LATHAM & WATKINS

Client Alert
White Paper

Latham & Watkins Benefits, Compensation & Employment Practice May 11, 2017 | Number 1844.2

FAQ: Recent Developments in US Law Affecting Pension and OPEB Claims in Restructurings (2017)[1]

From theory to practice, planning to enforcement, the answers to 42 of the most frequently asked questions can help you prepare, cope or respond to a restructuring.

This *Client Alert* answers some of the most frequently asked questions with respect to the treatment of pension-plan liabilities and other post-employment benefits (OPEB) obligations in US bankruptcies. Understanding the treatment of pension and OPEB obligations in bankruptcy continues to be important in today's business environment and the law relating to the treatment of these obligations continues to evolve. Many high-profile companies, as well as several states and municipalities, have utilized the bankruptcy process to address pension and OPEB obligations. In addition, several recent significant legal developments have affected pension and OPEB obligations and their treatment in bankruptcy, including increased efforts to pursue companies' foreign assets in connection with these obligations and significant judicial decisions regarding controlled group liability issues that affect private equity funds.

Table of Contents

1. What Are Pension and OPEB Obligations?

Pension plans generally provide for cash payments of retirement income to former employees of the plan sponsor or its affiliates.[2] In contrast, OPEB typically include retiree medical and retiree life insurance benefits. Although both pension and OPEB liabilities are initially created through plan documents or contracts with employees (including collective bargaining agreements that receive special treatment in bankruptcy), pension plans are also subject to a substantial body of federal statutory law that does not apply with respect to OPEB.

2. Are Pension and OPEB Obligations Significant?

By most accounts, the answer is a resounding “yes.” Although on the whole US pensions funding has improved in recent years, as of the end of 2016, the aggregate amount of underfunding of pension plans for the 410 Fortune 1000 companies that sponsor such plans and have a December fiscal year-end date was $325 billion,[3] resulting in an 80% funded status.[4] According to the Pension Benefit Guaranty Corporation’s (PBGC) 2016 Annual Report, approximately 30 million employees and retirees in about 22,000 single-employer pension plans and approximately 10 million employees and retirees in about 1,400 multiemployer plans are covered by PBGC pension guarantees. In 2016, the PBGC paid $5.7 billion in pension benefits for approximately 840,000 retirees in more than 4,700 failed plans. As of September 30, 2016, the PBGC had a deficit with respect to single-employer plans of $21 billion and a deficit with respect to multiemployer plans of $59 billion, resulting in a combined deficit of $80 billion.

The magnitude of OPEB liabilities is also significant. As of the end of 2015, the aggregate amount of OPEB underfunding for the S&P 500 was estimated to be approximately $171.1 billion, resulting in a 28.8% funding rate.[5]

In addition, many US states and municipalities have significantly underfunded pension plans and/or substantial OPEB liabilities. The overall funded level of state pension plans has recently been estimated at approximately 72.6%[6] and the aggregate amount of unfunded state pension liabilities has recently been estimated to be approximately $578 billion ($790 per capita).[7] The 25 most populous US cities had an aggregate unfunded pension liability of approximately $125 billion ($3,776 per capita) and an aggregate funded level of 66.4% (with a median unfunded liability of $1,556 per capita and median funded level of 76%).[8] Among states, Illinois had the least well-funded pension plan(s) and Wisconsin the best.[9] Among cities, New York City and Chicago had the least well-funded pension plans and Washington, D.C., the best.

Unfunded state OPEB liabilities have recently been estimated at $627 billion. In 2013, California had the largest unfunded OPEB liability at $80.3 billion, with New York and New Jersey close behind.[10] In 2009, unfunded OPEB liabilities totaled $118.2 billion for 61 key cities (defined as the most populous city in each state, together with all other cities with a population of greater than 500,000).[11]

3. Which Statutes Govern Pension Plans?

Tax-qualified pension plans providing defined benefits are generally governed by the Employee Retirement Income Security Act of 1974, as amended (ERISA), and the Internal Revenue Code of 1986, as amended (the IRC).

Together, ERISA and the IRC:

(i) Require the reporting and disclosure of pension plan information

(ii) Require periodic funding of pension plans by the plan sponsors and impose excise taxes on plan sponsors that fail to make such contributions

(iii) Impose liability on the sponsors of pension plans that are underfunded at the time of their termination[12]

If a plan sponsor files for bankruptcy protection, the US Bankruptcy Code determines the allowability and priority of all claims asserted against the plan sponsor, including any pension-related claims.

4. What Are the Primary Types of Pension Plans Subject to ERISA?

The primary pension-plan types governed by ERISA are single-employer plans and multiemployer plans.[13] Single-employer plans may be either defined benefit plans or defined contribution plans.[14] In most cases, defined benefit plans provide for the payment of benefits in an amount determined by a formula based upon factors such as the duration of an employee's service and/or the amount of the employee's compensation. Except upon termination of the plan, employee benefits are usually distributed under a defined benefit plan without reference to the amount of plan funds available. Defined benefit plans are funded on a group basis based upon actuarial assumptions as to the amount of money needed to pay the promised benefits. The plan sponsor bears the risk that its periodic funding contributions will not be sufficient to pay benefits promised pursuant to the defined benefit formula contained in the plan. Defined benefit plans, but not defined contribution plans, are covered by the PBGC, and defined benefit plan termination is subject to ERISA guidelines.

5. Why Are Defined Benefit Plans of More Concern in Bankruptcy Than Defined Contribution Plans?

Defined benefit plans are generally of substantially greater concern in bankruptcy proceedings than defined contribution plans because if a defined benefit plan is terminated (which, as described below, in certain instances may occur in connection with a bankruptcy liquidation or reorganization) at a time when the defined benefit plan is underfunded, the plan sponsor and its affiliates may be liable for the full amount of the underfunding. In addition, as described below, under ERISA, plan sponsors are required to fund defined benefit plans by making statutorily required, minimum funding contributions and pay annual insurance premiums to the PBGC. The PBGC and/or a pension plan may assert a claim in bankruptcy to recover any unpaid amounts of these items from the plan sponsor.

6. What Is the PBGC?

Title IV of ERISA established the PBGC, a federal corporation that guarantees the payment of a minimum level of pension benefits to participants of terminated, insolvent plans. The guarantee is adjusted annually to reflect increases in the cost of living. For single-employer plans terminating in 2017, the guarantee is just under $65,000 for a single life annuity starting at age 65. The maximum benefit is actuarially reduced for benefits commencing prior to age 65 and is lower for joint and survivor annuities.

The PBGC's guarantee does not cover all types of benefits. It generally covers normal retirement benefits, most early retirement benefits, disability benefits and survivor benefits. It does not cover: benefits that are not vested as of the plan termination; benefits for which any age, service or other requirements have not been met as of the plan termination; and lump sum payments in excess of $5,000. In addition, the PBGC's guarantee with respect to benefits that were increased in the five years prior to plan termination is limited.

The PBGC guarantees the payment of benefits from a multiemployer plan only when the plan becomes insolvent. Benefits in effect under multiemployer plans for less than five years are not guaranteed. The PBGC guarantee for multiemployer plans is 100% of the first $11.00 of the monthly benefit rate, plus 75% of the next $33.00 of the monthly benefit rate, times years of credited service, up to a maximum of $12,870 for a participant with 30 years of service.

7. What Are Companies' Obligations to the PBGC Outside of Bankruptcy?

The PBGC is not funded by general tax revenues. Instead, the PBGC is funded by mandatory premiums paid by pension plan sponsors and the investment income on assets of plans that the PBGC has assumed. The 2017 premium rate is $69.00 per participant in single-employer plans and $28.00 per participant in multiemployer plans. In addition to the flat-rate premium, a variable-rate premium of $34.00 per $1,000.00 of unfunded vested benefits is imposed on plan sponsors of underfunded plans. The variable-rate premium is capped at $517 per participant (in some cases lower for smaller plans). Multiemployer plans do not pay a variable-rate premium.

In addition to annual premiums, a termination premium applies in the case of termination of a single-employer plan that is not fully funded. This premium is described further under "May a Pension Plan Be Terminated if It Is Not Fully Funded?" below.

Annual premiums may be satisfied with plan assets if the plan permits. Termination premiums are the responsibility of the employer and its controlled group (see "What Is Controlled Group Liability?" below).

The PBGC — through its Early Warning Program — also monitors transactions involving financially troubled companies and companies with underfunded pension plans. If the PBGC learns of a potential transaction that the PBGC believes will cause the plan's underfunding to increase or interfere with the PBGC's ability to collect termination liability on a plan termination, the PBGC may negotiate with the plan sponsor and members of its controlled group to provide additional contributions, collateral, guarantees, letters of credit or security interests in company assets. For example, the PBGC may be especially focused if a company divests a large portion of its assets but retains significantly underfunded pension liabilities.

Back to TOC

8. What Is "Controlled Group" Liability?

Many pension-plan related liabilities apply jointly and severally with respect to a plan sponsor and any other member of its controlled group. Such liabilities include:

(i) Termination liability of an underfunded single-employer plan

(ii) Liability for a failure to satisfy minimum funding requirements and associated excise taxes

(iii) Liability for unpaid PBGC premiums

(iv) Withdrawal liability for multiemployer plans

Controlled group liability, however, does not typically apply with respect to OPEB obligations.

In general, the term “controlled group” refers to a group of corporations or unincorporated entities engaged in a “trade or business” with at least 80% common ownership. A controlled group may include parent-subsidiary relationships in which the parent owns (or is deemed to own) 80% or more of the voting power or value of the stock of a subsidiary as well as certain affiliate relationships.

Entities that were members of a controlled group within the five years prior to a pension plan termination may also be liable in connection with the plan termination if a principal purpose of the transaction by which the entity ceased to be a member of the controlled group was to evade pension plan liabilities.

Controlled group liability is an important concept in the bankruptcy context because controlled group members that are not in bankruptcy can be held responsible for single-employer and multiemployer pension plan liabilities of their bankrupt affiliates. The PBGC has intervened in proposed changes to controlled groups in order to prevent transactions that will decrease its recovery in bankruptcy. For example, the PBGC initiated an involuntary termination of a pension plan sponsored by Lehman Brothers Holdings, Inc. during its reorganization prior to the sale of a significant member of the controlled group. The PBGC was concerned that this sale would have compromised the PBGC’s potential recovery in bankruptcy proceedings.

9. What Is the *Sun Capital* Case and Is a Private Equity Fund in the Same Controlled Group as Its Portfolio Companies?

On July 14, 2013, the United States Court of Appeals for the First Circuit held, in *Sun Capital Partners III, LP v. New England Teamsters & Trucking Industry Pension Fund*, that in some circumstances a private equity fund could be engaged in a “trade or business” for purposes of the “controlled group” definition of ERISA and, therefore, could be in the same controlled group as its portfolio companies. This is an important case because prior to *Sun Capital,* no court had explicitly held in a publicly available decision that a private equity fund can be jointly and severally liable for the pension obligations of its portfolio companies.

In *Sun Capital*, affiliates of Sun Capital Advisers, Inc. purchased Scott Brass, Inc. (SBI), a manufacturing company, through three separate funds. SBI later withdrew from a multiemployer pension plan and filed for bankruptcy. The company was assessed with $4.5 million in withdrawal liability, and the multiemployer plan pension fund claimed that the private equity funds were under common control with the company and were jointly and severally liable for the withdrawal liability.

The First Circuit held that engagement in a trade or business would be determined based on the facts and circumstances of a fund’s actions over and above its investment in its portfolio company and that at least one of the funds at issue was engaged in a trade or business. The court noted that such fund (directly and/or indirectly through its general partner) was actively involved in the management and operation of the portfolio company through (i) oversight over employment and compensation decisions, (ii) creation of restructuring and operating plans, (iii) control of the board and (iv) provision of personnel (through a management company) in exchange for consideration. The court remanded to the District Court for a factual determination with respect to the other funds at issue.

On March 3, 2014, the Supreme Court denied Sun Capital’s petition for review of the First Circuit decision.

On remand, the District Court ruled that the private equity funds were jointly and severally responsible for the $4.5 million in withdrawal liability. The District Court's ruling disregarded the private equity funds' formal ownership structure and held that, for purposes of determining liability, the funds formed a partnership-in-fact that was a trade or business under common control with SBI, and thus the funds were liable under ERISA's controlled group liability rules.

10. What Are the Implications of the *Sun Capital* Decision on Private Equity Funds?

Even before the *Sun Capital* decision, it was important for private equity firms to understand the risks when acquiring interests in portfolio companies with unfunded pension liabilities. Following *Sun Capital*, private equity firms should continue to consider carefully how to structure their funds and acquisition structures to avoid characterization as a trade or business and avoid inclusion in the same controlled group as their portfolio companies.

For example, private equity firms may wish to consider, among other things, dividing their investment between two or more independently managed funds with distinct portfolios to support a finding that no individual fund (or group of "parallel" funds) controls any portfolio company (and no set of funds is treated as a joint venture). In *Sun Capital*, the court analyzed two of the funds as if they were one fund on the ground that they were "parallel funds" run by a single general partner and generally made the same investments in the same proportions.

For a more detailed description of the *Sun Capital* decision and its implications, please see the Latham & Watkins *Client Alerts* entitled "Private Equity Funds Further Exposed to Portfolio Company Pension Liabilities," dated July 29, 2013, and "Sun Capital: Private Equity Funds Liable for Portfolio Company's Withdrawal Liability," dated April 4, 2016.

11. Can Foreign Controlled Group Members Be Held Responsible for Pension Liabilities of Domestic Entities in Their Controlled Group?

Historically, ERISA controlled group claims have tended to stop at the US border. Although foreign controlled group members are technically included in the controlled group definition under ERISA, neither the PBGC (for single-employer plan termination liability) nor multiemployer plans (for multiemployer plan withdrawal liability) had pursued foreign controlled group members with respect to the pension plans of their US affiliates. However, in recent cases, the PBGC and multiemployer plans have taken a more aggressive approach both in US courts and elsewhere. Thus far, the PBGC and plans have had limited success. While the PBGC has obtained personal jurisdiction over a foreign controlled group member to prosecute claims in the US (see discussion of *Asahi Tec Corp.* below), a recent decision from a foreign court casts substantial doubt on the viability of controlled group claims abroad (see discussion of *Walter Canada* below).

Asahi Tec Corp.

One reason the PBGC has historically not been successful in assessing ERISA controlled group liability on foreign members of a US pension plan sponsor is that, until recently, the PBGC has been unsuccessful in its attempts to establish personal jurisdiction over foreign entities.[15] However, in the case of *Pension Benefit Guaranty Corp. v. Asahi Tec Corp.*, the District Court for the District of Columbia held that Asahi Tec Corp., the Japanese parent of the wholly owned US subsidiary, Metaldyne Corp., was subject to the court's jurisdiction and was a member of Metaldyne's controlled group.[16] Therefore, the court held that Asahi Tec was jointly and severally liable for the underfunding of Metaldyne's pension plan.

In 2009, Metaldyne filed for bankruptcy under Chapter 11 of the Bankruptcy Code. The PBGC sought to recover from Asahi Tec a portion of the underfunding, as well as termination premiums, totaling approximately $200 million. On March 14, 2012, the court denied Asahi Tec's motion to dismiss the case for lack of personal jurisdiction and held that there was personal jurisdiction over Asahi Tec because Asahi Tec "purposefully directed activity towards the U.S." in connection with the acquisition of a Michigan-based company and because the claims rose directly out of that specific conduct. The court held that Asahi Tec's acquisition of Metaldyne itself was sufficient to establish personal jurisdiction. The court focused on Asahi Tec's due diligence in connection with its purchase of Metaldyne, including its hiring of a consultant to review Metaldyne's employee benefit programs, and its knowledge of the pension-related liabilities, which it discussed factoring into its purchase price. The court stated that Asahi Tec should have reasonably anticipated being sued in the US, and that it was irrelevant that Asahi Tec was not involved with the funding decisions for the plan or the decision to terminate the plan.

On October 4, 2013, the court granted the PBGC's motions for partial summary judgment on the issues of (i) Asahi Tec's affirmative defense of lack of personal jurisdiction and (ii) its liability for unfunded benefit liabilities, in each case using reasoning similar to the reasoning it used in denying Asahi Tec's motion to dismiss. As evidence that Asahi Tec assumed responsibility for the controlled group obligations, the court cited (i) Asahi Tec's knowledge about the underfunded pension plan, (ii) the controlled group liability representations in the merger agreement for the acquisition of Metaldyne and (iii) Asahi Tec's use of the first person plural to describe the risks associated with the underfunded pension liabilities in an offering memorandum used to sell stock to finance the acquisition.

The court also decided that, while the text of ERISA is not clear as to whether liability for termination premiums should extend to controlled group members, the court would defer to the PBGC's interpretation and hold Asahi Tec liable for termination premiums as a controlled group member. Specific damages were not decided.

On November 4, 2014, Asahi Tec and the PBGC settled their dispute for $39.5 million, with no admission of liability or jurisdiction. However, *Asahi Tec* must be recognized as the PBGC's most successful effort to date in asserting ERISA liability on non-US controlled-group members.

Walter Canada

The ability of the PBGC or a plan to pursue foreign controlled group members or their assets *outside* of the United States has remained less certain. Until the *Walter Canada* decision discussed in this section, the most relevant — but still equivocal — precedent was the PBGC's workout with American Airlines. When American Airlines entered bankruptcy in 2011[17] and threatened to seek court authorization to terminate its pension plans, the PBGC took the first opportunity — American's failure to make most of its plan payments in January 2012 — to file more than 70 liens on foreign assets, predominantly in Latin America. Because American and the PBGC ultimately settled (by freezing rather than terminating the relevant plans), whether the PBGC would have succeeded in its pursuit of the foreign assets is unclear. Nevertheless the case signalled a risk of claims in foreign jurisdictions.

On May 1, 2017, the Supreme Court of British Columbia (the Court) cast doubt on the viability of at least some such claims when it handed down its decision in *Walter Energy Canada Holdings, Inc*. *(Re)*.[18] The decision holds that an ERISA controlled group claim fails because the claim raises a question of corporate personality — namely, whether corporate separateness may be disregarded to impose a plan sponsor's liability on its affiliates — and that the law of the place of incorporation, rather than US law, applies to such questions. Because the laws of the places of incorporation, British Columbia and Alberta, do not include ERISA, and because ERISA's controlled group provisions were the sole basis for liability, the claim failed. The decision (explored in more detail below) creates an important guide to the limits of controlled group liability in Canada, and potentially in other jurisdictions guided by the decision.

Background to the Decision — Walter Energy's US & Canadian Bankruptcies

The Walter Energy Group is an international coal production and export company. Walter Energy, Inc. (n/k/a New WEI, Inc.) (Walter Energy US) is the US-based parent corporation of the Walter Energy Group. One of its subsidiaries, Jim Walter Resources, Inc. (Walter Resources), was the sole Walter Energy Group participant in the "1974 Plan," a multiemployer pension plan established in 1974 pursuant to the collectively bargained National Bituminous Coal Wage Agreement of 1974, which was last amended and executed in 2011 (the 2011 CBA).

Also in 2011, and after execution of the 2011 CBA, Walter Energy US incorporated Walter Energy Canada Holdings, Inc. (Walter Canada) and, through Walter Canada, acquired the coal mining operations of Western Coal Corporation by purchasing all of its outstanding common shares. Afterwards, the Walter Energy Group engaged in a series of internal restructurings to organize into geographical business segments: the Walter US Group, the Walter Canada Group and the Walter UK Group. As a result, all US assets were transferred to Walter Energy US, which remained the parent entity of the Walter Energy Group.

On July 15, 2015, Walter Energy US and certain of its subsidiaries, including Walter Resources, commenced Chapter 11 proceedings in the Northern District of Alabama.[19] In October 2015, the 1974 Plan filed a proof of claim for the anticipated withdrawal liability of Walter Resources in the amount of $904 million. As anticipated, the bankruptcy court ultimately authorized Walter Resources to reject the 2011 CBA and thereby to withdraw as a participating employer from the 1974 Plan. In the same order, the bankruptcy court declared that any sale of the Walter debtors' assets would be free and clear of liabilities under the 2011 CBA. The bankruptcy court approved a sale of the debtors' assets, which closed on April 1, 2016, causing all contributions by Walter Resources to the plan to cease — and the withdrawal liability to arise.

In late 2015, Walter Canada and certain of its subsidiaries had sought, and received, protection under the Companies' Creditors Arrangement Act (CCAA) in Canada, creating a parallel bankruptcy proceeding in Canada. After the sale proceedings concluded in the US bankruptcy, the 1974 Plan filed a claim in the CCAA proceeding, seeking to recover withdrawal liability from Walter Canada and its subsidiaries exclusively on the theory that they were members of Walter Resources' controlled group under ERISA. If the claim were allowed, it would swamp all other unsecured claims in the CCAA proceeding; if it were disallowed, all other unsecured claims would recover in full, including the claims of Canadian unionized coalworkers, but no funds would be paid to the 1974 Plan with respect to its unsecured claim.

The Court's Decision — Canadian Law Applies, and Does Not Include ERISA

Setting aside debates over procedure, the parties addressed three main questions: (1) whether US law (*i.e.*, ERISA) or the law of the place of incorporation, should apply to a claim seeking to impose a plan sponsor's liability on affiliate corporations; (2) whether application of ERISA under the circumstances would constitute an impermissible extraterritorial application of ERISA; and (3) whether application of ERISA under the circumstances would be contrary to Canadian public policy. Because the Court held that ERISA does not apply, it did not address the second and third questions.

To begin its analysis of the applicable law, the Court applied Canadian choice of law principles. The Court concluded that the Canadian choice of law analysis required first characterizing, or classifying, the legal issue requiring adjudication, then considering the "connecting factor" tying the issue to a particular legal system, and then applying the chosen governing law.

In this case, as the court recognized, the critical step was the first one. Walter Canada asserted that the central issue was one of the law of corporations or "an issue of legal corporate ... status or personality," because the 1974 Plan's claim was based entirely on ERISA's controlled group provisions, which would impose liability solely on the basis that Walter Resources and the Walter Canada entities were both indirectly owned by Walter Energy US. If accepted, this characterization would lead directly to defeat of the ERISA claim, because under Canadian choice of law principles the predominant connecting factor between issues of corporate personality and a given legal system is the place of incorporation, and the laws of the places of incorporation — British Columbia and Alberta — do not include ERISA.

The 1974 Plan asserted that the central issue was one of the "law of obligations." In other words, the claim was essentially contractual, arising from obligations under the 2011 CBA. The Court disagreed, stating that the 1974 Plan had no "contractual expectations" in relation to the Walter Canada entities, which were not signatories to the 2011 CBA. Any expectations in relation to the Walter Canada entities would have been "statutory expectations."

Instead, the Court agreed with Walter Canada that the ultimate question was one of "separate legal existence or personality," because the alleged liability arose solely from the ERISA's provisions, which "impose[d] liability by ignoring separate corporate personalities and effectively amalgamating, consolidating, or collapsing 'common control' entities into a single 'employer' for any withdrawal liability of any other entity within that group."

Having concluded that it was addressing a question of corporate personality, the Court then held that such questions are connected to, and governed by, the law of the place of incorporation of the corporation. Here, all of the Walter Canada entities were incorporated in British Columbia or Alberta. "As a result, British Columbia and Alberta law [would] determine whether the separate legal personalities of the Walter Canada Group entities can be ignored." Finally, the Court applied the relevant law in summary fashion, stating: "ERISA is not part of British Columbia or Alberta law. Accordingly, the 1974 Plan's claim must fail for that reason."

Implication of Recent Controlled Group Cases for Non-US Controlled Group Members

Despite the mixed results in the current case law, the PBGC and multiemployer plans will likely continue to pursue aggressively the assets of foreign controlled group members in connection with pension-related obligations. Hence companies with underfunded pension plans must consider the potential liability of foreign members of the controlled group in their bankruptcy planning.

While the risks include actions both within and outside of the US, the greater risk at present appears to be a suit in the US after a successful assertion of personal jurisdiction over the foreign controlled group member, although such risk is likely reduced in the absence of the facts of the *Asahi Tec* case, *i.e.*, inbound acquisition activity with a focus on pension liabilities and express representations as to controlled group liability.

For claims against foreign controlled group members in foreign jurisdictions, *Walter Canada* may create a substantial barrier. The Canadian court applied a cogent legal framework to foreclose a claim that may be difficult for any foreign court to accept, *i.e.*, a claim based on a US statutory provision that imposes liability in derogation of general principles of corporate separateness — and in aid of a US statutory insurance scheme. Especially in the absence of other relevant authority, future courts in other jurisdictions may take note, and the failure of the ERISA claim in Canada, a jurisdiction whose courts work often and closely with their US counterparts, especially in matters of insolvency, could be a strong indicator that such claims will face challenges elsewhere.

If circumstances do create the risk of exposure of foreign controlled group members for pension plan liabilities, a company may wish to consider including the foreign entity in the bankruptcy filing by filing a case in the foreign entity's home jurisdiction and seeking recognition in the US, or by including the foreign entity in the US main filing, if the foreign entity is eligible to be a debtor under the Bankruptcy Code.[20] Otherwise, the non-debtor foreign entity will not have the benefit of the protection provided by the automatic stay and may be left with substantial liens filed on its assets.

Back to TOC

12. What Are the Minimum Funding Requirements for Single-employer Defined Benefit Plans?

ERISA and the IRC establish the minimum funding requirements for defined benefit plans. The Pension Protection Act of 2006 (the PPA) changed the funding requirements of defined benefit pension plans for plan years beginning after December 31, 2007. In December 2008, the Worker, Retiree, and Employer Recovery Act of 2008 eased the funding rules under the PPA in light of the turbulent economic environment.

Although there is no requirement that a defined benefit plan be fully funded, the plan sponsor must make minimum annual contributions to the plan. Pursuant to the PPA, each year, the plan sponsor generally must contribute an amount that will cover the accrued benefits for the year and amortize any funding shortfall over a seven-year period.

Accrued benefits are measured by reference to the plan's "target normal cost," which consists of (i) service cost, the present value of benefits earned in the year (including increases in benefits as a result of current salary increases), and (ii) interest cost, the annual accrued interest on previously incurred pension obligations.

If the value of a plan's assets is less than the plan's funding target for a plan year (the present value of all benefits accrued or earned as of the beginning of the plan year), the plan has a funding shortfall. Contributions in excess of minimum required contributions (funding standard carryover balance) and credit balances under pre-PPA law (prefunding balance) generally cannot eliminate a funding shortfall. If there is a funding shortfall in any plan year, the following seven years' minimum required contributions must include the aggregate amount of such shortfall, divided into equal installments over the seven years.

Required minimum annual contributions to defined benefit plans are calculated by an actuary using actuarial methods and assumptions set forth in the IRC, which were revised under the PPA. The two basic actuarial methods used are the accrued benefit and the projected benefit. The accrued benefit cost method calculates liabilities based on benefits accruing in a particular year, while the projected benefit cost method calculates benefits by treating them as accruing over the entire time of plan participation.

The assumptions include:

- Employee turnover
- Employee disability
- Employee mortality
- The age difference and mortality of the spouse
- The number of employees who will select early retirement versus normal retirement
- The compensation level of employees
- The plan's expected investment experience, liabilities and administrative expenses

The PPA specifies three interest rates used to determine a plan's target normal cost and funding target, each for a different period of benefit accruals and each determined monthly by the Secretary of the Treasury based on the yield on high grade corporate bonds.

Required installments are generally due eight and a half months after the plan year's end. Quarterly contributions must be made during a plan year, if the plan had a funding shortfall for the preceding plan year.

13. Are There Special Funding Requirements for Severely Underfunded Plans?

Yes. "At-risk" plans have accelerated funding requirements. Whether a plan is in at-risk status for a plan year depends on its "funding target attainment percentage." A plan's funding target attainment percentage for a plan year is the ratio, expressed as a percentage, that the value of the plan's assets (reduced by any funding standard carryover balance and prefunding balance) bears to the plan's funding target for the year.

A plan is in at-risk status if, for the preceding year, (i) the plan's funding target attainment percentage, determined without regard to the at-risk assumptions (described in the next paragraph), was less than 80%, and (ii) the plan's funding target attainment percentage, determined using the at-risk assumptions (without regard to whether the plan was in at-risk status for the preceding year), was less than 70%. The at-risk rules do not apply to certain small plans.

Special assumptions apply under the PPA for determining whether a plan is in at-risk status and the funding target and normal cost for such plans. All employees who will be eligible to elect benefits in the current and 10 succeeding years are assumed to retire at the earliest retirement date under the plan, but not before the end of the plan year, and all employees are assumed to elect the retirement benefit available under the plan at the assumed retirement age that results in the highest present value.

The funding target and normal cost of plans in at-risk status are calculated using certain "loading factors" that increase such amounts. Special transition rules apply to plans in at-risk status for less than five consecutive years.

14. Are There Any Other Restrictions That Apply to Underfunded Plans?

Various restrictions apply to plans that have "adjusted funded target attainment percentages" (AFTAP) below certain specified percentages. The AFTAP is the funding target attainment percentage determined by increasing both the value of plan assets and the funding target of the plan by the aggregate amount of purchases of annuities for employees, other than highly compensated employees, that were made during the two preceding plan years.

Generally, if the AFTAP is below 80%, no amendment can be made that has the effect of increasing plan liabilities. If the AFTAP is between 60% and 80%, certain payments from the plan are prohibited. If the AFTAP is below 60%, limitations on "unpredictable contingent event benefits" apply and all benefit accruals must cease.

Employers can often avoid these limitations by contributing amounts to the plan as security. There are specific rules that determine what types of security employers can contribute.

Additional restrictions apply if a pension plan has a "liquidity shortfall," which means any excess of the "base amount" over the value of the plan's liquid assets, as of the last day of a quarter. The "base amount” is three times adjusted disbursements from the plan for the 12 months ending on the last day of the relevant quarter. In the event of a liquidity shortfall, additional contributions are required and there are prohibitions on certain payments. An excise tax is imposed for failure to make a liquidity shortfall payment. If the debtor’s pension plan has funding problems, the plan should be examined to determine whether a “liquidity shortfall” has occurred.

15. Can Minimum Funding Contributions Be Waived Under Any Circumstances?

Yes. The Secretary of the Treasury may waive all or a portion of a plan’s minimum required contributions (a waived funding deficiency). Waivers may be granted if the company demonstrates temporary substantial business hardship (with respect to its controlled group) and the IRS determines that the application of the minimum funding standard would be adverse to the interests of plan participants. A waiver may not be granted with respect to more than three years in any 15-consecutive-year period for single-employer plans, and five years in any 15-year period for multiemployer plans.

If a plan has a waived funding deficiency for a year, the following five years’ minimum required contributions must include the aggregate amount of such deficiency, divided into equal installments over the five years.

Employers may be required to furnish security with respect to waived contributions. Plans subject to minimum funding waivers may generally not be amended to increase benefits. In addition, several notice requirements apply, including requirements to provide notice to the PBGC and to plan participants.

16. What Happens If a Sponsor of a Defined Benefit Plan Fails to Meet Its Minimum Funding Requirement?

In addition to interest on underpayments, an initial excise tax of 10% is levied upon an unpaid funding deficiency for single-employer plans (5% for multiemployer plans), which may be ratcheted up to 100% of the liability after notice from the IRS. The IRS may waive the 100% penalty upon a showing of hardship. The penalties are imposed each year the deficiency is not paid.

For plans with funding target attainment percentages of less than 100%, failure to make a required contribution that, together with all other unpaid contributions, exceeds $1 million will result in the imposition of a statutory lien in favor of the defined benefit plan for the required installment (plus interest). The lien attaches to all assets of the plan sponsor and all members of the sponsor’s controlled group. The lien exists from the date of the missed payment through the last day of the first plan year in which the aggregate amount owed is reduced to $1 million or less. Note that liens filed by the PBGC may constitute events of default under certain credit and other financing agreements.

The failure to satisfy a minimum funding payment can be asserted as either a statutory claim, by a plan participant, beneficiary or trustee or the PBGC, or a contract claim, held by the union and the employees pursuant to a collective bargaining agreement. The appropriate claimant depends upon whether the obligation runs to the plan or to the employee. If the plan requires employees to look solely to the plan’s assets, the plan sponsor generally will not be liable. If the statutory funding obligations are unmet, however, more stringent standards apply for the plan sponsor to limit its liability.

Plan sponsors must notify plan participants of contributions that are more than 60 days late. There may be penalties owing to participants in the amount of up to $110.00 per day for failure to so notify.

17. Do Plans Have to Inform Participants of Their Funding Statuses?

Yes. Pursuant to the PPA, each plan must provide an annual funding notice to participants, beneficiaries, unions, contributing employers and the PBGC.

Back to TOC

18. If a Company Files for Bankruptcy, Does That Necessarily Mean That the Company's Pension Plan Will Terminate?

No. Plans are not always terminated in connection with bankruptcies. In fact, the PBGC often makes it difficult for companies to terminate underfunded pension plans, in an effort to minimize the pension obligations for which the PBGC will become responsible. In addition, companies in bankruptcy may not desire termination, because it may lead to large PBGC claims and to termination premiums owing at emergence from bankruptcy. Also, following plan termination, the PBGC may play a large role on the creditors' committee in a reorganization. Finally, companies often want to avoid the potential resulting negative impact on employee morale and relationships with unions.

Sometimes, debtors enter into settlements with the PBGC in order to avoid involuntary terminations of their plans. In a settlement, the plan sponsor or another member of its controlled group may be required to provide a guarantee or security to the PBGC, and the funding schedule may be extended.

The PBGC also has the power to restore plans that have been terminated if it determines that the plan sponsor has become financially healthy again.

19. What Are the Procedures for Terminating a Fully Funded Single-employer Pension Plan?

If a plan is fully funded, a plan sponsor can voluntarily terminate the plan in a standard termination. A plan is considered fully funded for these purposes only if it has sufficient assets to pay all "benefit liabilities." Benefit liabilities are defined generally as all fixed and contingent benefits that would be provided if the plan had sufficient assets. Companies contemplating bankruptcy are not likely to have fully funded pension plans, so the following is only a brief overview of standard termination procedures.

In order to implement a standard termination, the plan administrator must provide participants and beneficiaries with between 60 and 90 days' advance notice and notify the PBGC not later than 180 days after the proposed date of termination. The PBGC notice must include an actuarial certification. The PBGC has 60 days from its notice to issue a notice of noncompliance stating that the requirements for a standard termination have not been satisfied. Assuming the PBGC does not issue such a notice, the plan administrator will distribute assets to plan participants within 180 days of the expiration of the PBGC review period, often in the form of annuities from a highly rated insurer.

An employer may desire to terminate a plan that is overfunded in order to receive the excess assets. This is possible if certain requirements are met: (i) all plan liabilities to participants and beneficiaries must be satisfied; (ii) the distribution of residual assets must not violate any law and (iii) the plan must provide for such a distribution. The IRC imposes a nondeductible 50% excise tax (in addition to regular income tax) on reversions of excess plan assets to employers. The excise tax is reduced to 20% if the employer (i) transfers 25% of the reversion amount to a "qualified replacement plan," which may include a qualified defined contribution plan, or (ii) provides pro rata increases in benefits to qualified plan participants in connection with plan termination equal to at least 20% of the maximum reversion that could be received.

The excise tax is also limited to 20% if the plan sponsor is in Chapter 7 bankruptcy or similar state court proceedings on the plan termination date.

20. May a Single-employer Pension Plan Be Terminated If It Is Not Fully Funded?

Yes, but the plan can only be terminated by the plan sponsor in a "distress termination" or by the PBGC in an "involuntary termination." In both a distress termination and an involuntary termination, the plan sponsor must pay a termination premium. The premium is $1,250 per participant per year for each of the three consecutive 12-month periods beginning with the first of the month following the month in which the date of termination falls.

If a plan is terminated in a distress or involuntary termination during a bankruptcy proceeding under Chapter 11 or similar state law, the premium is payable with respect to each of the three consecutive 12-month periods beginning with the first of the month following the month in which the date of discharge or dismissal occurs. The termination premium is not dischargeable in bankruptcy. The termination premium will not be triggered if the debtor is in liquidation at the time of a distress termination; however, the law is not clear as to whether the termination premium applies after an involuntary termination in a liquidating bankruptcy, or if the plan sponsor converts to a liquidating case after a distress or involuntary termination has already occurred.

Airlines are subject to special termination premium rules.

21. What Is Involved in a "Distress Termination" of a Single-employer Pension Plan?

Under ERISA, a plan sponsor may terminate a pension plan in a distress termination only if all of the following apply:

(i) The plan sponsor issues a notice of intent to terminate to the PBGC and affected parties.

(ii) The plan sponsor provides the PBGC with certain required information, including an actuarial report.

(iii) The PBGC determines that one of the following financial distress tests is met with respect to the plan sponsor and each member of its controlled group:

- A petition has been filed seeking liquidation in bankruptcy.
- A petition has been filed seeking reorganization in bankruptcy and the bankruptcy court (or applicable state court) has determined that the company will not be able to reorganize with the plan in place and will be unable to continue in business outside reorganization and approves the plan termination.
- The plan sponsor demonstrates to the PBGC that the plan sponsor will be unable to continue in business unless the plan is terminated.
- The plan sponsor demonstrates to the PBGC that the costs of providing pension coverage have become unreasonably burdensome solely as a result of the decline in the number of covered participants.

Note that while the statute provides that the bankruptcy court determines whether the distress test is met in the case of a reorganization, the PBGC often seeks to have some input in the decision as well.

22. What Is Involved in an "Involuntary Termination" of a Single-employer Pension Plan?

Under ERISA, the PBGC may institute proceedings to terminate a pension plan (even if the plan sponsor has taken no action to terminate the plan) upon the occurrence of any of the following:

(i) The plan has failed to meet statutorily required minimum funding requirements.

(ii) The plan will be unable to pay benefits when due.

(iii) A lump-sum payment is made to a participant who is a significant owner of the plan sponsor.

(iv) The possible long-run loss to the PBGC with respect to the plan may reasonably be expected to increase unreasonably if the plan is not terminated.

In order to initiate an involuntary termination, the PBGC notifies the plan administrator and also generally publishes notice for participants in local newspapers. If the plan administrator does not agree to the termination or any of the PBGC's desired procedures, the PBGC must seek a court order from a District Court.

23. What If a Collective Bargaining Agreement Contemplates Pension Plan Participation?

If a collective bargaining agreement provides for continued pension plan participation, the pension plan may not be terminated by the plan sponsor (in a standard or distress termination) unless, in addition to meeting the ERISA requirements for the applicable type of plan termination, the plan sponsor and union modify or reject the collective bargaining agreement in accordance with Section 1113 of the Bankruptcy Code. To terminate a collective bargaining agreement under Section 1113, the plan sponsor must prove to the court all of the following:

(i) The plan sponsor has made a proposal to the union that is based upon the most complete and reliable information available at the time of the proposal.

(ii) The modifications of the collective bargaining agreement are necessary to permit reorganization of the plan sponsor and all affected parties are treated fairly and equitably.[21]

(iii) The plan sponsor has met with the union representative at reasonable times subsequent to making the proposal and has negotiated in good faith.

(iv) The union has refused to accept the plan sponsor's proposal without good cause.

(v) The balance of the equities clearly favors modification or rejection of the collective bargaining agreement.

If a union has challenged a plan termination asserting that the termination would violate the terms and conditions of an existing collective bargaining agreement, the PBGC must suspend the termination process while the challenge to the termination is being considered.

Section 1113 and the collective bargaining process in general often make it difficult for debtors to terminate or withdraw from plans covering union employees, even if termination or withdrawal makes economic sense for all parties.

By contrast, the PBGC may terminate a pension plan in an involuntary termination even if the applicable collective bargaining agreement provides for continued participation.

24. How Does Plan Termination Affect Participants?

Upon any plan termination, the accrued benefits of all participants must be 100% vested, to the extent funded. While the termination of a plan is pending, the plan must continue to operate as usual, subject to certain restrictions on benefit distributions.

Upon a plan termination, the PBGC takes over the plan. After that point, participants can generally no longer make claims against the plan for their benefits, and must only look to the PBGC. However, some case law has held that state law claims or claims against third-party service providers are still permitted.

When the PBGC takes over a plan following termination, certain benefits will be guaranteed, based on the plan's terms and ERISA. In addition, the PBGC may be able to pay more than the guaranteed benefits if there are sufficient plan assets (including a portion of the PBGC's recovery of termination liability).

The PBGC calculates the amount of benefits that it can pay from plan assets based on six priority categories set forth in ERISA:

Category 1: Accrued benefits from voluntary participant contributions

Category 2: Accrued benefits from mandatory employee contributions

Category 3: Benefits that were being paid or could have been paid (*i.e.*, payable if a participant actually retired or could have retired) as of the beginning of the three-year period ending on the termination date, based on the terms of the plan in effect during the five years before the termination under which the benefit would be the least

Category 4: All other benefits guaranteed by the PBGC under Section 4022 of ERISA and certain benefits guaranteed by the PBGC to substantial owners

Category 5: All other nonforfeitable benefits under the plan

Category 6: All other plan benefits

After allocating plan assets based on priority categories, starting with Category 1, the PBGC pays all guaranteed benefits plus any additional amount funded by the plan assets based on the categorization. The PBGC guarantees all benefits in Categories 2 and 4 and guarantees some benefits in Category 3. It does not guarantee benefits in Category 1, 5 or 6.

For benefits implemented within five years prior to a plan termination, the PBGC guarantee of those benefits is phased in at the greater of 20% per year or $20.00 per year of service.

If a plan terminates while the plan sponsor is in bankruptcy, the PBGC's liability for guaranteed benefits and the amount of Category 3 benefits are determined as of the date of the bankruptcy filing, rather than as of plan termination.

25. What Amounts Are the PBGC Entitled to Recover Following a Plan Termination? How Can It Enforce Its Recovery?

In connection with an involuntary termination or distress termination of a defined benefit plan, the PBGC will typically file a claim for termination liability in an amount equal to the plan underfunding (*i.e.*, the excess of the actuarial present value of benefit liabilities under the plan over the fair market value of the plan's assets). The PBGC generally asserts that the amount of benefit liabilities under a terminated plan should be determined based upon interest rate and other actuarial assumptions set forth under applicable PBGC regulations. Use of the PBGC assumptions generally leads to an increase in the amount of benefit liabilities as compared with other actuarial methodologies and thus a larger claim by the PBGC.

If, in connection with the termination of an underfunded defined benefit plan, a company fails to pay its liability to the PBGC, a lien may be created in favor of the PBGC (assuming that creation of the lien is not stayed under bankruptcy law, as described below). The maximum amount of the lien that may be imposed is equal to the lesser of (i) the total amount of any liability owed to the PBGC (as determined under ERISA) as of the plan's termination date, and (ii) 30% of the "collective net worth" of the plan sponsor and all members of its controlled group.[22]

The lien securing the PBGC's claim arises automatically by operation of law, but the PBGC's lien will not have priority against certain other persons with properly perfected liens (*e.g.*, purchaser, secured creditor, judgment lien creditor or mechanic's lienor) unless and until the PBGC files a notice of employer liability lien, regardless of whether or not such other person has actual knowledge of the PBGC's lien. After the PBGC files a notice of employer liability lien, the PBGC's lien will have priority over most security interests that have not been properly perfected at or prior to the filing of the notice. However, the IRC protects holders of certain security interests notwithstanding the PBGC's notice filing. Among others, the exception to the general priority rule applies, in certain circumstances, to:

(i) Financing agreements for commercial transactions

(ii) Real property construction or improvement financing agreements

(iii) Disbursements made under the terms of a written agreement and made before the 46th day after the date of the PBGC's notice filing

In each case only if the applicable security interest is protected under local law against a judgment lien arising, as of the time of the PBGC's notice filing, out of an unsecured obligation.

Back to TOC

26. Are the Assets of Pension Plans Subject to the Claims of Creditors in Bankruptcy?

Assets of qualified pension plans are required to be set aside in a trust and do not constitute property of the employer's bankruptcy estate. Therefore, they are not subject to the claims of the employer's creditors in bankruptcy.

27. How Are PBGC Claims Treated in Bankruptcy?

The PBGC will typically file a claim in bankruptcy for:

(i) The full amount of underfunded benefit liabilities

(ii) Due and unpaid minimum funding contributions[23]

(iii) Unpaid premiums to the PBGC

The Bankruptcy Code, rather than ERISA, governs the treatment of PBGC claims in bankruptcy. Under the Bankruptcy Code, certain claims against the debtor are paid prior to others. Generally, the first claims to be paid are secured claims. Following secured claims, there are 10 levels of priority for unsecured claims. Most claims that are not secured and not afforded priority status are referred to as "general unsecured claims" and are usually the last to be paid.

The treatment of the PBGC's claims in bankruptcy will depend upon a number of factors, such as whether the claim arose pre-petition (prior to the filing of a bankruptcy case) or post-petition (during the bankruptcy case), the type of claim, and whether the PBGC properly perfected a lien prior to the commencement of the bankruptcy case.

As discussed above, if the PBGC perfects a lien for any of its liabilities prior to the commencement of the bankruptcy case, the PBGC will be a secured creditor and its claim will be among the first to be paid out of the debtor's estate. However, the automatic stay imposed by the Bankruptcy Code prohibits the PBGC from creating and/or perfecting liens post-petition against debtors.

Where its claims are unsecured, the PBGC generally asserts various bases on which its claims should be afforded priority status. However, courts have typically rejected the PBGC's attempts to assert priority status for claims arising from the termination of the plan post-petition. The end result is likely to be that portions of the PBGC's claims will be entitled to priority under only two circumstances: (i) a claim, or a portion thereof, will be given second priority status as an administrative expense, if the claim arises from a transaction between the creditor and the debtor in possession and provides a direct and substantial benefit to the estate, such as claims for services performed by employees after commencement of the bankruptcy case, and (ii) a claim, or a portion thereof, may be eligible for fifth priority treatment as an employee benefit plan expense if it relates to benefits accruing for pre-petition services of employees within 180 days prior to the bankruptcy petition. Fifth priority treatment is limited to the product of $12,850 and the number of employees covered by the plan, reduced by the aggregate amount of fourth priority claims for wages, salaries and commissions earned during the same 180-day period and by amounts for the same employees under other benefit plans. Each of these circumstances is discussed in further detail below.

The remainder (and majority) of the PBGC's claims often end up being treated largely as general unsecured claims. However, they frequently are the largest in a bankruptcy. The result is that the PBGC may have significant negotiating power among general unsecured creditors and may exert significant influence in connection with the formulation of a plan of reorganization.

28. How Is the PBGC's Claim Valued in Bankruptcy?

As noted above, the PBGC usually uses very conservative interest rate assumptions in the case of plan termination that cause the value of benefit liabilities to be larger than they would otherwise be. In the bankruptcy context, courts have sometimes found that bankruptcy principles require that interest rate assumptions other than the conservative ones normally proposed by the PBGC should be used (a prudent investor rate).[24] However, in recent cases, courts have deferred to the PBGC and used its rates.[25]

29. Can a Plan Sponsor Continue to Make Minimum Funding Contributions During a Bankruptcy Case?

During a bankruptcy case, an issue often arises as to whether and to what extent the pension plan sponsor will continue to make its minimum funding contributions. As a general rule, the PBGC requires plan sponsors who maintain underfunded defined benefit plans to make quarterly minimum funding payments during the administration of a bankruptcy case. The PBGC has often contended that such payments are permitted because they are necessary fringe benefits and that a failure to make the minimum funding obligations could lead to termination of the plan and substantial tax levies for failure to fund. To the extent that a minimum funding payment is based upon pre-petition underfunding, however, creditors and the debtor often contend that the minimum funding payment should be treated in the same manner as pre-petition unsecured claims that are not required to be paid because of the "automatic stay" under Section 362 of the Bankruptcy Code. Consequently, plan sponsors often seek approval from the bankruptcy court and creditors in order to make such contributions.

30. Can a Plan Sponsor in Bankruptcy Engage in a Corporate Transaction to Decrease Its Pension Liabilities?

Asset sales and stock sales are possible while a company is in bankruptcy, although bankruptcy court approval is required. The purchaser of a debtor's assets may or may not assume pension liabilities. The purchaser of the equity of a debtor would generally succeed to the debtor's pension liabilities.

31. What Other Plan-related Requirements or Limitations Does a Bankruptcy Filing Trigger?

Plan sponsors must generally notify plan participants and the PBGC of bankruptcy filings, subject to penalties for failure to notify.

While in bankruptcy, a plan sponsor generally cannot amend a plan to increase plan liabilities other than by a de minimis amount. Certain forms of payment, such as lump sum, are also prohibited during bankruptcy without court approval.

Back to TOC

32. What Are Multiemployer Plans?

Multiemployer plans are defined benefit plans maintained by two or more employers pursuant to a collective bargaining agreement. An employer's required contributions to a multiemployer plan are typically set forth in the applicable collective bargaining agreement, often by reference to participants' wages or hours worked.

33. What Are the Funding Requirements for Multiemployer Plans?

The PPA added new funding rules for multiemployer plans that are in "endangered," "seriously endangered" or "critical" status. Status generally is based on current funding percentages and projected accumulated funding deficiencies.

Endangered plans must develop 10-year funding improvement plans, and seriously endangered plans must develop 15-year funding improvement plans.

Critical status plans must develop rehabilitation plans that aim to remove the critical status in 10 years. Contributing employers are required to pay additional contributions to the underfunded plan during the rehabilitation period and to attempt to reduce certain benefits through collective bargaining.

During the funding improvement period and the rehabilitation period, plan sponsors are restricted from reducing contributions and increasing benefits.

34. What Liabilities Are Imposed in Connection With the Withdrawal From a Multiemployer Plan?

Each employer participating in a multiemployer plan is subject to "withdrawal liability" (*i.e.,* the employer's share of the plan's underfunded vested benefits) if the employer wholly or, in certain cases, partially ceases to participate in the plan. Withdrawal liability generally applies jointly and severally to the contributing employer and other members of the employer's controlled group.

Withdrawal liability is usually paid in annual installments. If an employer defaults in the payment of any installment of withdrawal liability, the plan may require immediate payment of the remaining balance of the withdrawal liability. Any event that indicates a substantial likelihood that an employer will be unable to pay its withdrawal liability — such as a bankruptcy filing — may be considered a default.

35. How Can a Multiemployer Plan Be Terminated?

There are four primary methods for terminating a multiemployer plan: (i) freeze, (ii) conversion, (iii) mass withdrawal and (iv) partition by the PBGC.

In a freeze, benefit accruals cease. In a conversion, the plan is converted into a defined contribution plan. In both a freeze and a conversion, each employer's contributions under the plan for each future plan year (until full funding is achieved) must equal or exceed the highest rate of its contributions in the five years before the termination date.

In a mass withdrawal, every employer withdraws from the plan. All employers must pay withdrawal liability until the assets of the plan are sufficient to meet obligations (not including withdrawal liability obligations). If assets of the plan are not sufficient to meet obligations (including withdrawal liability obligations), benefits must be reduced (but not below guaranteed benefits). If the assets cannot cover guaranteed benefits, the plan is considered insolvent and additional restrictions apply.

In a partition, the PBGC divides the liabilities of the plan among the withdrawing employer and the other employers, and allocates assets accordingly. Following the partition, there is a successor plan covering employees of the non-withdrawing employer and a terminated plan covering the employees of the withdrawing employer.

36. How Are Multiemployer Plans Treated in Bankruptcy?

Unlike for single-employer plans, the board of trustees in a multiemployer plan (and not the PBGC) enforces the plan's rights in bankruptcy.

Contributions to multiemployer plans that relate to pre-petition service have generally been considered pre-petition obligations for purposes of determining priority status in bankruptcy.

A multiemployer plan may assert a claim in bankruptcy for the full amount of withdrawal liability with respect to a withdrawing employer. As discussed above, in some circumstances, all or a portion of this claim may be entitled to administrative expense priority under the Bankruptcy Code. In general, for a claim to qualify as an administrative expense under Section 503(b)(1)(A) of the Bankruptcy Code, the claim must both (i) arise from a transaction between the creditor and a debtor in possession (not the pre-petition entity); and (ii) provide a direct and substantial benefit to the estate.[26] Thus, in order to meet the first prong, the claim must arise post-petition. Courts have held that multiemployer plan withdrawal liability arises at the time the employer withdraws. Multiemployer pension plans have argued that, if withdrawal occurs post-petition, all withdrawal liability should be entitled to administrative expense priority. However, such arguments have failed. Instead, courts have generally focused on whether and how much of the withdrawal liability claim is based on service performed post-petition as opposed to pre-petition (as determined under ERISA). Courts have varied greatly in how they make this determination. Some courts have held that withdrawal liability is solely a pre-petition claim not entitled to administrative expense status because there are many factors other than service (market forces, contribution histories, etc.) that affect the determination of withdrawal liability, so no direct benefit to the estate could be connected to the payment of withdrawal liability.

The Third Circuit addressed the issue of whether and how much withdrawal liability to consider an administrative expense in the matter of *In re Marcal Paper Mills, Inc.*[27] In this case, the Third Circuit held that the portion of the claim directly attributable to services provided by the employees during the post-petition period was entitled to administrative expense priority, reasoning that the continued work of the employees post-petition conferred a clear benefit on the estate.

Back to TOC

37. How Are OPEB Obligations Treated in Bankruptcy?

OPEB obligations are generally not viewed by credit rating agencies as debt, because:

(i) They are generally modifiable or cancelable in bankruptcy.

(ii) Their liability does not mature at one time.

(iii) They generally have no funding requirements.

Also, OPEB liabilities projected in a company's financial statements are based on actuarial estimations. A company's cash expense for OPEB may vary, even significantly, from its projections. Nonetheless, investors should carefully consider OPEB because such obligations represent substantial company obligations that may be difficult to modify. This is particularly true with respect to OPEB obligations subject to collective bargaining agreements or tied to a large retiree population or a company with a high ratio of retirees to active employees.

As noted above, Section 507(a)(5) of the Bankruptcy Code grants fifth priority to claims for contributions to an "employee benefit plan," but only if such claims arise in conjunction with an employee-participant's services rendered to the debtor within 180 days before the date the bankruptcy petition was filed or the date of the cessation of the debtor's business, whichever occurs first. Courts have held that payments to self-funded plans of the plan sponsor (including OPEB obligations) are contributions to an "employee benefit plan" under Section 507(a)(5). Therefore, OPEB obligations will be afforded priority to the extent the benefits or contributions claimed by a plan's participants arise from services rendered by the employee-participant within the aforementioned 180-day period. In addition, the plan trustee's obligation to pay benefits must also arise during the 180 days prior to the bankruptcy filing (*e.g.*, medical care must have been received within such 180-day period). However, as noted above, the Bankruptcy Code caps the priority claim that arises under Section 507(a)(5) at the number of employees covered by the employee benefit plan multiplied by $12,850 per employee (less the sum of (i) the aggregate amount paid to the employees as priority wages under Section 507(a)(4) of the Bankruptcy Code, and (ii) the aggregate amount paid by the estate on behalf of such employees to any other employee benefit plan).

Since this cap applies on an aggregate basis, an individual employee may receive benefits under the plan in excess of $12,850, so long as the aggregate limit is not exceeded. The amount of the claim for unpaid contributions in excess of this limit is treated as a general unsecured claim.

38. How Are OPEB Obligations Modified in Bankruptcy?

As noted above, OPEB obligations generally represent unsecured claims against the debtor. Prospective OPEB obligations can be modified in bankruptcy, but the debtor generally must comply with Section 1114 of the Bankruptcy Code. Specifically, Section 1114 provides that retirees' previously earned benefits may be modified only upon the consent of the appointed retiree representative or by order of the bankruptcy court. The procedure for obtaining a court order authorizing modification of retiree benefits is similar to that which is required to reject a collective bargaining agreement under Section 1113. The debtor must prove to the court all of the following:

(i) The debtor has made a proposal to the retirees' authorized representative that is based upon the most complete and reliable information available at the time of the proposal.

(ii) The modifications are necessary to permit reorganization of the debtor and all affected parties are treated fairly and equitably.

(iii) The debtor has met with the authorized representative at reasonable times subsequent to making the proposal and has negotiated in good faith.

(iv) The authorized representative has refused to accept the debtor's proposal without good cause.

(v) The balance of the equities clearly favors modification of retiree benefits.

Pursuant to Section 1114(l), if, during the 180-day period prior to the bankruptcy filing, the debtor modifies retiree benefits and was insolvent on the date such benefits were modified, then the court, on motion of a party in interest and after notice and a hearing, shall issue an order reinstating, as of the date such modification was made, such benefits, unless the court finds that the balance of the equities clearly favors such modification. Unless the court orders modification or the retiree representative agrees to a modification, retiree medical and other OPEB obligations will remain unaffected during a Chapter 11 proceeding.

If the retirees are covered by a collective bargaining agreement, the authorized representative is the labor union, unless the court determines that there should be a different representative. The court appoints a committee of retirees to act as the authorized representative of retired non-union employees.

Notably, courts have taken different approaches regarding whether Section 1114 applies if the debtor has the unilateral right to modify or terminate such benefits under non-bankruptcy law. A majority of courts have concluded that Section 1114 does not limit a debtor's ability to modify or terminate benefits during bankruptcy if the debtor may modify or terminate retiree benefits at will under the applicable plan documents.[28] However, in *IUE-CWA v. Visteon Corp. (In re Visteon Corp.)*,[29] the Court of Appeals for the Third Circuit ruled that the above procedure for modifying retiree benefits applies to all retiree benefit plans, regardless of whether the debtor has the unilateral right to modify or terminate the retiree plan at will prior to the commencement of the bankruptcy case.[30] The *Visteon* court did explain that the limitations on unilateral termination rights only apply while a debtor is in bankruptcy, acknowledging that once a debtor emerges from bankruptcy "a debtor who reserved the right to terminate retiree benefits has no ongoing obligation, other than one that may have been voluntarily undertaken during the § 1114 process, to continue to provide benefits."[31]

Prior to even reaching the issue of whether a debtor must comply with Section 1114, courts are often tasked with determining whether the applicable plan documents give a debtor the right to modify or terminate retiree benefits under non-bankruptcy law. In the American Airlines bankruptcy case (*AMR Corp. v. Committee of Retired Employees*, Adv. Pro. No. 12-01744), the debtors argued that they had the right to unilaterally terminate various retiree benefits plans with both union and non-union employees. With respect to the majority of the retiree benefits plans, the court denied the debtors' request for summary judgment that the benefits plans could be unilaterally modified or terminated, finding that "the relevant documents contain language reasonably susceptible to interpretation as a promise to vest benefits and lack language categorically reserving the Plaintiffs' right to terminate their contributions to the retiree benefits."[32]

Back to TOC

39. Are Pension and OPEB Obligations for Government Workers Affected by State and Municipal Financial Problems and Bankruptcies?

Over the past few years, the following municipalities have filed for protection under Chapter 9 of the Bankruptcy Code: Jefferson County, Alabama; Detroit, Michigan; Stockton, California; San Bernardino, California; and Vallejo, California. Although a detailed discussion of the effects of bankruptcy on government pension plans is beyond the scope of this *Client Alert*, notably these cases have demonstrated that many municipal pension plans are severely underfunded. Thus, when cities declare bankruptcy, often the pension and OPEB plans compete with bondholders for government funds. In addition, the bankruptcy cases often reveal improper historical management of the pension and OPEB plans. Moreover, certain unique issues arise with respect to pension plans and OPEB obligations in Chapter 9 cases. These cases are often more complicated than Chapter 11 cases — not only because Chapter 9 does not contain as much guidance on pension plans as Chapter 11 does, but also because bankruptcy judges in Chapter 9 cases are more constrained than judges in Chapter 11 cases in that they cannot order cities to raise taxes, change spending policies or avoid incurring more debt.

Recent financial problems of cities and states have led many to implement pension and OPEB reforms, such as raising employee contributions and reducing benefits. However, governments face significant limitations on the actions they can take in this regard because many states are prohibited from reducing benefits for existing employees, either under the applicable state constitutions or under the states' interpretations of contract and property law. For example, Illinois attempted to restructure its pension plan in response to recent financial difficulties, but the Illinois State Supreme Court rejected the plan because of language in the Illinois constitution prohibiting the diminution or impairment of pension commitments. This language was interpreted to prevent the alteration not just of accrued benefits but even future not-yet-accrued benefits for existing workers.[33]

40. Can Coal Industry OPEB Liabilities Be Discharged Through the Same Bankruptcy Processes and Procedures as OPEB Liabilities in Other Industries?

The Coal Retiree Health Benefit Act and the Black Lung Benefits Act create statutory benefit obligations for coal operators that are significantly more difficult to discharge through the bankruptcy process than other companies' OPEBs. For further information on coal company bankruptcies, see the Latham & Watkins *Client Alert* entitled "Coal Bankruptcies: Complications and Risks Associated with Federal Coal Legislation", dated August 29, 2012.

41. Are There Any Restrictions on Compensation Payable to Directors and Executive Officers of Companies With Underfunded Pension Plans?

Under Section 409A(b)(3), as amended by the PPA, if, during a "restricted period" with respect to a defined benefit pension plan, assets are transferred to a trust for purposes of paying deferred compensation (defined using Section 409A's very broad definition) for an "applicable covered employee," then these assets are taxable to the covered employee at the time the amounts are transferred to the trust (rather than at the time these amounts are actually paid from the trust to the covered employee). A "restricted period" is defined as (i) any period during which the plan is in at-risk status, (ii) any period the plan sponsor is a debtor in a case under Title 11 or similar law or (iii) the 12-month period beginning on the date that is six months before the termination date of the plan if the assets are not sufficient for benefit liabilities. "Covered employees" generally include executive officers and directors. An "applicable covered employee" means any covered employee of a plan sponsor, covered employee of a member of a controlled group that includes the plan sponsor, or former employee who was a covered employee at the time of termination of employment. Any tax gross-ups with respect to the above amounts are treated as additional deferred compensation subject to tax and are not deductible by the employer.

42. How Are Underfunded Pension Issues Addressed in Other Countries, Such as the UK?

Similar issues arise with respect to pension obligations and their treatment in bankruptcy in many other countries, including, most notably, the United Kingdom. In the last decade, significant case law has developed in the UK regarding the ranking of certain pension debts in insolvency and an increased level of activity by the UK Pensions Regulator in this area. For further information on the treatment of pension and OPEB obligations in UK bankruptcies, see the Latham & Watkins *Client Alert* entitled "'Super-priority' Rejected – Practitioners and Lenders Alike Welcome Hotly Anticipated Supreme Court Decision", dated July 26, 2013.

Back to TOC

If you have questions about this *Client Alert*, please contact one of the authors listed below or the Latham lawyer with whom you normally consult:

Mitchell A. Seider
mitchell.seider@lw.com
+1.212.906.1637
New York

Bradd L. Williamson
bradd.williamson@lw.com
+1.212.906.1826
New York

Lori D. Goodman
lori.goodman@lw.com
+1.212.906.4533
New York

Hugh K. Murtagh
hugh.murtagh@lw.com
+1.212.906.1648
New York

You Might Also Be Interested In

2016 Year-End Key Executive Compensation Reminders and Considerations

Examining the Impact of the 2016 US Elections on Executive Compensation

New SEC Staff Guidance on CEO Pay Ratio Disclosure Rules – Determining the Median Employee

Out-of-Court Restructuring Transactions: What's Old Is New Again after Marblegate

Ever-Expanding Safe Harbor Leaves Creditors' Claims Stranded at Sea

---

Endnotes

[1] This *Client Alert* updates a Latham & Watkins *Client Alert* originally published on June 15, 2015.

[2] As used here, the term "pension plan" will generally refer to a single-employer defined benefit pension plan (rather than a single-employer defined contribution plan such as a 401(k) plan or a multiemployer plan). *See* "What Are the Primary Types of Pension Plans Subject to ERISA?" and "What Are Multiemployer Plans?"

[3] All dollar values reflect US dollars.

[4] Towers Watson, *After a few ups and downs, corporate pension funding levels showed little change in 2016* , February, 2017.

[5] S&P Dow Jones Indices*, S&P 500 Corporate Pensions and Other Post-Employment Benefits (OPEB) in 2015*, August 2016.

[6] MorningStar, *The State of State Pension Plans 2013: A Deep Dive Into Shortfalls and Surpluses*, September 16, 2013.

[7] Standard & Poor's Rating Services, U.S. State Pensions: Weak Market Returns Will Contribute to Rise in Expense, September 12, 2016.

[8] MorningStar, *The State of City Pension Plans 2013: A Deep Dive Into Shortfalls and Surpluses*, November 12, 2013.

[9] MorningStar, *The State of State Pension Plans 2013: A Deep Dive Into Shortfalls and Surpluses*, September 16, 2013.

[10] The Pew Charitable Trusts, State Retiree Health Care Liabilities, May 11, 2016.

[11] The Pew Charitable Trusts, *A Widening Gap in Cities: Shortfalls in Funding for Pensions and Retiree Health Care*, January 16, 2013.

[12] Whether a pension plan is considered underfunded or fully funded depends upon, among other things, whether the present value of the plan's liabilities is determined based upon the actuarial methods and assumptions required for purposes of (i) plan termination, (ii) minimum funding or (iii) financial accounting. References in this *Client Alert* to the underfunded or fully funded

status of a pension plan generally refer to the funded status of the plan as determined on a plan termination basis. Plans giving rise to OPEB are not generally subject to the sort of minimum funding requirements applicable to pension plans and may be completely unfunded. References to the unfunded OPEB obligations refer to the amount of unfunded OPEB liabilities determined on a financial accounting basis.

13 *See* "What Are Multiemployer Plans?" for a description of multiemployer plans.

14 Defined contribution plans, such as 401(k) plans, establish an individual account for each participant under which the participant's benefit is his or her vested account balance (*i.e.* contributions less distributions, plus or minus investment experience) at retirement or other termination of employment.

15 *See GCIU-Employer Retirement Fund v. Goldfarb Corp.*, 565 F.3d 1018 (7th Cir. 2009); *PBGC v. Satralloy, Inc.*, 1993 U.S. Dist. LEXIS 21422 (S.D. Ohio Aug. 6, 1993).

16 839 F. Supp. 2d 118 (D.D.C. 2012). The only reported decision citing *Asahi Tec* refused to apply its logic in similar circumstances, finding the case "unpersuasive and distinguishable" and dismissing the claims of the multiemployer fund against the foreign parents of the defunct U.S. entity. *GCIU-Employer Ret. Fund v. Coleridge Fine Arts*, 154 F. Supp. 3d 1190, 1199 (D. Kan. 2015).

17 *In re AMR Corporation, et al.*, Case No. 11-15463 (Bankr. S.D.N.Y. filed Nov. 29, 2011).

18 2017 BCSC 709.

19 *In re New WEI, Inc. f/k/a Walter Energy, Inc.*, Case No. 15-02741 (N.D. Ala. filed July 15, 2016).

20 *See* 11 U.S.C. § 109(a); *In re Global Ocean Carriers Ltd.*, 251 B.R. 31 (Bankr. D. Del. 2000) (holding that even minimal property in the United States creates eligibility to be a debtor under the Bankruptcy Code).

21 The Third Circuit has held that "necessary" — as in "necessary modifications" — must "be construed strictly to signify only those modifications that the trustee is constrained to accept" to meet the "short[] term goal of preventing the debtor's liquidation." *Wheeling-Pittsburgh Steel Corp. v. United Steelworkers of Am., AFL-CIO-CLC*, 791 F.2d 1074, 1089 (3d Cir. 1986). Other courts have taken a more flexible approach. *See Truck Drivers Local 807, Int'l Bhd. of Teamsters, Chauffeurs, Warehousemen & Helpers of Am. v. Carey Transp. Inc.*, 816 F.2d 82, 90 (2d Cir. 1987) ("[W]e conclude that the necessity requirement places on the debtor the burden of proving that its proposal is made in good faith, and that it contains necessary, but not absolutely minimal, changes that will enable the debtor to complete the reorganization process successfully."); *accord In re Mile-Hi Metal Systems, Inc.*, 899 F.2d 887, 897 (10th Cir. 1990); *In re Mesaba Aviation, Inc.*, 341 B.R. 693, 731 (Bankr. D. Minn. 2006) (collecting cases). Recent cases offer holdings tending to expand the effectiveness of use of Section 1113. *See In re Trump Entm't Resorts*, 810 F.3d 161 (3d Cir. 2016) (debtor may reject expired CBA (whose terms continue to govern by default until execution of new CBA)); *In re Walter Energy, Inc.*, 542 B.R. 859 (Bankr. N.D. Ala. 2015) (debtor may reject CBA as part of liquidating, rather than only reorganizing, Chapter 11 plan).

22 "Collective net worth" is defined as an amount equal to the sum of the individual net worths of all entities that (i) have individual net worth greater than zero, and (ii) are, as of the termination date, contributing sponsors of the terminated plan or members of their controlled group. "Net worth" of an entity for these purposes is equal to the fair market value of the entity, as determined by the PBGC, which is afforded broad discretion to consider any factor relevant in determining the entity's net worth.

23 Claims for due and unpaid minimum funding contributions are often considered to be duplicative of claims for underfunded benefit liabilities.

24 *See In re CSC Indus. Inc. & Copperweld Steel Co.*, 232 F.3d 505 (6th Cir. 2000); *In re CF & I Fabricators of Utah, Inc.*, 150 F.3d 1293 (10th Cir. 1998).

25 *See In re Durango Georgia Paper Co.*, No. 02-21669, 2017 WL 221785 (Bankr. S.D. Ga. Jan. 18, 2017); *Crawford v. Riley (In re Wolverine, Proctor & Schwartz, LLC)*, 436 B.R. 253, 263 (D. Mass. 2010); *In re Kaiser Aluminum Corp.*, 339 B.R. 91, 95-96 (Bankr. D. Del. 2006); *In re US Airways Group*, 303 B.R. 784 (Bankr. E.D. Va. 2003).

26 *Trustees of the Amalgamated Ins. Fund. v. McFarlin's Inc. (In re McFarlin's Inc.)*, 789 F.2d 98, 102 (2d Cir. 1986).

27 650 F.3d 311 (3d Cir. 2011).

28 *See In re Delphi Corp.*, 2009 Bankr. LEXIS 576 (S.D.N.Y. Mar. 10, 2009); *Retired W. Union Employees Ass'n v. New Valley Corp. (In re New Valley Corp.)*, 1993 U.S. Dist. LEXIS 21420 (D.N.J. Jan. 28, 1993); *In re N. Am. Royalties, Inc.*, 276 B.R. 860 (Bankr. E.D. Tenn. 2002).

29 612 F.3d 210 (3d Cir. 2010).

30 *See also Retailers Serv. Corp. v. Employees' Comm. of Ames Dep't Store, Inc. (In re Ames Dep't Stores, Inc.)*, 1992 U.S. Dist. LEXIS 18275, *4 (S.D.N.Y. Nov. 30, 1992) (holding that "the Debtor must follow the requirements of § 1114 of the Bankruptcy Code if it seeks to terminate the Retired Employees' life insurance benefits" despite plan language permitting unilateral termination).

31 *In re Visteon Corp.*, 612 F.3d at 236.

32 *AMR Corporation v. Committee of Retired Employees*, Adv. Pro. No. 12-01744, at 3 (Bankr. S.D.N.Y. Apr. 14, 2014) (mem.).

33 Heaton v. Quinn (*In re Pension Reform Litig.*) 2015 IL 118585 (Ill., May 8, 2015).