale rather than a reorganization.

²⁴ See 11 U.S.C. § 541(b)(7).

PENSION AND LEGACY: NEW LAWS AND OLD OBLIGATIONS

Fact Pattern 1

DPM Co., a manufacturer of automotive parts, is contemplating a chapter 11 case. It has plants in Ohio (100 employees) and Michigan (200 employees). It is the sponsor of a defined benefit plan, which has 400 participants. That plan is under-funded by approximately \$3.0 million. The Company has not paid its workers compensation premiums for six months; in addition, in Ohio, it has been hit with a \$700,000 premium readjustment for 2006. Finally, the Company is a party to a collective bargaining agreement with the UAW at each plant. Pursuant to those agreements, the Company is obligated to provide medical benefits to its hourly retirees. Separately, the Company has historically provided medical benefits to its salaried retirees, although the written salaried retiree medical plan provides that the Company is under no obligation to continue such plan.

A preliminary analysis of value suggests that, under the best case, a sale of DPM's assets would not generate sufficient funds to pay DPM's secured lender. DPM's customers, however, are worried about losing a source and have indicated an interest in committing to future business and providing accommodations to fund a reorganization plan.

PENSION AND LEGACY: NEW LAWS AND OLD OBLIGATIONS

Fact Pattern 2

You represent the principal of an entity that is the debtor in a Chapter 11 case which is confronting the decision of whether or not to jettison an ERISA-qualified pension plan. The debtor is Alacrity, Inc., a misnomer indeed with respect to the corporation's contributions to the pension plan on behalf of its employees. The plan is required by the terms of a collective bargaining agreement between Alacrity and the Consolidated Humanistic Association of Shoestring Employees (CHASE), and as is true in most such circumstances, contributions are made both by employees by means of check-off withholdings from their wages and by Alacrity as a separate employer contribution. Prior to Alacrity's bankruptcy filing, your client made a decision totally motivated by his/her view of the financial dictates of keeping Alacrity afloat – i.e., not motivated by the need to maintain his/her style of living, including the vacation home and cigar boat in Florida, funded by the assets and revenues of Alacrity – by which a substantial unpaid obligation for both employee and employer contributions to the CHASE pension plan accrued.

Counsel for the pension fund has told you, in a totally cordial but matter-of-fact way, that if Alacrity does not make good on the unpaid prepetition obligations to the Union plan, the Union will file a suit against your client for both the unpaid employee and the unpaid employer contributions.

1. Does your client have anything to worry about with respect to this proposal Union action?
2. Can your client threaten in response that he/she will just file his/her own bankruptcy and wipe out the obligations without considering the implications of 11 U.S.C. §523(a)(4) in doing so?