Pension and OPEB Obligations in U.S. Bankruptcies: Answers to the Most Frequently Asked Questions

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This article 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 U.S. bankruptcies. As creditors recognize, businesses that have significant "underfunded" pension or "unfunded" OPEB obligations and that reorganize under Chapter 11 of the Bankruptcy Code often seek to resolve their current and future pension and OPEB liabilities as part of the reorganization process.

Understanding the treatment of pension and other post-employment benefits (OPEB) obligations[1] in bankruptcy is important in today's business environment, particularly for companies in industry sectors that are under significant pressure with respect to these obligations (such as companies in the steel, airline and automotive industries). Many high-profile companies in these sectors have utilized, or may utilize, the bankruptcy process to address pension and OPEB oblig-

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ations. In addition, Congress is currently considering legislation that may modify the method by which pension plans are required to be funded.

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.

Are Pension and OPEB Obligations Significant

By most accounts, the answer is a resounding “yes.” As of mid-2005, the Pension Benefit Guaranty Corporation (PBGC) was involved in approximately 321 active bankruptcy cases, a 33 percent increase over 2004.[3] As of Sept. 30, 2004, the PBGC had a deficit in excess of $23 billion.[4] In addition, the PBGC has estimated that, as of Sept. 30, 2004, the aggregate amount of underfunding of pension plans exceeded $450 billion.[5]

The magnitude of OPEB liabilities is also significant. At the beginning of 2003, Merrill Lynch estimated that the aggregate amount of OPEB liabilities for the S&P 500 was approximately $317 billion.[6] As of Dec. 31, 2003, Credit Suisse First Boston estimated that such unfunded OPEB liabilities had increased to approximately $339 billion.[7] Moreover, as of April 2005, General Motors alone reportedly had a projected OPEB liability of approximately $77 billion ($57 billion of which was unfunded).[8] We understand that OPEB obligations are 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, and
(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, OPEB should be carefully considered by investors because they 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.

Which Statutes Govern Pension Plans?

Tax-qualified pension plans providing defined benefits are generally governed by the Employee Retirement Income Security Act of 1974 (ERISA), as amended, and the Internal Revenue Code of 1986 (IRC), as amended. Title IV of ERISA established the PBGC, a federal corporation that guarantees the payment of a minimum level of pension benefits to participants of insolvent plans. The PBGC is funded by mandatory premiums paid by pension plan sponsors and the investment income on assets of plans that it has assumed. Together, ERISA and IRC:

> (i) require the reporting and disclosure of financial and 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, and
> (iii) impose liability on the sponsors of pension plans that are underfunded at the time of their termination.

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

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.[9] Single-employer plans may be either defined benefit plans or defined contribution plans.[10] Defined benefit plans are generally of substantially greater concern in bankruptcy proceedings than defined contribution plans. In most cases, defined benefit plans provide for the payment of benefits in an amount determined by a formula that is 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 that will be 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.

Why Are Defined Benefit Plans of More Concern in Bankruptcy?

Defined benefit plans are generally of greater concern in bankruptcy 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 it is underfunded, the plan sponsor may be liable for the full amount of the underfunding. In addition, 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 an amount equal to the:

(i) termination liability of an underfunded pension plan,

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

(iii) liability for unpaid PBGC premiums.

These and other types of claims can result in liability for the plan sponsor and any member of its controlled group.

What Is “Controlled Group” Liability?

In general, the term “controlled group” refers to a group of corporations or other trades or businesses (whether or not incorporated) with at least 80 percent common ownership. A controlled group may include parent-subsidiary relationships where the parent owns (or is deemed to own) 80 percent or more of the voting power or value of the stock of a subsidiary as well as certain affiliate relationships. Pension plan-related liabilities that may apply jointly and severally with respect to a plan sponsor and any other member of its controlled group include:

(i) termination liability of an underfunded single-employer plan,
(ii) liability for a failure to satisfy minimum funding requirements and associated excise taxes, and
(iii) liability for unpaid PBGC premiums.

In addition, as described below, withdrawal liability for multiemployer plans may apply jointly and severally with respect to a participating employer and any other member of its controlled group. Controlled group liability, however, does not typically apply with respect to OPEB obligations. Although foreign controlled group members are technically included in the controlled group definition, as a general matter the PBGC has not historically pursued such members. 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.

What Are the Minimum Funding Requirements for Defined Benefit Plans?

ERISA and the IRC establish the minimum funding requirements for defined benefit plans. Required minimum annual contributions to defined benefit plans are calculated by an actuary using actuarial methods and assumptions permissible under the IRC. Although there is no requirement that a defined benefit plan be fully funded, the plan sponsor must annually contribute amounts determined by the actuary. Installments are generally due 15 days following the close of each quarter of the defined benefit plan's fiscal year, with a final payment for the year due eight and a half months after the plan year's end.

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

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. The lien attaches to all assets of the plan sponsor and all members of the sponsor's controlled group. An initial excise tax of 10 percent is levied upon an unpaid funding deficiency, which may be ratcheted up to 100 percent of the liability after notice from the Internal Revenue Service (IRS). The IRS may waive the 100 percent penalty upon a showing of hardship. The PBGC has asserted that a lien arising from failure to make a required contribution should be treated as a federal tax priority claim in bankruptcy, but courts have rejected this position.

The failure to satisfy a minimum funding payment can be asserted as either a statutory claim, by a plan participant, beneficiary, 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.

Alternatively, a plan sponsor may seek a waiver from the IRS of the minimum funding standard.

Is Congress Currently Considering Changes to the Minimum Funding Requirements?

Yes. Congress is actively considering legislation that would revise the funding requirements for defined benefit pension plans.

On Sept. 27, 2005, the Senate Finance Committee and the Senate Health, Education, Labor and Pensions Committee reached an agreement creating the Pension Security and Transparency Act (S. 1783), which merged portions of the National Employee Savings and Trust Equity Guarantee Act, sponsored by Sen. Chuck Grassley (R-Iowa), and the Defined Benefit Security Act, sponsored by Sens. Mike Enzi (R-

Wyo.) and Edward Kennedy (D-Mass.), among others. The Pension Security and Transparency Act would overhaul a number of key funding requirements for defined benefit pensions plans and impose a requirement that such plans amortize any underfunding over seven years (or, with respect to plans maintained by commercial passeneger airlines, 14 years). Having been approved by both committees, the bill is now expected to be sent to the Senate floor for a full vote.

A competing bill in the House of Representatives, the Pension Protection Act (H.R. 2830), sponsored by Rep. John Boehner (R-Ohio), was approved by the house Committee on Education and the Workforce on June 30, 2005. Some of the funding provisions found in the bill are identical to those in the Senate bill, including the relief extended to commerical passenger airlines. The House Ways and Means Committee must still approve the bill before it can be sent to the House floor for a full vote. Assuming the Pension Security and Transparency Act and the Pensions Protection Act are approved by the full Senate and House, respectively, the bills would then be reconciled in conference committee. Based upon the foregoing, at this time is it unclear what provisions, if any, of the proposed Senate and House bills will ultimately become law.

May a Pension Plan Be Terminated if It Is Not Fully Funded?

Yes, but it can only be terminated by the plan sponsor in a "distress termination"[11] or by the PBGC in an "involuntary termination." When an underfunded pension plan is terminated, the PBGC has a claim against the plan sponsor and each member of its controlled group equal to the entire amount of underfunded benefit liabilities. As discussed in greater detail below, the PBGC's claim will be secured by a lien that attaches to the assets of the plan sponsor and its controlled group, unless the automatic stay under the Bankruptcy Code prevents creation of the lien. 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 (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.

What Is Involved in a "Distress Termination"?

Under ERISA, a plan sponsor may terminate a pension plan in a distress termination only if:

(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, and
(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 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, or
- 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.

What Is Involved in an "Involuntary Termination"?

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, or
(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.

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 distress termination or otherwise) unless the plan sponsor complies with Section 1113 of the Bankruptcy Code. To terminate a collective bargaining agreement under Section 1113, the plan sponsor must prove to the court that:

(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 are necessary to permit reorganization of the plan sponsor and all affected parties are treated fairly and equitably,
(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, and
(v) the balance of the equities clearly favors rejection of the collective bargaining agreement.

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

How Is the Amount of the PBCG's Claim for Termination Liability in Bankruptcy Determined?

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. In several instances, however, courts have found that bankruptcy principles require that interest-rate assumptions other than those proposed by the PBGC should be used.

What Is the Maximum Amount of the PBGC Lien That May Be Imposed with Respect to a Terminated Plan?

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). 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, or (ii) 30 percent of the "collective net worth" of the plan sponsor and all members of its controlled group.[12] However, the automatic stay imposed by the Bankruptcy Code will typically prohibit the PBGC from creating and/or perfecting post-petition liens against debtors, and courts have typically rejected the PBGC's attempts to assert priority status for claims for post-petition termination liabilities. As a result, the PBGC's claims often end up being treated as general unsecured claims.

It is worth noting that if the automatic stay is not in effect and the PBGC is otherwise able to perfect its lien, the PBGC's lien will generally have priority over security interests that have not been properly perfected at or prior to the time the PBGC files a notice of employer liability lien. 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) commercial transactions financing agreements,
(ii) real property construction or improvement financing agreements, and
(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.

How Are Pension Plan Claims Treated in Bankruptcy?

In bankruptcy, one must consider claims arising prior to the filing of the bankruptcy case (i.e. "pre-petition" claims) and claims arising during the bankruptcy case. With respect to claims arising pre-petition, the PBGC will typically file a claim for:

(i) underfunded benefit liabilities,
(ii) due and unpaid minimum funding contributions, and
(iii) unpaid premiums to the PBGC.

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, plan sponsors who maintain underfunded defined benefit plans must 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, creditors and the debtor often contend that it should be treated in the same manner as pre-petition unsecured claims.

The PBGC generally asserts various bases on which its claims should be afforded priority status. The end result, however, is likely to be that only those portions of the PBGC's claims (i) attributable to services performed by employees after commencement of the bankruptcy case will be given second priority status as an administrative expense, and (ii) relating to benefits accruing for pre-petition services of employees within 180 days prior to the bankruptcy petition may be eligible for fifth priority treatment as an employee benefit-plan expense.[13] Notwithstanding that the PBGC's claims often end up being treated largely as general unsecured claims, 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.

What Are Multiemployer Plans? How Are Multiemployer Plans Treated in Bankruptcy?

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. 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 it 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. A multiemployer plan may assert a claim in bankruptcy for the full amount of this withdrawal liability.

How Are OPEB Obligations Treated in Bankruptcy?

As noted above, Section 507(a)(5) of the Bankruptcy Code grants 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 obligation of the plan trustee 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, the Bankruptcy Code caps the priority claim that arises under Section 507(a)(5) at $4,925 per employee (less any amounts paid to the employee as priority wages under Section 507(a)(4) of the Bankruptcy Code), and the amount of the claim for unpaid contributions in excess of this limit is treated as a general unsecured claim. Under the Bankruptcy Abuse Prevention and Consumer Protection Act (BAPCPA), which was signed into law on April 20, 2005, the cap is increased to $10,000 for all cases filed after April 20, 2005.

How Are OPEB Obligations Modified in Bankruptcy?

OPEB obligations generally represent unsecured claims against the debtor. Prospective OPEB obligations can be modified in bankruptcy, but the debtor must comply with Section 1114 of the Bankruptcy Code. Specifically, Section 1114 requires 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 that:

> (i) the debtor has made a proposal to the authorized representative of the retirees 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, and
> (v) the balance of the equities clearly favors modification of retiree benefits.

Through an amendment to Section 1114 in the BAPCPA that applies to all cases filed after April 20, 2005, Congress has made it more difficult for companies to terminate retiree benefits on the eve of bankruptcy. The amendment provides that 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 (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.

Does the Newly Effective UK Pensions Act Affect U.S. Companies?

Yes. The UK Pensions Act, which became effective on April 5, 2005, establishes a PBGC-like entity referred to as the Pension Protection Fund. It will be run by a new Pensions Regulator with wide-reaching powers. Under the Pensions Act, pension-fund liabilities may extend not only to a company being acquired and its affiliates, but also in certain cases to its or their shareholders or the funds of private equity investors. Although unclear, it is our understanding that talks have taken place between the United Kingdom and the United States with respect to the possibility of enabling UK administrators to pursue pension claims under the new Pensions Act against U.S. affiliates (and their shareholders and investors) of UK companies.

NOTES

[1] 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 article 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 refers to the amount of unfunded OPEB liabilities determined on a financial accounting basis.

[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 contribu-

tion 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] Dow Jones Daily Bankruptcy Review, "Added Complexity of Chapter 11 Cases Keeps PBGC Lawyers Busy," (May 6, 2005), *available at* http://www.djnewsletters.com.

[4] Pension Benefit Guaranty Corporation, 2004 Annual Performance and Accountability Report (Nov. 15, 2004), *available at* http://www.pbgc.gov/publications/annrpt/2004txt/2004finstatements.htm.

[5] *Id.*

[6] *CFO Magazine*, "Analyze This ... Please" (Jan. 1, 2003), *available at* http://www.cfo.com/article.cfm/3007714?f=advancesearch.

[7] *CFO Magazine*, "Promises, Promises" (Feb. 22, 2005), *available at* http://www.cfo.com/article.cfm/3665052?f=advancesearch.

[8] *Forbes*, "Black Hole" (April 11, 2005), *available at* http://www.forbes.com/free_forbes/2005/0411/054.html.

[9] *See* "What Are Multiemployer Plans?" for a description of multiemployer plans.

[10] 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.

[11] In addition, a fully funded pension plan may be terminated by the plan sponsor in its discretion by means of a "standard termination" so long as the plan administrator complies with applicable notice and other requirements under ERISA. Standard terminations, involuntary terminations and distress terminations are the exclusive methods of terminating a pension plan under ERISA.

[12] "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.

[13] Bankruptcy Code Section 507(a)(5). The 2005 Bankruptcy Act altered the priority among certain types of claims under Section 507 of the Bankruptcy Code for cases filed on or after April 20, 2005. In cases filed prior to April 20, 2005, the PBGC's claims could be given first priority status as an administrative expense or fourth priority status as an employee benefit plan expense, as applicable.