

**The Effect of
§ 1114 of the Bankruptcy Code
on the Non-Bankruptcy Right of a
Chapter 11 Debtor to Terminate or Reduce
Non-Vested Retiree Benefits**

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A. Introduction

Section 1114 of the Bankruptcy Code limits the ability of a debtor in possession or trustee to "modify" "retiree benefits" following the filing of a chapter 11 case.

Notwithstanding any other provision of this title, the debtor in possession, or the trustee if one has been appointed under the provisions of this chapter (hereinafter in this section "trustee" shall include a debtor in possession), shall timely pay and shall not modify any retiree benefits, except that –

(A) the court, on motion of the trustee or authorized representative, and after notice and a hearing, may order modification of such payments, pursuant to the provisions of subsections (g) and (h) of this section, or

(B) the trustee and the authorized representative of the recipients of those benefits may agree to modification of such payments,

after which such benefits as modified shall continue to be paid by the trustee.

Section 1129(a)(13) of the Bankruptcy Code extends the protection of retiree benefits beyond the confirmation of a chapter 11 plan, by including, as one of the requirements for plan confirmation, that:

The plan provides for the continuance after its effective date of payment of all retiree benefits, as that term is defined in section 1114 of this Title, at the level established pursuant to subsection (e)(1)(B) or (g) of section 1114 of this Title, and at any time prior to confirmation of the plan, for the duration of the period the debtor has obligated itself to provide such benefits.

For purposes of sections 1114 and 1129(a)(13), "retiree benefits" are defined as payments "for the purpose of providing or reimbursing payments for retired employees and their spouses and dependents, for medical, surgical, or hospital care benefits, or benefits in the event of sickness, accident, disability, or death, under any plan, fund, or program ... " which was maintained or established prior to the filing of the chapter 11 case. 11 U.S.C. § 1114(a).

As currently written, section 1114 (as well as section 1129(a)(13)) does not purport to address or limit the pre-chapter 11 "modification" of retiree benefits. Thus, nothing in the Bankruptcy Code would prevent a debtor from reducing or terminating retiree health benefits in accordance with the terms of the benefits plan itself, prior to filing a chapter 11 case. Moreover, if the Debtor exercised such a right prior to filing a chapter 11 case, nothing in section 1114 or section 1129(a)(13) would require reinstatement of the retiree benefits that were eliminated or reduced in accordance with rights reserved under the benefits plan.

Suppose, however, that although the retiree benefits plan expressly reserved the employer's right to reduce or terminate retiree benefits (and this reservation of rights was valid under nonbankruptcy law), the debtor/employer did not exercise this right before the chapter 11 filing. Does section 1114 eliminate the debtor/employer's right under the plan and applicable nonbankruptcy law to reduce or terminate retiree benefits unilaterally once the employer files a chapter 11 case? As set forth below, the courts do not agree on the answer. Instead, the courts are split on the issue of whether a chapter 11 debtor in possession or trustee must comply with section 1114 when seeking to reduce or terminate retiree benefits pursuant to rights specifically reserved to the employer in the benefit plan itself that are valid under nonbankruptcy law. This split may have important implications for an employer with substantial retiree obligations that is planning for a chapter 11 filing.

B. Doskocil And Its Progeny – Section 1114 Does Not Limit The Termination Or Modification Of Retiree Benefits In Accordance With The Terms Of The Governing Plan.

One line of cases has held that "[c]ompliance with section 1114 is irrelevant to the issue of termination in accordance with the contract's terms." In re N. Am. Royalties, Inc., 276 B.R. 860, 867 (Bankr. E.D. Tenn. 2002).¹ These cases have recognized that section 1114 "says nothing about whether a debtor can exercise a power reserved in the contract to terminate it and thereby end any obligation for retiree benefits, as defined in section 1114." Id. at 866. Hence, "[d]espite § 1114, the debtor can terminate the contract as allowed by its terms." Id. See also CF&I Stell Corp. v. Conners (In re CF&I Fabricators of Utah Inc.), 163 B.R. 858, 874 (Bankr. D. Utah 1994) ("§ 1114 does not protect retiree benefits beyond the contractual obligations of the debtor."), appeal dismissed, United Mine Workers Combined Fund v. CF&I Fabricators (In re CF&I Fabricators), 169 B.R. 984 (D. Utah 1994); Retired W. Union Employees Ass'n v. New Valley Corp. (In re New Valley Corp.), No. 92-4884, 1993 U.S. Dist. LEXIS 21420, at *16 (D.N.J. Jan. 28, 1993) (affirming bankruptcy court's holding that reservation by debtor of the right to modify or terminate its retiree benefit plans renders section 1114 inapplicable to such action taken by the debtor in the course of reorganization proceedings).

This line of cases has its genesis in In re Doskocil Cos., Inc., 130 B.R. 870 (Bankr. D. Kan. 1991), where the court came to essentially the same conclusion in addressing the issue of "[w]hether the Court must appoint a Retiree Committee under § 1114 of the Bankruptcy Code when the debtor has reserved the power to amend, modify or terminate ERISA welfare

¹ Instead of applying section 1114, North American Royalties, applied a "sound business purpose" standard to the question of whether a debtor should be allowed to terminate a retiree benefit plan pursuant to the contract's terms, similar to the standard applied under sections 363 (governing the debtor's right to use property of the bankruptcy estate out of the ordinary course of business) and 554 (governing the debtor's right to abandon property of the bankruptcy estate). Id. at 866.

plan benefits by unambiguous language in the plan." Id. at 871. Answering this question in the negative, the court reasoned that:

There is no language in § 1114 to indicate that Congress expected it to operate on nonallowable claims – claims for which the debtor has no contractual or other legal liability. If Congress had intended § 1114 to create some new right in the retirees upon debtor's entry into Chapter 11, it is improbable that Congress would have adopted the same standard for § 1114 as prescribed for modification of agreements under § 1113. The better inference is that Congress intended to focus primarily on the modification of debtor's legal obligations to retirees as opposed to creating for the debtor some new obligation not already imposed by the terms of the retiree benefit plan.

Id. at 876. See also N. Am. Royalties, 276 B.R. at 867 ("If § 1114 takes away the contractual right to terminate, then the filing of a chapter 11 case causes the vesting of retiree welfare benefits that were not previously vested."); CF&I Fabricators of Utah, 163 B.R. at 875 ("The Bankruptcy Code does not create new rights upon filing bankruptcy that were not in existence prior to filing."); New Valley Corp., 1993 U.S. Dist. LEXIS 21420, at *7 (affirming lower court's reasoning that "[t]o apply section 1114 to [the debtor] and thereby extend certain terms of the benefit plan beyond that which had been agreed to by the parties would ... ignore the parties' contractual bargain and impose a vesting requirement that had been rejected by Congress in the ERISA statute").

C. Farmland – Section 1114 Applies To Any Change In Retiree Benefits, Whether Or Not Expressly Permitted By The Terms Of The Governing Plan.

A dissonant note in the chorus of cases dealing with this issue was struck recently by the court in In re Farmland Industries, Inc., 294 B.R. 903 (Bankr. W.D. Mo. 2003). There, the court held that "§ 1114 prohibits a debtor from terminating or modifying any retiree benefits ... during a Chapter 11 case unless the debtor complies with the procedures and requirements of

§ 1114, regardless of whether the debtor has a right to unilaterally terminate the benefits." Id. at 914. Farmland Industries read the statute on its face in a manner different from that considered in the cases cited above, noting that "[t]here is nothing in the language of the statute to suggest that Congress intended to allow the termination of retiree benefits in those instances where the debtor has the right to unilaterally terminate those benefits under the language of the plan or program at issue." Id. at 917. In other words, while the Doskocil line of cases reasons that there is nothing in the statute to indicate that a benefit plan cannot be modified or terminated pursuant to its own terms without section 1114 compliance, Farmland Industries reasoned that there is nothing in the statute to indicate that a benefit plan can be so modified or terminated. In addition, the Farmland Industries court observed that

[i]f one were to accept [that the benefit contract could be modified or terminated pursuant to the contract's terms without compliance with the requirements of section 1114], the statute would be eviscerated and rendered virtually meaningless. Any debtor – most debtors, more than likely – would be able to point to language in the underlying documents establishing voluntary programs such as the Debtors' giving them the right to unilaterally terminate the programs.

Id.

D. Doskocil v. Farmland

The position adopted in the Doskocil line of cases appears to be more consistent with the language of the Bankruptcy Code than does that adopted in Farmland, and avoids the anomalous and counterintuitive results that can result from the Farmland approach. To begin with, although the "notwithstanding" lead-in to section 1114 explicitly overrides any contrary provision of the Bankruptcy Code, it contains no parallel "notwithstanding" language that overrides contractual provisions that are valid under applicable non-bankruptcy law and that

would permit the unilateral termination or reduction of retiree benefits. The lead-in to section 1114 states, "Notwithstanding any other provision of this title ..." (emphasis added). This language makes it clear that Congress intended that section 1114 prevail over any other provision of the Bankruptcy Code that might be construed to permit the termination or reduction of retiree benefits or that would permit the obligation to provide retiree benefits to be treated simply as a general, unsecured, nonpriority claim. In contrast, Congress did not include language such as "notwithstanding any other provision of non-bankruptcy law" or "notwithstanding any provision of any contract or plan..." in section 1114.

The significance of this omission is highlighted by the fact that, elsewhere in the statute, Congress knew how to use such "notwithstanding" language when it sought to trump non-bankruptcy law or contractual terms. See, e.g., 11 U.S.C. § 365(e)(1) ("Notwithstanding a provision in an executory contract or unexpired lease, or in applicable law, ... "); § 541(c) ("[A]n interest of the debtor in property becomes property of the estate under subsection (a)(1), (a)(2), or (a)(5) of this section, notwithstanding any provision in an agreement, transfer instrument, or applicable non-bankruptcy law ... that restricts or conditions transfer of such interest by the debtor ... "). The use of a "notwithstanding" lead-in to section 1114 that refers only to provisions of the Bankruptcy Code, but includes no reference to provisions of non-bankruptcy law, a contract or a plan, indicates that Congress never intended to trump the terms of the benefits plan itself.

Moreover, interpreting section 1114 to prevent a chapter 11 debtor in possession or trustee from exercising a right reserved in a plan to terminate or reduce retiree benefits appears to be inconsistent with section 1129(a)(13). Section 1129(a)(13) requires that a chapter 11 plan of reorganization provide for the continuance after the plan effective date of the

payment of all retiree benefits, at the level established under subsection (e)(1)(B) or (g) of section 1114 "for the duration of the period the debtor has obligated itself to provide such benefits" (emphasis added). If the debtor has reserved the right in the plan to terminate or reduce benefits, then the debtor has not "obligated itself to provide such benefits" for any period at all. Hence, the result of Farmland would be that the debtor in possession or trustee could not reduce the level of retiree benefits during the chapter 11 case, even if permitted by the benefits plan, but the reorganized debtor could exercise the contractual right to terminate or reduce benefits under the plan immediately after the chapter 11 plan became effective. There seems to be no logic behind such a distinction.

Finally, the result of the Farmland court's reading of section 1114 is to give retirees greater rights to retiree health benefits from financially distressed employers who have a lesser ability to pay such benefits than retirees have against financially sound employers which do not need recourse to chapter 11. Absent bankruptcy, an employer is free to exercise a right explicitly reserved under a benefits plan to terminate or reduce retiree health benefits, absent some non-bankruptcy law limitation. Under Farmland, however, a company in need of financial relief under chapter 11 loses its contractual right to terminate or reduce retiree health benefits upon filing for chapter 11 relief.

There seems to be no cogent reason for discriminating in this fashion between the employer that has no need for chapter 11 relief and the employer that requires such relief. To the contrary, it seems counterintuitive to create a structure under which a financially healthy company which has no need for chapter 11 protection can freely exercise a contractual right to reduce retiree benefits unilaterally, while a financially troubled company may find its financial problems compounded upon the filing of a chapter 11 case by the loss of the right to reduce or

eliminate retiree benefits in accordance with the terms of the benefits plan itself. It seems odd, to say the least, to permit a solvent debtor to exercise a contractual right to reduce retiree benefits, while denying that ability to an insolvent debtor.



PENSION BENEFIT GUARANTY CORPORATION IN WORKOUTS AND BANKRUPTCY REORGANIZATIONS

By

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The Pension Benefit Guaranty Corporation (“PBGC”) can be a major creditor in large corporate bankruptcies when the debtor sponsors a defined benefit pension plan. The amounts and priority of PBGC’s claims are based on provisions of Employee Retirement Income Security Act of 1974 (“ERISA”)¹ and Internal Revenue Code rather than in the Bankruptcy Code. As a result, both the amount and the priority of the claims have become the subject of much litigation in bankruptcy cases. Recent decisions have reopened some questions previously thought settled, increasing the likelihood that these issues will be hotly contested in future cases involving underfunded defined benefit plans.

PBGC Background

PBGC, the federal government agency established under Title IV of the ERISA,² administers the federal pension plan insurance program for defined benefit pension plans.³ PBGC is funded from a combination of sources:

- Insurance premiums paid annually by the plan or the employer sponsoring the plan, consisting of a per participant premium of \$19 plus a variable rate premium equal to .9 percent of the plan’s unfunded vested benefits.⁴
- Claims against an employer and its controlled group for terminating an underfunded pension plan, as described below.
- Assets of terminated plans that PBGC trustees.

As of September 30, 2003 (the most recent audited financials available), PBGC had assets of \$45.2 billion and liabilities for actual and probable terminations of

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\$34 billion, resulting in a deficit of \$11.2 billion.⁵ As recently as September 30, 2000, however, PBGC had a surplus of almost \$10 billion.⁶

Premiums and PBGC's recoveries from employers are required by law to be invested in fixed income securities.⁷ By policy, all of these assets have been invested exclusively in Treasury obligations. Assets of plans that PBGC trustees may be invested in any prudent investment.⁸ The trustee assets have been invested heavily in equities to balance the fixed income nature of the premium assets, although PBGC's Board recently adopted an investment policy that would limit equities to 15-25 percent of PBGC's total assets. This is likely to reduce PBGC's long-term returns and lock in the existing deficit.

PBGC is generally a "person" eligible to serve on the Creditors' Committee,⁹ although in some Circuits the U.S. Trustee will not appoint the PBGC to the Committee unless the plan is terminated.

Defined Benefit Liabilities.

Defined benefit plans are pension plans in which benefits are determined under a formula set forth in the plan document. The formula will usually involve factors such as the age and service of the employee when he retires and, in many cases, the salary of the employee. Defined benefit plans are funded on a group basis, using actuarial assumptions about long-term interest rates, mortality, turnover, retirement age and other factors that influence how much money will be needed to pay the promised benefits.

While there are minimum funding standards under Code and ERISA,¹⁰ there is no guarantee that the plan will have sufficient assets to cover accrued liabilities. Under ERISA, an employer is given an extended period to fund past service liabilities created either when the plan is established or as a result of subsequent amendments.¹¹ While an employer is not required to take advantage of the extended period to fund past service liabilities,¹² most employers do. In addition, it is not possible to fund certain contingent event benefits, such as plant shutdown benefits or job elimination benefits, in advance.¹³ Many employers have implemented early retirement window benefits¹⁴ in recent years to facilitate downsizing and that has created unfunded pension liabilities. All of these factors can lead to unfunded benefit obligations even though the employer is meeting all required minimum funding payments.

Defined benefit plans can also have surplus assets, *i.e.* assets exceed liabilities. The minimum funding rules generally require that employers fund for

projected benefits in plans that base benefits on future salary (called “final average pay plans”). These plans often have more assets than are needed to pay for benefits accrued to date. The financial accounting rules require that liabilities (called “benefit obligation” in the financial statement footnotes) be measured on the basis of the “projected benefit obligation” (“PBO”), which also takes into account future salary increases.

The issue for both underfunded and overfunded plans is what assumptions are used to determine the liabilities. There are at least three purposes for which these liabilities are normally determined: funding, financial accounting, and termination liability. Each of these involves a different set of assumptions and methods:

- **Funding assumptions** reflect long-term projections of economic factors and do not necessarily represent current conditions. For example, most pension plans are funded using a 7-9% interest rate assumption, reflecting long-term expectations for the return on the trust’s assets. These liabilities are generally funded on a projected basis. Underfunded plans are required to make an additional “deficit reduction contribution” that is based on current liabilities determined using an interest rate based on an average of 30-year Treasury rates and a specified mortality table. Because Treasury has stopped issuing the 30-year bond, the interest rate on the outstanding bonds has fallen below the rate used by PBGC to calculate termination liability.
- **Financial accounting** requires that the interest rate be adjusted to reflect current rates at which the liabilities could be “settled.” The Securities and Exchange Commission (SEC) has indicated that this rate should not be higher than the yield on a portfolio of double-A or higher-rated bonds whose cash flows matches the predicted schedule of benefit payments. Since this rate will change with bond yields, there can be substantial changes in the value of the liabilities. This can result in considerable volatility in the annual expense calculation. For example, at the end of 1997, most employers were using an interest rate in the range of 6.5-7.25%; by the end of the following year, rates were about 50 basis points lower. Since lower interest rates translate into higher pension liabilities, the value of the liabilities for most companies increased even before taking into account the additional benefits earned in 1998. Rates reversed direction again for 1999, lowering employers’ pension liabilities.

- **Termination liability**, the basis for PBGC’s claim in bankruptcy, is determined under assumptions set by the PBGC. Unlike the funding and financial accounting rules, termination liability is based only on benefits accrued to the date of a plan termination, without any liability for future salary increases. PBGC rates are generally lower than the financial accounting assumption and may be higher or lower than funding assumptions depending on whether current interest rates are higher or lower than the historic returns generally used to set the funding assumption. Other PBGC assumptions, such as those related to mortality and expected retirement age, can also have a significant effect on the funded status of a defined benefit pension plan.
- **Prudent investor rate**, applied by bankruptcy courts to value PBGC’s claims in bankruptcy, is the rate that a reasonably prudent investor would receive from investing the funds.¹⁵ This is generally a higher rate than any of the other rates and therefore results in a lower value of the liabilities.

Termination Liability: PBGC Assumptions v. the Prudent Investor Rate

PBGC’s employer liability claim is for 100 percent of the “unfunded benefit liabilities” under the plan.¹⁶ Generally, benefit liabilities include all benefits provided under a plan at the date of plan termination date, as determined under section 401(a)(2) of the Internal Revenue Code.¹⁷ PBGC then determines the plan’s “unfunded benefit liabilities” by subtracting the assets of the plan, at their fair market value on the termination date, from the value of benefit liabilities “determined as of such date on the basis of assumptions prescribed by the [PBGC] for purposes of §4044.”¹⁸

PBGC’s methodology for valuing its claim for unfunded liabilities was recently upheld in the *US Airways* bankruptcy. The decision involved the assumptions to be used in valuing PBGC’s claim for unfunded liabilities of the US Airways pilots’ plan.¹⁹ PBGC determines the actuarial present value of the benefit liabilities pursuant to the assumptions prescribed by PBGC in its valuation regulation.²⁰ Under PBGC’s methodology, the unfunded liabilities were \$2.219 billion.²¹ The debtor, on the other hand, valued the benefits using a “prudent investor” interest rate combined with a more stringent mortality table and an older assumed retirement age, resulting in underfunding of only \$894 million.²² Neither figure reflects PBGC’s expected recovery, which the bankruptcy judge indicated was likely to be less than 2 cents on the dollar (\$44 million if the PBGC

assumptions are used versus \$17.8 if the debtor's valuation prevailed), to be paid in US Airways stock.

The interest rate assumption in PBGC's valuation regulation can have a substantial effect on the amount of PBGC's claims and therefore it is challenged in virtually every bankruptcy.²³ The Sixth Circuit in *CSC Industries* case and the Tenth Circuit in the *CF&I* case have both held that the bankruptcy court may value the liability using a "prudent investor rate," the rate that a reasonably prudent investor would receive from investing the funds.²⁴ Interestingly, the bankruptcy judge in the *CF&I* case, like the bankruptcy judge in the *US Airways* case had upheld use of PBGC valuation assumptions in determining the amount of the unfunded benefit liabilities claim but was reversed by the district court on appeal.

Bankruptcy courts have authority under the Bankruptcy Code to determine the amount of claims in bankruptcy proceedings.²⁵ Moreover, the Bankruptcy Code requires that same-class creditors be treated equally.²⁶ Since PBGC's claim is for the stream of future payments it will have to make to pension plan participants, these courts have concluded that the bankruptcy court may determine the present value of this stream of payments under this authority and must apply an interest rate that treats PBGC and similarly-situated creditors the same. The prudent investor rate applied by the bankruptcy courts has been higher than the PBGC rates. The effect of the higher interest rate has been to lower or even eliminate PBGC's allowed claim.

The prudent investor rate had its genesis in a decision rendered by Judge Lifland, then the chief bankruptcy judge for the Southern District of New York that was subsequently vacated as part of a settlement, but remains the intellectual underpinning for all of the cases that have applied the prudent investor standard.²⁷ Judge Lifland determined that "bankruptcy law controls the applicable discount rate to be used in determining the value of a claim based on ... liability for cash payments subsequent to the [f]iling [d]ate."²⁸

Because the PBGC and the debtor in US Airways uses different mortality tables and expected retirement ages as well as interest rates, it is difficult to isolate the effect of the interest rate differences. The *CSC* bankruptcy provides a good example of the differences that just interest rates can make in valuing the liabilities and how difficult it is to judge those liabilities from a company's financial statements. Three of the *CSC* plans were terminated. The following chart compares *CSC*'s unfunded pension liabilities on three bases: as reported by

CSC on its financials at the end of the year before the termination, as claimed by PBGC, and as determined using a prudent investor rate:

| | Unfunded liabilities | Interest rate |
|-----------------------|-----------------------------|---|
| CSC financials | \$16.5 million | 8.75% |
| PBGC claim | \$49.7 million | 6.4 % for the first 20 years and 5.75% thereafter |
| Prudent investor rate | \$ 1.8 million | 10% |

The parties stipulated that the "prudent investor rate" would be 10 percent; PBGC's actual 5-year average investment returns have consistently exceeded this rate and therefore a higher rate might reasonably be used. The unfunded pension liability shown on its audited financial statement was for only two underfunded plans. One of the three plans terminated by PBGC was overfunded on an accounting basis. Had its net assets been included, the amount of unfunded liabilities would have been reduced even further.

In the *US Airways* case, the PBGC interest rates were 5.1% for the first 20 years and 5.25% thereafter, while the prudent investor rate advanced by the debtor's valuation expert was 8%.²⁹ The prudent investor rate represented the midpoint in a range of 7.1-9.1% derived from the expected return on an asset pool that was 60% stocks and 40% bonds. While the decision indicates that this range was derived from a survey of professional money managers, it is also consistent with the long-term averages derived from the Ibbotson data on returns on investment classes since 1926. PBGC's rates are based on a survey of insurance companies, who are asked to quote on specific annuities. From these quotes, PBGC derives the interest rate that would be used if the insurance companies were using PBGC's mortality table (since the insurance companies generally use different mortality assumptions). A study by the American Academy of Actuaries ("AAA") in 2000 indicated that PBGC assumptions overvalue the liabilities by 3-4% compared to actual annuity purchases. This may be because negotiation of actual annuities usually results in more favorable results than the initial quotes would suggest. The difference in large cases can be significantly greater than the reflected by the AAA study, since the mean value of the annuities in the study was only \$5 million. For example, for annuities on a plan with liabilities in the \$300-400 million range, the ultimate quotations after several rounds of bidding were more than 10 percent lower than the PBGC's assumptions.

The *US Airways* court concluded that the PBGC assumptions should be applied. The court concluded that the claim should be determined based on applicable nonbankruptcy law (i.e., ERISA), based on the Supreme Court's

opinion in *Raleigh v. Illinois Dep't of Revenue*.³⁰

Terminating the Plan

There are two types of voluntary termination under Title IV of ERISA — standard termination and distress termination.³¹ Neither a standard termination nor a distress termination may proceed if it would violate a collective bargaining agreement.³² PBGC may move to involuntarily terminate a plan without regard to collective bargaining agreements.

Standard Termination. A plan may only be terminated in a standard termination if there are sufficient assets to pay all benefits under the plan, either through the purchase of annuities or lump sum payments.³³ If a plan is fully funded at the time of the bankruptcy filings, consideration should be given to immunizing the portfolio – i.e., matching the liabilities with debt instruments of similar duration. This will permit the plan to terminate if necessary and protect participants' benefits against declines in assets or declining interest rates, either of which could cause a plan to become underfunded.

Distress Termination. The plan sponsor may terminate an underfunded plan only if it meets one of four distress criteria. Two of the criteria are specifically bankruptcy related:

- The debtor is liquidating in bankruptcy, either in Chapter 7 or in a liquidating 11;³⁴ or
- “The bankruptcy court (or such other appropriate court) determines that, unless the plan is terminated, [the debtor] will be unable to pay all its debts pursuant to a plan of reorganization and will be unable to continue in business outside the chapter 11 reorganization process and approves the termination.”³⁵

The other two distress criteria, related to inability to pay debts when due and pension obligations that have become unduly burdensome as a result of a declining workforce, must be determined by PBGC³⁶ and PBGC's agreement that the criteria have been satisfied is difficult to obtain. Each member of the debtor's controlled group must meet one of the distress criteria, which may present difficulties if members of the controlled group are not in bankruptcy.

Recently, PBGC has objected in a number of proceedings where the debtor has sought bankruptcy court permission to terminate its pension plans via the distress termination process using the reorganization criteria. PBGC takes the position that each pension plan individually must meet the distress criteria. For example, in a recent case *In re Special Metals*, the debtor sponsored five defined benefit pension plans. Two were large in terms of underfunding and future minimum funding requirements, two were *de minimis* and one was of moderate size. PBGC did not dispute that minimum funding for the two largest plans was significant and those plans needed to be terminated in order for the company to emerge from bankruptcy. However, the debtors argued that the minimum funding for all five plans should be aggregated, in which case all plans would meet the distress termination criteria. The debtors also argued that it was important to treat all plan participants equally, so that if one group of employees were to receive reduced pensions due to PBGC's guarantee limit, it would be unfair to permit another group to receive full benefits from an ongoing plan. The judge concurred with PBGC's position that each plan must individually satisfy the distress termination criteria. He wrote: "I believe that the contention of the Pension Benefit Guaranty Corporation is correct that the Court must apply that standard to each plan individually, and that each plan must...qualify or the Court cannot find that it meets the requirement of IV of that statute."

Despite this finding, the court concluded that even the *de minimis* plans met the criteria for distress termination, since the lenders were unwilling to finance the reorganization if any of the plans were still ongoing. PBGC and the lenders subsequently negotiated an agreement under which the two small plans remained ongoing under the ultimate plan of reorganization and the PBGC took over the three large plans.³⁷

To meet the reorganization distress criteria, the debtor must show that the pension plan must be terminated in order for a company to reorganize. PBGC argues that if a potential plan of reorganization ("POR") exists that permits the continuation of the pension plan, then the plan need not be terminated. Thus the debtor must usually show that there is no viable plan of reorganization, not merely that the POR currently proposed requires the plan to be terminated.

In re Philip Services Corporation,³⁸ the debtor argued that termination of all its pension plans was a condition precedent to the funding of the POR and its ability to emerge from bankruptcy. It argued that since there was only one proposed POR and this POR called for the rejection of the plans, this satisfied the distress termination criteria. The judge disagreed. He said that to allow other

parties (in this case, the prospective financiers) to dictate what should or should not occur would transfer “the decision reserved to the bankruptcy court under ERISA.” Further, he quoted Judge Mitchell’s *In re US Airways* decision:

The reference in the statute to “a” plan of reorganization does not permit a distress termination simply because a particular plan requires it; rather the test is whether the debtor can obtain confirmation of *any* plan of reorganization without termination of the retirement plan.³⁹

In the *US Airways* case, the bankruptcy court found that there was overwhelming evidence that the debtor was unable to reorganize without terminating its pilots’ plan. The *Phillip Services* court concluded that the termination was not necessary, even though the investor financing the reorganization desired it. The court reviewed the model underlying the plan of reorganization and determined that “the pension plan liabilities are so small that they would not seem to cause material changes in the rest of the model.”

In *Phillip Services*, the plan of reorganization had already been approved at the time of the court’s decision on the pension plan termination motion. In most cases, the termination motion is advanced before the vote on the plan of reorganization is approved and, in some cases, before the final plan is presented. Unless a viable plan of reorganization is presented that would allow the pension plans to continue, it is likely that the plans will terminate under the liquidation distress criteria. Thus a court’s decision not to terminate a plan may simply lead to a liquidating 11 rather than reorganization.

Involuntary Termination. PBGC may move to terminate a plan if required contributions to the plan have not been paid when due or if the “possible long-run loss of the [PBGC] may reasonably be expected to increase unreasonably if the plan is not terminated.”⁴⁰ For example, PBGC moved to terminate the WHX Pension Plan after its debtor subsidiaries failed to obtain a federal loan guaranty necessary for it to reorganize. PBGC moved to terminate to prevent shutdown benefits from becoming nonforfeitable and therefore guaranteed (see Termination Date below). The debtor subsidiaries ultimately received the federal loan guaranty and were able to reorganize.

Although PBGC initiates an involuntary termination, PBGC must bring an action in federal court to terminate the plan. The court determines whether the statutory criteria have been satisfied as well as the termination date.

Termination Date

If the PBGC and the plan administrator agree on a termination date for an underfunded plan, that is the termination date.⁴¹ If the PBGC and the plan administrator cannot decide, the court determines the termination date.⁴² The statute does not provide any guidance to the courts, however, in making that determination.⁴³

In *PBGC v. Heppenstall*,⁴⁴ one of the earliest cases to consider this question, the court concluded that the termination date should be selected “in order to protect the interests of the participants and to avoid any further deterioration of the financial condition of the plan or any unreasonable increase in the liability of the fund.” Thus the court balanced the interests of the participants, on the one hand, and the interests of the PBGC, on the other. In that case, the court found that the participants had no justifiable expectation of additional pensions once the company had shut down.

Most courts have required some notice to the participants. This principle was first enunciated in *PBGC v. Broadway Minimum Maintenance Co.*,⁴⁵ in which the court opined that “[a]s in Heppenstall . . . this case should begin by determining the earliest date when the Plan’s participants had actual or constructive notice, *i.e.*, notice sufficient to extinguish their reliance interest... Once that date is ascertained, the District Court should then select whatever later date serves the interests of PBGC.”⁴⁶

In *PBGC v. Republic Technologies International, LLC*,⁴⁷ the court rejected PBGC's proposed termination date, which was immediately before a shutdown to eliminate PBGC coverage of shutdown benefits in the plan, even though participants were given notice on the proposed date. The court concluded that the pre-shutdown termination date did not adequately protect participants' reliance interests in these special benefits. In reaching this conclusion, the court distinguished participants' reliance interest in shutdown benefits under the facts of the case from their reliance interest in merely accruing additional benefits. Shortly before the proposed termination date, the union had reached an agreement with the debtor that allowed the debtor to delay liquidation (which would have established the right to the shutdown benefits) to allow time for the debtor to complete a sale based on the debtor's acknowledgement that the sale would constitute a shutdown. Thus the court felt that the participants "had a reasonable expectation as to the vesting of those shut-down benefits—subject only to the Bankruptcy Court’s approval of the sale." The court did adopt the PBGC's

proposed termination date, however, for plans that did not have shutdown benefits.

PBGC Bankruptcy Claims

Once a company has filed for bankruptcy, PBGC typically files several claims. With the exception of claims related to premiums and certain ongoing funding obligations, the claims are filed as a result of, or contingent on, the termination of the plan and/or PBGC's appointment as statutory trustee. If the sponsor reorganizes in such a way that the plan does not terminate, the termination contingency does not arise and PBGC typically withdraws the contingent claims.

Employer Contributions. Claims for unpaid employer contributions are filed in bankruptcy cases as claims of the pension plan, not the PBGC. PBGC will file contingent claims, since they will usually become the plan trustee if the plan terminates during the bankruptcy. Claims for unpaid employer contributions may fall into any of five categories, which are, in order of priority:

- Secured claims. Failure to make required contributions in excess of \$1 million gives rise to a lien on all controlled group property in favor of the plan, which is enforceable by the PBGC. If this lien is perfected prior to the filing of the bankruptcy petition, the PBGC will have a secured claim to the extent of the value of assets subject to the lien in each controlled group member's bankruptcy case. The lien is treated as a statutory tax lien.⁴⁸

The plan may also have a secured claim for the unamortized amount of any funding waivers if the sponsor has posted collateral as security and a security interest had been perfected.⁴⁹ Although the IRS grants funding waivers, PBGC negotiates the collateral and enforces the lien. A plan sponsor may also grant PBGC a security interest in connection with a negotiated agreement under the Early Warning Program, usually to permit a corporate transaction that in PBGC's view would pose an increased risk of increased risk of loss to the PBGC. These liens are consensual rather than statutory.

- Administrative Priority Claim. PBGC files an administrative priority claim⁵⁰ for the amount of unpaid minimum funding accruing from the date the debtor filed its petition under bankruptcy law through the date of pension plan termination as a ordinary and necessary business expense of

the estate. The amount is determined by applying a ratio of days ongoing to days in the plan year to the minimum funding.⁵¹ Of course, any amount allowed as a secured claim would not be claimed again as administrative.⁵²

Virtually every court that has considered the question has limited the administrative priority claim to the value of the benefits accrued during the pendency of the bankruptcy case as measured by the plan's normal cost.

PBGC will also claim administrative priority for unpaid minimum funding contributions in excess of \$1 million. PBGC claims that administrative priority is available without need for a showing that the debt constitutes a benefit to the estate or necessary business expense of the estate. The amount of contributions missed gives rise to the tax lien discussed above and is "treated as taxes due and owing the United States."⁵³ This priority was rejected by the 10th Circuit in *In re CF&I Fabricators of Utah, Inc.* and by the 6th Circuit in *In re CSC Industries*.⁵⁴

- Employee Plan Priority Claim. A fourth priority claim⁵⁵ is filed for the unpaid minimum funding accruing during the 180 day period ending on the date the bankruptcy petition was filed (or the date the debtor's business ceased, if earlier).⁵⁶ This claim is limited to a maximum of \$4,650 times the number of employee/participants during that period, minus the aggregate amount paid those employee/participants on account of third priority wage claims. Any amounts accruing during the 180-day period in excess of the limitation become part of the unsecured claim below. Any funding waivers allowed as a secured claim would not be claimed again here.
- Tax Priority Claim. To the extent the missed contribution above \$1 million arose pre-petition but is not allowable as a secured claim, PBGC claims that amount as a priority pre-petition tax.⁵⁷ This priority was rejected in *CF&I Fabricators of Utah, Inc.* and *In re CSC Industries*.⁵⁸
- General Unsecured Claim. All unpaid minimum funding amounts not permitted under the secured or priority categories above are filed as an unsecured claim. Again, all funding waivers may be treated as revoked in the computation of the amount if the waiver contains language that nullifies the waiver on plan termination.

Employer Liability to PBGC. The PBGC files a priority claim for the amount of the unfunded benefit liabilities (or 30 percent of the combined net worth of the contributing sponsor and all trades or businesses under common control with the sponsor, if that amount is less than the underfunding). In bankruptcy and insolvency cases, PBGC asserts that this claim is to be “treated as a tax due and owing to the United States” as provided by section 4068 of ERISA, so it is filed as a tax priority claim. If the plan is terminated during the administration of the bankruptcy, it is filed as an administrative tax claim. In the event that any part of the claim is determined to have arisen pre-petition, that part is claimed in the alternative as a seventh priority pre-petition tax. If the plan is terminated prior to the bankruptcy case, it is filed as a pre-petition tax claim.⁵⁹ This priority has been consistently rejected under the Bankruptcy Code.⁶⁰

PBGC’s employer liability claim is for 100 percent of the unfunded benefit liabilities under the plan. Generally, benefit liabilities will include all fixed and contingent benefits provided under a plan at the date of plan termination date from the value of benefit liabilities under the plan as of that date.⁶¹ Prior to 1986, PBGC’s *claim* was limited to the amount of unfunded guaranteed benefits or 30 percent of net worth, whichever was less. Now 30 percent of net worth is only relevant as a limit on the PBGC tax lien and priority claims.⁶²

PBGC determines the actuarial present value of the benefit liabilities pursuant to the assumptions prescribed by PBGC in its valuation regulation.⁶³ The interest rate assumption in PBGC’s valuation regulation can have a substantial effect on the amount of PBGC’s claims and therefore it is challenged in virtually every bankruptcy.⁶⁴ The Sixth and Tenth Circuits have both held that the bankruptcy court may value the liability using a “prudent investor rate,” the rate that a reasonably prudent investor would receive from investing the funds.⁶⁵ Bankruptcy courts have authority under the Bankruptcy Code to determine the amount of claims in bankruptcy proceedings.⁶⁶ Moreover, the Bankruptcy Code requires that same-class creditors be treated equally.⁶⁷ Since PBGC’s claim is for the stream of future payments it will have to make to pension plan participants, these courts have concluded that the bankruptcy court may determine the present value of this stream of payments under this authority and must apply an interest rate that treats PBGC and similarly-situated creditors the same. The prudent investor rate applied by the bankruptcy courts has been higher than the PBGC rates. The effect of the higher interest rate has been to lower or even eliminate PBGC’s claim, as illustrated by the CSC example above.

Premium Claims. Premiums payable to the PBGC are the joint and several liability of the plan’s contributing sponsor and members of the sponsor’s

controlled group. However, these premiums are also obligations of the plan itself and generally may be paid from plan assets. PBGC claims administrative priority to the extent that the premium relates to the post-petition period.

Contractual Claims. Occasionally, the PBGC of the terminated plan may have rights under a contract that will give rise to an additional claim. Situations in which such contractual claims may arise include:

- settlement agreements to which the PBGC is a party,
- commitments to make a plan sufficient in a standard termination filed with the PBGC,
- notes held by a plan, and
- sales agreements providing for continuing funding responsibility on the part of a seller.

As noted above, the claim will be filed as a secured claim if collateral was pledged as part of the contract.

Fiduciary Breach Claims. Occasionally, the PBGC discovers that a fiduciary violation has taken place. In such cases, PBGC pursues a claim for damages to the plan in the bankruptcy case of any liable fiduciary after PBGC becomes plan trustee.⁶⁸ That claim has been found to be “non-dischargeable” in an individual fiduciary’s bankruptcy.⁶⁹ In order to be exempt from discharge under section 523(a)(4) of the Bankruptcy Code, the claim must arise from “fraud or defalcation while acting in a fiduciary capacity, embezzlement or larceny.”⁷⁰ To the extent that such a claim goes unpaid in the bankruptcy, it is not forgiven by the bankruptcy discharge and may be pursued after the bankruptcy case is over.

The Ninth Circuit concluded that an ERISA fiduciary was a fiduciary for purposes of section 523(a)(4).⁷¹ However, the court held that a breach of fiduciary duty under ERISA was not sufficient to constitute “defalcation while acting in a fiduciary capacity.” The decision indicates that there were no allegations of “accounting failure or misappropriation.”

Employee Contributions. From time to time, the PBGC encounters a case in which employee contributions were withheld by an employer but not paid over to the plan. A claim that these amounts are impressed with a trust is filed on behalf of the plan, stating that the Debtor’s estate had no title to the amounts, and that they must be paid in full to the rightful custodian, the pension plan. Employee contributions in defined benefit plans are relatively rare, however, and this issue rarely comes up.

Prebankruptcy: PBGC's Early Warning Program

Companies with large amounts of underfunded pension liabilities are likely to hear from the PBGC long before bankruptcy, particularly if the company has below investment-grade bond ratings. PBGC has established an Early Warning Program that focuses on transactions that, in PBGC's opinion, may pose an increased risk of long-run loss to PBGC. PBGC issued Technical Update 2001-3 in July 2000 to explain when the PBGC is likely to intervene in a transaction and the types of pension protections PBGC is likely to seek. The Technical Update indicates that PBGC will focus only on transactions involving financially troubled companies and transactions involving companies with pension plans that are underfunded on a current liability basis, although in the past they have also intervened in transactions involving plans that were fully funded on a current liability basis but underfunded on a termination basis. In prior years, PBGC had taken a more expansive view of when it would intervene.

PBGC is concerned about transactions that substantially weaken the financial support for a pension plan or PBGC's potential recovery in a future bankruptcy. Examples of transactions that will attract PBGC's attention include:

- Breakup of a controlled group (for example, a sale or a spin-off of a subsidiary);
- Corporate transaction in which significantly underfunded pension plans (or portions of plans) are transferred to a new controlled group that has a below-investment grade bond rating;
- Leveraged buyout;
- Major divestiture by an employer who retains significantly underfunded pension liabilities;
- Payment of extraordinary dividends (e.g., a dividend, stock redemption or other payment within the controlled group that exceeds the adjusted net income of the company making the distribution, either for the prior year or for the four preceding years); or
- Substitution of secured debt for previously unsecured debt.

Thus, many of the transactions involved in a pre-bankruptcy workout will result in PBGC intervention.

Technical Update 2001-3 encouraged companies and their advisors to contact PBGC's Corporate Finance and Negotiations Department ("CFND") in advance of a transaction. CFND is a small group of financial analysts and

actuaries who monitor the companies with the largest underfunded plans. CFND analysts act much like Wall Street analysts, following particular companies and particular industries, particularly industries that have previously resulted in large claims such as the auto, steel and airline industries. They monitor financial publications, company press releases and on-line financial information. They also talk to analysts and others who follow their industries.

Depending on the nature of the transaction, there are four possible legal grounds that PBGC may assert when it intervenes in a transaction:

- the plan has not met minimum funding requirements.
- the “possible long-run loss of the [PBGC] may reasonably be expected to increase unreasonably if the plan is not terminated.”
- a cessation of operations at a facility that results in a 20 percent reduction in active participants under the plan.
- the threat that PBGC will bring a subsequent evasion action if the plan is terminated within 5 years after the transaction (see below).

In the first two cases, PBGC may move to terminate the plan(s) and pursue the employer and each member of its controlled group for termination liability. If there is a cessation of operations at a facility that results in a 20 percent reduction in active participants under the plan, PBGC may require the employer to make a payment into the plan or, at the employer’s election, post a bond or escrow equal to 150 percent of the liability attributable to the closed facility for five years.⁷²

If PBGC identifies a long-run loss case, PBGC will attempt to negotiate with the parties to obtain protection for itself and the plan without terminating the plan. Protections that PBGC has accepted in the past include:

- a guaranty from a strong company that’s leaving the controlled group;
- additional contributions to the plan, with restrictions on how the resulting credit balance may be used; or
- security to protect the plan against future missed contributions or termination liability.

Typically the guaranty or security stays in place for a set period of five years or, if later, until the plan sponsor meets certain performance benchmarks. These are usually tied to the risk that threatened to increase the long run loss. For example, when American Cyanamid was spinning off Cytec in 1993, the guaranty was tied to the resolution of environmental problems that were the reason for the increased

risk. In other cases, release of the guaranty or security may be tied to achieving investment grade status or financial benchmarks customized to the specific company or industry.

PBGC's bargaining position is strongest when termination prior to a transaction will result in a full recovery for the plan, protecting both PBGC and the participants. When termination will bring a loss to PBGC, PBGC may accept less favorable terms rather than terminating the plan. Therefore, a careful analysis of the plan liabilities, PBGC guarantees and the potential recovery if PBGC terminated the plan (both in bankruptcy and outside) must be made before negotiating with the PBGC.

Evasion Transactions

If a principal purpose of any transaction is to evade liability and the transaction becomes effective within 5 years before termination, any person involved in the transaction (and that person's controlled group on the termination date) can be held liable as if that person were a contributing employer under section 4069 of ERISA.⁷³ Benefit increases after the transaction are excluded.

There has been very little litigation under this provision. In a case governed by ERISA as in effect prior to the enactment of section 4069, International Harvester had been found liable for its highly leveraged sale of the Wisconsin Steel Company.⁷⁴ In that case, the buyer failed and the transferred plan terminated so quickly that the plan's assets had not yet been transferred from the International Harvester master trust.

In contrast, the only case decided under section 4069 involved the termination of a plan more than 5 years after the initial business sale that gave rise to the claim. In *PBGC v. White Consolidated Industries*,⁷⁵ the Third Circuit held that a sale transaction did not become effective—and therefore the five-year period with respect to a former plan sponsor did not begin—until the former sponsor ceased making substantial contributions to fund the plan. In a subsequent decision, White Consolidated was found to have engaged in an evasion transaction by transferring underfunded plans in a highly leveraged buyout in which assumption of the pension liabilities was the sole consideration for the business.⁷⁶ In settlement, White Consolidated agreed to resume sponsorship of the terminated plans, to increase benefits by five percent, to merge the restored plans with an overfunded plan it maintained and to purchase annuities to provide the benefits.⁷⁷

Controlled Group Liability

Minimum funding requirements, PBGC premiums and termination liabilities on are joint and several liabilities of the plan's contributing sponsor and each member of its controlled group.⁷⁸ The "controlled group" is determined under section 414 of the Internal Revenue Code.⁷⁹ There are two different definitions of controlled groups that are used for different purposes in ERISA and the Internal Revenue Code.

One definition includes only corporations or trades or businesses under common control within the meaning of section 414(b) or (c) of the Internal Revenue Code. This includes parent-subsidiary control groups and brother-sister controlled groups. Parent-subsidiary controlled groups are groups in which a parent company directly or indirectly owns 80 percent of at least one or more subsidiary. Brother-sister controlled groups exist if the same five or few shareholders who are individuals, trusts or estates own 80 percent of more of two or more companies ("controlling interest") and, taking account the lowest ownership percentage in each company, the same shareholders own more than 50 percent each company ("effective control"). There are complex attribution rules in making these determinations⁸⁰ and understanding them can be critical to avoid inadvertently creating a controlled group that could become liable for missed minimum funding contributions, PBGC termination liability and PBGC premiums.

In addition, for qualified plan purposes (including minimum funding) and for PBGC premiums, the controlled group also includes affiliated service groups and other related employers under section 414(m) and (o) of the Internal Revenue Code. Affiliated service groups are generally limited to organizations providing professional services that have some common ownership and companies that provide management services, whether there is any common ownership or not.⁸¹ Section 414(o) of the Code provides broad authority to the IRS to define other categories of organizations that should be treated as under common control "as may be necessary to prevent avoidance" of the a variety of Code requirements governing employee benefit plans. There are currently no regulations under either of these sections although the IRS in the past has attempted to promulgate rules designed to curb perceived abuses of the nondiscrimination rules for qualified plans, but inadvertently drew otherwise unrelated groups into the controlled group, thus potentially subjecting them to some, but not all, of the PBGC claims.

PBGC may claim the entire amount from each member of the controlled group and collect all or part from any of them, although PBGC's total recoveries

cannot exceed the amount of the statutory obligation. The 30 percent of net worth tax status claim is filed in each member's bankruptcy case (but not granted) and could be demanded from each member that is not a bankruptcy debtor. Each, in turn, may have rights against the other members for contribution to the amount paid to PBGC.

Because of PBGC's joint and several liability claims, it will examine how any transaction (or the proposed POR treatment) will affect its claim against each controlled group member. For example, the sale of a subsidiary with little debt would move value from the subsidiary (where PBGC's claims have little competition) to a parent company with significant debt, diluting PBGC's potential recovery. PBGC will object to such a transaction if it believes its claim may be compromised. These disputes can usually be resolved without jeopardizing the sale.

For example, in the *Enron* bankruptcy, PBGC took issue over the proposed sale of Portland General Electric ("PGE"), a valuable entity in the Enron controlled group. The sale would have removed those assets from the reach of the PBGC if the Enron plans terminated and therefore PBGC objected. It did not matter whether or not any PGE employees participated in the Enron pension plan or whether any PGE funds had been used to satisfy the plan's minimum funding requirements. All that concerned the PBGC was that it would lose its separate claim against the PGE assets when PGE left the Enron controlled group as a result of the sale. Once the sale proceeds became part of the Enron assets, PBGC would lose its separate claim against those assets and, while the parent company assets would increase by an equivalent amount, PBGC's claim would have to share those assets with other creditors. PBGC, Enron and its creditors agreed that the proceeds from the sale would be kept in a separate account and the funds would not be co-mingled or used for other purposes. This allowed the sale to proceed on schedule and reserved all parties' rights to argue about the PBGC's claim at a later day.

Many of the defenses to PBGC claims discussed above arise because of the interplay between the Bankruptcy Code and ERISA. Controlled group members that are not in bankruptcy may have difficulty asserting these claims. Therefore, when PBGC claims are likely, all members of the controlled group normally file for bankruptcy if possible. Some businesses, such as banks and insurance companies, may not be able to file for bankruptcy, however.⁸²

Foreign controlled group members present a different problem for the PBGC. Although they generally will not be included in a U.S. bankruptcy

proceeding, PBGC is not able to make a direct claim against them in U.S. courts unless they meet the minimum contacts test that permits the U.S. courts to assert jurisdiction over them.⁸³

PBGC Guarantees

PBGC guarantees most, but not all, of the plan's nonforfeitable pension benefits. Exceptions that often lead to loss of benefits when an underfunded plan terminates include:

- Benefits over the maximum monthly pension benefit that PBGC guarantees for an individual commencing benefits at 65, which for plans terminating in 2004 is \$3,698.86 per month (\$44,386.32 per year). This cap is reduced for benefits commencing at earlier ages. At 55, for example, the maximum guaranteed benefit is less than half (\$1,610.80 per month in 2004).⁸⁴ The maximum benefit will also be reduced when a survivor benefit is provided or a benefit form other than a straight life annuity is elected.⁸⁵
- Benefit increases and new benefits that have been in place for less than a year. Those that have been in place for less than 5 years are guaranteed 20 percent (or \$20 per year of service, if greater) for each full year in effect. Substantial owners' benefits are phased in over 30 years.⁸⁶
- Early retirement payments that are greater than payments at normal retirement age.⁸⁷ For example, a Social Security supplement will not be guaranteed to the extent it brings the monthly benefit above the monthly benefit payable at normal retirement.
- Ancillary benefits such as health insurance, life insurance or death benefits.⁸⁸
- Benefits for which a participant has not yet met the conditions in the plan, such as an early retirement benefit for which the participant has not yet met the age and service requirements.⁸⁹

Participants may obtain benefits not guaranteed benefits to the extent they are funded by the assets of the plan at termination.

On termination, plan assets are allocated to benefits by category, in the following order:

- Category 1—voluntary employee contributions;
- Category 2—mandatory employee contributions;
- Category 3—benefits in pay status (or eligible to be in pay status) for at least three years prior to termination, under terms of the plan in effect for at least five years prior to termination;
- Category 4—PBGC-guaranteed benefits;
- Category 5—other nonforfeitable benefits;
- Category 6—all other benefits.

Thus, participants who are retired (or eligible to retire) at least three years prior to termination are least likely to lose benefits.

Although PBGC does not guarantee all benefits in a terminated plan, PBGC's claim is for the full amount of the unfunded benefit liabilities. A portion of the recovery on PBGC's employer liability claim is allocated to participants' non-guaranteed benefit entitlements.⁹⁰ For most terminated plans, the recovery ratio is determined by PBGC's average recovery percentage. For plans with more than \$20 million in unfunded liabilities, the participants share in the PBGC's actual recovery from the plan sponsor and controlled group members. In the *US Airways* decision, the judge indicated that approximately 73 percent of any recovery would go to pay non-guaranteed benefits.⁹¹ Because of this recovery sharing, PBGC takes the position that neither participants nor their collective bargaining representatives have the right to make claims separately for lost benefits.⁹²

Conclusion

The recent recession has led to a significant increase in both bankruptcy and pension plan terminations. As a result, courts have been revisiting issues related to PBGC claims and, in some cases, reaching different conclusions than earlier precedents would have suggested. Often these cases have turned on the particular facts presented to the court, making it difficult to predict the outcomes in future cases.

FOOTNOTES

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- ¹ 29 U.S. C. § 1001 *et seq.*
- ² 29 U.S. C. § 1301 *et seq.*
- ³ PBGC administers two insurance programs, one for single-employer plans and the other for multiemployer plans. This paper discusses only claims related to single-employer plans, since multiemployer plan claims are asserted by the plans themselves.
- ⁴ *See* ERISA § 4006(a)(3)(A)(i) and (E).
- ⁵ PBGC 2003 Annual Report at 22-23. Taking into account only PBGC's actual terminations, the deficit would have only been \$6 billion.
- ⁶ PBGC 2000 Annual Report at 28-29.
- ⁷ *Compare* ERISA § 4005(f)(3) (fund containing premiums over \$8.50 per participant may be invested in "in such obligations as the corporation considers appropriate") *with* ERISA § 4005(a)(3) (PBGC may request investment of funds from first \$8.50 of premiums and employer liability claims in Treasury obligations).
- ⁸ ERISA § 4042(d)(1)(A)(iii), (3).
- ⁹ 11 U.S.C. §§ 101(41)(B), 1102(b)(1).
- ¹⁰ Internal Revenue Code ("IRC") §412 and ERISA §302.
- ¹¹ Originally, ERISA §302(b)(2)(B)(ii) and IRC §412(b)(2)(B)(ii) provided that past service liabilities could be funded over a 30 year period for single-employer plans. Subsequent legislation has added ERISA §302(d) and Code §412(l) which provide for a deficit reduction contribution which requires that sponsors of severely underfunded plans make additional deficit reduction contributions.
- ¹² IRC §404(a)(1)(D) allows an employer which has more than 100 employees who participate in defined benefit pension plans to make a contribution to such plans up to the amount of their unfunded current liabilities as defined in IRC §412(l) and to deduct the full amount of the contribution. Employers

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- with fewer than 100 employees who participate in defined benefit pension plans cannot fund past service liabilities faster than over a 10 year period without incurring adverse tax consequences.
- ¹³ See ERISA §302(d)(7)(B)(i) and IRC §412(l)(7)(B)(i).
- ¹⁴ An early retirement window benefit involves an enhancement to the regular early retirement benefit provided by the pension plan for any employee who retires early during a specified period of time – the “window period.”
- ¹⁵ *In re CSC Industries*, 232 F.3d 505 (6th Cir. 2000); *PBGC v. CF&I Fabricators of Utah, Inc.*, 150 F.3d 1293 (10th Cir.1998), *cert. denied*, 119 S. Ct. 2020 (1999). The bankruptcy court in CF&I had upheld use of PBGC valuation assumptions in determining the amount of the unfunded benefit liabilities claim but was reversed on appeal.
- ¹⁶ ERISA § 4062(a), 29 U.S.C. § 1362(a). Prior to 1986, PBGC’s *claim* was limited to the amount of unfunded guaranteed benefits or 30 percent of net worth, whichever was less. Now 30 percent of net worth is only relevant as a limit on the PBGC tax lien and priority claims.
- ¹⁷ ERISA § 4001(a)(16), 29 U.S.C. § 1301(a)(16).
- ¹⁸ ERISA § 4001(a)(18), 29 U.S.C. § 1301(a)(18).
- ¹⁹ *In re US Airways Group, Inc.*, Case No. 02-83984-SSM, slip op. (Bankry. E.D. Va. Dec. 29, 2003) (“*US Airways I*”). The court’s decision approving the termination of the plan is reported at 296 B.R. 734, 743 (E.D. Va. 2003) (“*US Airways I*”).
- ²⁰ 29 C.F.R. Part 4044.
- ²¹ *US Airways II* at 4.
- ²² *US Airways II* at 5.
- ²³ IRS Rev. Rul. 79-237.

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- ²⁴ *In re CSC Industries*, 232 F.3d 505 (6th Cir. 2000); *PBGC v. CF&I Fabricators of Utah, Inc.*, 150 F.3d 1293 (10th Cir.1998), *cert. denied*, 119 S. Ct. 2020 (1999).
- ²⁵ 11 U.S.C. §§ 502(b) and 1123(a)(4).
- ²⁶ 11 U.S.C. § 1123(a)(4).
- ²⁷ *In re Chateaugay*, 126 B.R. 165 (Bankr. S. D. NY 1991), *vacated, op. withdrawn sub nom. The LTV Corp. v. PBGC*, 1993 WL 388809 (S.D. NY 1993).
- ²⁸ *Id.* at 171.
- ²⁹ *US Airways II* at 7.
- ³⁰ 530 U.S. 15, 120 S.Ct. 1951, 147 L.Ed.2d 13 (2000).
- ³¹ ERISA § 4041(a); 29 U.S.C. § 1341(a).
- ³² ERISA § 4041(a)(3); 29 U.S.C. § 1341(a)(3).
- ³³ See ERISA § 4041(b); 29 U.S.C. § 1341(b).
- ³⁴ ERISA § 4041(c)(2)(B)(i); 29 U.S.C. § 1341(c)(2)(B)(i).
- ³⁵ ERISA § 4041(c)(2)(B)(ii); 29 U.S.C. § 1341(c)(2)(B)(ii).
- ³⁶ ERISA § 4041(c)(2)(B)(iii); 29 U.S.C. § 1341(c)(2)(B)(iii).
- ³⁷ “Federal Pension Insurer To Pay Special Metals Corp. Pensions,” PBGC Press Release (Dec. 4, 2003).
- ³⁸ *In re Phillip Services Corporation*, Case No. 03-37718-H2-11 ((Bankry. S.D. Texas, Houston Div.)
- ³⁹ *US AirwaysI.*, 296 B.R. at 743.
- ⁴⁰ ERISA § 40

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- ⁴¹ ERISA § 4048(a)(2)-(3).
- ⁴² ERISA § 4048(a)(4). *See PBGC v. Heppenstall Co.*, 633 F.2d 293, 301 (3d Cir. 1980) (rejecting PBGC's proposed date and refusing to defer to PBGC's expertise).
- ⁴³ *See PBGC v. Heppenstall Co.*, 633 F.2d 293, 297-300 (3d Cir. 1980),
- ⁴⁴ *Id.*
- ⁴⁵ 707 F.2d 647 (2d Cir. 1983).
- ⁴⁶ 707 F.2d at 652-53.
- ⁴⁷ ___ F.Supp.2d ___, 2003 WL 22348920 (N.D. Ohio, Sep 30, 2003).
- ⁴⁸ IRC § 412(n)(4)(C), 29 U.S.C. §1082(f)(4)(C); 11 U.S.C. §§ 545, 547(c)(6).
- ⁴⁹ ERISA § 306, 29 U.S.C. § 1085a; ITC § 412(f)(3).
- ⁵⁰ 11 U.S.C. §§ 503(B)(1)(A), 507(a)(1).
- ⁵¹ IRS Revenue Ruling 79-237.
- ⁵² *Columbia Packing Co. v. PBGC*, 81 B.R. 205 (D. Mass. 1988).
- ⁵³ U.S.C. §§ 503(b)(1)(B), 507(a)(1); ERISA § 302(f)(4)(C), 29 U.S.C. § 1082(f)(4)(C); and IRC § 412(n)(4)(C).
- ⁵⁴ 150 F.3d 1293, 1298 at note 4 (10th Cir. 1998) and 2000 FED App. 0393P (6th Cir.).
- ⁵⁵ 11 U.S.C. § 507(a)(4).
- ⁵⁶ *Columbia Packing Co. v. PBGC*, 81 Bankr. 205 (D. Mass. 1988); *In re Saco Local Development Corp.*, 23 Bankr. 644 (Bankr. D. Me. 1982), *aff'd* 711 F.2d 441 (1st Cir. 1983); *In re P.C. White Truck Line Inc.*, 22 Bankr. 540 (M.D. Ala. 1982).

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- ⁵⁷ 11 U.S.C. § 507(a)(7); ERISA § 302 (f)(4)(C), 29 U.S.C § 1082(f)(4)(C); and IRC § 412 (n)(4)(C).
- ⁵⁸ See note. 15, *supra*.
- ⁵⁹ *In re Washington Group*, No. C-86-665-G (M.D.N.C. Mar. 9, 1987), modified, No. C-86-665-G (M.D.N.C. Mar. 29, 1987), *aff'g in part. rev'g in part*, Nos. B-77-695, B-77-697 through 702 (Bankr. M.D.N.C. June 16, 1986); *see also*, *In re Bollinger Corp.*, No. 76-282 (Bankr. W.D. Pa Jan. 30, 1981). Note that both of these cases were under the Bankruptcy Act, rather than the current Bankruptcy Code.
- ⁶⁰ See *In re Tenn-Ero Corp.*, 14 B.R. 884 (Bankr. D. Mass. 1981), *aff'd sub nom*, *PBGC v. Ouimet Corp.*, 32 B.R. 65 (D. Mass. 1982); *In re Divco Philadelphia Sales Corp.*, 64 B.R. 232 (Bankr. E.D. Pa. 1986); *In re CSC Industries, Inc.*, 232 F.3d 505 (6th Cir. 2000).
- ⁶¹ ERISA § 4001(a)(18), 29 U.S.C. § 1301(a)(18).
- ⁶² ERISA § 4062(a), 29 U.S.C. § 1362(a).
- ⁶³ 29 C.F.R. Part 4044.
- ⁶⁴ IRS Rev. Rul. 79-237.
- ⁶⁵ *In re CSC Industries*, 232 F.3d 505 (6th Cir. 2000); *PBGC v. CF&I Fabricators of Utah, Inc.*, 150 F.3d 1293 (10th Cir.1998), *cert. denied*, 119 S. Ct. 2020 (1999). The bankruptcy court in CF&I had upheld use of PBGC valuation assumptions in determining the amount of the unfounded benefit liabilities claim but was reversed on appeal.
- ⁶⁶ 11 U.S.C. §§ 502(b) and 1123(a)(4).
- ⁶⁷ 11 U.S.C. § 1123(a)(4).
- ⁶⁸ See ERISA §§ 404-406, 502 29 U.S. C. §§ 1104-6, 1132.
- ⁶⁹ See, e.g., *In re Daniels*, Case No. 92-13051-JNF, Adv. P. No. 93-1332 (Bankr. D. Mass. April 25, 1994) (“a fiduciary’s failure to account constitutes a defalcation”).

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- ⁷⁰ See 11 U.S.C. § 523(a)(4).
- ⁷¹ *Blyler v. Hemmeter*, No. 99-55777, DC No. CV-98-03640-CBM (9th Cir. Mar. 26, 2001).
- ⁷² ERISA §§ 4062(e), 4063(b)(3); 29 U.S.C. §§ 1362(e), 1363(b)(3).
- ⁷³ ERISA § 4069, 29 U.S.C. § 1369.
- ⁷⁴ *In re Consol. Lit. Concerning International Harvester's Disposition of Wisconsin Steel*, 681 F. Supp. 512 (N.D. Ill. 1988).
- ⁷⁵ 988 F.2d 1192 (3d Cir. 1993), *cert. denied*, 62 U.S.L.W. 3477 (U.S. Jan. 11, 1994) (No. 93-661).
- ⁷⁶ *PBGC v. White Consolidated Industries Inc.*, 215 F.3d 407 (3d Cir. 2000).
- ⁷⁷ “White Consolidated Agrees to Resume Sponsorship of Pension Plans; Retirees Promised Full Benefits,” PBGC Press Release (July 6, 2000).
- ⁷⁸ ERISA §§ 302(c)(11)(B) (minimum funding), 4007(e)(2) (premiums), and 4062 (termination liability); IRC § 412(c)(11)(B) (minimum funding).
- ⁷⁹ ERISA § 4001(b)(1).
- ⁸⁰ See Treas. Reg. § 1.414(c)-4.
- ⁸¹ Code § 414(m)(2) and (5).
- ⁸² See 11 USC § 109 (b)(1)-(3), (d).
- ⁸³ *PBGC v. Satralloy, Inc.*, No. C-2-90-0630 (S.D. Ohio July 16, 1992).
- ⁸⁴ 29 CFR § 4022.22 and Appendix to Part 4022. Guarantees at various ages for each year since PBGC was created appear in a chart on PBGC’s website at http://www.pbgc.gov/services/descriptions/guarantee_table.htm.
- ⁸⁵ 29 CFR § 4022.23.

⁸⁶ 29 CFR § 4022.24-.26.

⁸⁷ 29 CFR § 4022.21.

⁸⁸ 29 CFR § 4022.3(b) (only pension benefits guaranteed).

⁸⁹ See ERISA § 4001(a)(8) (definition of “nonforfeitable benefit”); 29 CFR §§ 4022.3(a), 4022.4(a)(3).

⁹⁰ ERISA § 4022 (c), 29 U.S.C. § 1322(c).

⁹¹ *USAirways II*, slip op. at 12.

⁹² *USWA v. United Engineering*, 52 F.3d 1386 (6th Cir. 1995) (rejecting *Murphy v. Heppenstall Co.*, 635 F.2d 233 (3d Cir. 1980), *cert. denied*, 454 U.S. 1142 (1982) and cases following *Heppenstall* based on subsequent statutory changes); *Fusco v. Rome Cable*, 946 F. Supp. 171 (N.D.NY 1996).

**PENSION AND RETIREE LIABILITIES
IN BANKRUPTCY**

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I. CONTROLLED GROUP

A. Generally

ERISA defines a "controlled group" to include any group consisting of a "person" and all other persons under common control with such person within the meaning of Section 414 of the Internal Revenue Code of 1986 (the "Code"). Section 4001(a)(14) of ERISA. The term "person" is defined by ERISA to include, among other entities, an individual, a partnership, a joint venture or a corporation. Section 3(9) of ERISA.

- a. A "parent-subsidiary" controlled group exists where there is at least 80% ownership measured, in the case of a corporation, by either voting rights or the value of all outstanding stock. Treas. Reg. § 1.414(c)-2(b).
- b. A "brother-sister" controlled group exists where: (i) at least 80% of each trade or business is owned by the same five or fewer individuals; and (ii) at least 50% is owned by the same five or fewer individuals counting only the lowest percentage held by that individual in each entity. Treas. Reg. §1.414(c)-2(c). In determining whether an individual's stock may be taken into account for purposes of the 80% ownership test, the individual must own stock in each member of the purported controlled group. Vogel Fertilizer Co. v. U.S., 455 U.S. 16 (1982).
- c. "Controlled group" generally includes affiliated service organizations under Section 414(m) of the Code and other related persons described in regulations under Section 414(o) of the Code. Prop. Treas. Reg. §§ 1.414(m)-5 and 1.414(o)-1.

B. Joint and Several Liability

1. In the case of a single employer defined benefit plan, joint and several liability is explicitly imposed on all members of a sponsoring employer's controlled group for the amount of any delinquent contributions, delinquent PBGC premiums and any underfunding on plan termination. Sections 4062, 4007(e)(2) and 302(c)(11)(B) of ERISA and Section 412(c)(11)(B) of the Code. Similarly, joint and several liability is imposed on each member of the controlled group for any excise taxes assessed for failure to satisfy the minimum funding standards. Section 4971(e)(2) of the Code. For underfunded terminating plans, ERISA provides that "[i]n any case in which a single employer plan is terminated, in a distress termination under 4041(c) or a termination otherwise instituted by the ...[PBGC]... any person who is, on the termination date, a contributing sponsor of the plan or a member of such a contributing sponsor's controlled group shall incur liability ... [and] ... [t]he liability ... of all such persons shall be joint and several." Section 4062(a) of ERISA. For this purpose, "controlled group" has the same meaning as under Section 414(b) and (c) of the Code. See ERISA Section 4001(a)(14). With respect to contributions, both ERISA and the Code provide that if the ... [sponsoring] ... employer ... is a member of a controlled group, each member of such group shall be jointly and severally liable for payment of such contribution or required installment." Section 302(c)(11)(b) of ERISA; Section 412(c)(11)(B) of the Code. For purposes of liability for delinquent contributions and PBGC premiums, "controlled group" has the same meaning as under Section 414(b), (c), (m) and (o) of the Code. See Section 412 (c)(11)(B)(ii) of the Code and Sections 302(c)(11)(B)(ii) and 4007(e)(2) of ERISA.

2. Similarly, all members of the controlled group (within the meaning of Section 414 (b) and (c) of the Code) of a contributing employer to a multiemployer plan are

jointly and severally liable for that employer's withdrawal liability. See In Re Northeast Dairy Cooperative Federation, Inc., 88 B.R. 21 (Bankr. N.D.N.Y. 1988) and Sections 4001(b) and 4001(c)(14) of ERISA.

3. Non-pension retiree liabilities of the type described in Bankruptcy Code Section 1114 are specific to the plan sponsor. There is no joint and several liability for retiree medical, life and other welfare benefits, except as may have been agreed to contractually.

4. In the bankruptcy context, the existence of joint and several liability can give the plan, the PBGC or the IRS in the case of delinquent contributions a significant advantage vis-à-vis other creditors.

a. For example, ignoring possible priorities for the PBGC, assume that two entities, A Corp. and B Corp., constitute a "parent-subsidary" controlled group and both file a chapter 11 petition. Assume further that A Corp. sponsors a defined benefit pension plan which is underfunded by \$10 million, B Corp. has no plans, and that A Corp. and B Corp. have separate assets of \$10 million each and separate non-pension liabilities equal to \$20 million each.

b. If A Corp. and B Corp. were a single entity (or if there were substantive consolidation of these entities for bankruptcy purposes), they would have \$20 million of assets and \$50 million of liabilities (including pension liabilities), resulting in an approximate 40% recovery for all claimants. However, pursuant to ERISA's provision of joint and several liability, the separate bankruptcy cases for A Corp. and B Corp. will show \$10 million of assets and \$30 million of liabilities (assuming the PBGC claim is fully

asserted against each debtor) and the PBGC will recover approximately 33-1/3% from each debtor, for a 66-2/3% recovery overall, as opposed to the 33-1/3% recovery experienced by other similarly situated creditors.

- c. Assume the same facts as in 4a, above, but that B Corp. has \$10 million of assets and no other liabilities. In that circumstance, B Corp. will effectively have to fund A Corp.'s pension plan, or else be liable for the full termination liability.

Therefore, the recovery by the plan, the PBGC or the IRS can far exceed the recovery of a similarly situated creditor who can only claim against a single entity. Further, the only limit on the recovery from a related entity is the full satisfaction of the government's claim. As a result, all other things being equal, the greater the number of entities which comprise a controlled group, the greater the likelihood of the government's full recovery.

C. Right of Contribution

1. Nothing explicit in ERISA or its legislative history supports a right of contribution. Since, under common law "... liability for contribution is coextensive with liability for debt, and all persons who are so liable are proper contributors", the question arises whether a right of contribution under ERISA is implied by its joint and several liability provisions. 18 American Jurisprudence 2d § 1.

2. The case law analyzing the appropriateness of the right of contribution in connection with joint and several liability under ERISA is sparse. See PBGC v. Ouimet Corp., 711 F.2d 1085 (1st Cir. 1983) ("Ouimet II"); and In Re Northeast Dairy Cooperative Federation Inc., 88 B.R. 21 (Bankr. N.D.N.Y. 1988).

Ouimet II is the second of two frequently cited opinions rendered by the Court of Appeals for the First Circuit arising out of the termination of an underfunded pension plan sponsored by two bankrupt subsidiaries of Ouimet Corp. Other members of the same controlled group (who were not sponsors of the terminated pension plan) remained viable enterprises, and the PBGC filed suit to recover the termination liability from the entire Ouimet controlled group. The Ouimet II court found that the non-employer solvent member of the controlled group was fully liable for the underfunding and that no Congressional policy or objective justified the imposition of a right of contribution. Indeed, the court surmised that in the face of such a legislative void any other conclusion would have been tantamount to judicial legislation. See also Texas Industries, 451 U.S. 630 (1981), in which the Supreme Court rejected outright the equation of joint and several liability with the right of contribution. Texas Industries, 451 U.S. at 646.

By contrast, Northeast Dairy concluded in dicta and without elaboration that a right of contribution was established under Title IV through the inclusion of joint and several liability under ERISA. Northeast Dairy, 88 B.R. at 23. The court observed that "Joint and several liability establishes that the ... [obligors] ... may, through contribution, seek from each other the excess of their proportionate share of the withdrawal liability . . ." Id.

II. CLAIMS FOR UNPAID BENEFIT PLAN CONTRIBUTIONS IN BANKRUPTCY

A. Claims Brought by PBGC or Plan

Claims for due and unpaid contributions to an employee benefit plan may be brought against the debtor by the plan itself or, in the case of a defined benefit plan, by the PBGC (on a contingent basis if the plan has not been terminated). The plan administrator may

have a fiduciary duty to file a claim for due and unpaid contributions against the debtor, even if the PBGC files claims on behalf of the plan.

B. Priority Claims for Unpaid Pre-Petition Contributions

Under Section 507(a)(4) of the Bankruptcy Code, claims for unpaid contributions to employee benefit plans (both pension and welfare plans) arising from services during the 180-day period prior to the earlier of the petition date or the cessation of business are entitled to a limited priority (to the extent of the \$4,650 per employee statutory limit). See In re Saco Dev. Corp., 23 B.R. 644 (Bankr. D. Me. 1982), affd., 711 F.2d 441 (1st Cir. 1983); Columbia Packing, 47 B.R. 126, 130-31 (Bankr. D. Mass. 1985) (finding priority under 507(a)(4), even for the past service liability component attributable to the priority period). For purposes of Section 507 of the Bankruptcy Code, reimbursements under a self-insured medical plan and unpaid premiums owed to an insurance company for coverage and administrative services are generally considered as contributions to an employee benefit plan. See In re Braniff, Inc. 218 B.R. 628 (Bankr. M.D. Fla. 1998); In re Maxwell Newspapers, Inc., 192 B.R. 633 (Bankr. S.D.N.Y. 1996); In re Jet Florida Systems Inc., 80 B.R. 544 (S.D. Fla. 1987). But see, In re Aer-Aerotron, Inc., 182 B.R. 725 (Bankr. E.D.N.C. 1995) (claims for unpaid insurance premiums do not arise from services within the meaning of the statute); In re Edward W. Minte, Company, Inc., 286 B.R. 1 (Bankr. D.C. 2002) (fourth level priority for allowed unsecured claims for contributions to an employee benefit plan arising from service rendered within 180 days before the petition filing date is limited to services rendered by employees, not services rendered by a third party). In determining whether the payment at issue arises “from services rendered with 180 days preceding the filing” the court in In re A.B.C. Fabrics of Tampa, Inc., 259 B.R. 759 (Bankr. M.D. Fla. 2001) examined when the debtor’s obligations to make payments arose, and concluded

that if the obligation with respect to a covered employee arose within such 180 day period, the claim should be afforded priority status. Id. At 766. Alternatively, the determination has been found to rest on when the services to which the claim relates were provided (i.e., within the 180 day period), without regard to when the claim arose. See In re Braniff, Inc. 218 B.R. at 631. The 507(a)(4) claim of a benefit plan is limited to \$4,650 multiplied by the number of covered employees. Covered employees do not include retired employees who may be covered under the plan. In re Crafts Precision Industries, Inc., 244 B.R. 178 (2000). The amount of the plan's Section 507(a)(4) priority claim is reduced, dollar-for-dollar, by the priority amounts paid to the same employees under Section 507(a)(3) of the Bankruptcy Code for wages, salaries, commissions (including vacation, severance and sick leave pay) earned during the 90-day period prior to the earlier of the filing of the petition or the cessation of business, and further reduced by the amount paid on behalf of such employees to any other employee benefit plan. The priority amount contributed (or reimbursed) for any employee under Section 507(a)(4) is not subject to a \$4,650 per employee limitation, but is an aggregate limit on the plan's priority claim. In re Edgar B., Inc., 200 B.R. 119, 124 (M.D.N.C. 1996); In re Braniff, Inc., 218 B.R. 628, 635 (M.D. Florida 1998).

C. Post-Petition Contributions to Defined Benefit Pension Plans

1. Normal Cost Portion

Contributions which are attributable to services rendered post-petition constitute administrative expenses under Section 503(b)(1)(A) of the Bankruptcy Code as "actual, necessary costs and expenses of preserving the estate." Thus, the "normal cost" portion of a defined benefit pension plan contribution attributable to the post-petition period of the plan year

can be paid to the plan as an administrative expense. See In re Sunarhauserman, Inc., 126 F.3d 811 (6th Cir. 1997); In re Columbia Packing Co., 47 B.R. 126.

2. Past Service Portion

That portion of a post-petition contribution which is not a part of the normal (or current) cost, but rather is attributable to the amortization of past service liability, is attributable to pre-petition services and hence should be treated as a pre-petition liability for bankruptcy purposes. See Sunarhauserman, 126 F.3d at 819; In re Finley, Kumble, 160 B.R. 882 (Bankr. S.D.N.Y. 1993); In re Chateaugay Corp., 115 B.R. 760 (Bankr. S.D.N.Y. 1990), aff'd 130 B.R. 690 (S.D.N.Y. 1991) (vacated by request of parties). But see the earlier case of Columbia Packing, which upheld priority treatment for the entire past service portion of contributions coming due post-petition on the theory that such amounts are a necessary cost of doing business for the debtor and should be entitled to priority as an administrative expense.

D. Claims for Contributions to Defined Contribution Plans

Post-petition contributions to a defined contribution plan will be deemed a priority administrative expense under Section 507(a)(1) of the Bankruptcy Code if the obligation accrues during the administrative priority period. In In re The Greater Southeast Community Hospital Foundation, Inc., 267 B.R. 7 (Bankr. D.C. 2002), the plan required employees to be employed on the last day of a plan year in order to be entitled to a contribution for the year. The court held that the full annual contribution is entitled to administrative priority for the year of the filing. Although the debtor in Greater Southeast Community Hospital argued that the priority of the claim should be limited to the portion of the contribution related to services performed during the 180 day period, the court concluded that the plan contribution was not calculated on a per diem basis and thus the liability under the plan was an all or nothing proposition predicated on the

employees' being employed on December 31st. Id. At 61. Contributions for employees who were not employed on the last day of the plan year, "and who were entitled to contributions under a plan because they retired, died or became disabled during the year, were not entitled to priority under Section 507(a)(4) of the Bankruptcy Code if they died, retired or became disabled more than 180 days prior to the filing. Id. at 30. Greater Southeast Community Hospital Foundation attempted to distinguish Sunarhauserman, because the portion of the debtor's funding obligation in Sunarhauserman was an established pre-petition liability although it was payable post-petition, while the funding obligation in Greater Southeast Community Hospital Foundation did not exist pre-petition and actually came into being post-petition. Id. at 23. However, the case is difficult to reconcile with the prevailing analysis of the defined benefit contribution and withdrawal liability cases.

E. PBGC Lien

If a defined benefit pension plan is underfunded, failure to make cumulative required quarterly or annual contributions of more than \$1 million will result in the imposition of a statutory lien in favor of the plan on the due date for the required installment. Section 412(n)(1) of the Code and Section 302(f)(1) of ERISA. The lien is imposed on the property of the employer and all members of its controlled group, under Section 414(b), (c), (m) and (o). of the Code. Section 412(n)(6) of the Code and Section 302(f)(6) of ERISA.

The employer must (i) notify the PBGC within 10 days of any missed payment, and (ii) notify all plan participants and beneficiaries within 60 days of the missed payment unless a funding waiver request has been filed. Section 412(n)(4)(A) of the Code and Section 101(d) of ERISA.

The lien imposed is to be treated as a tax due and owing the U.S. and rules similar to those imposed under Title IV of ERISA for the benefit of the PBGC shall apply. See Section 4068 of ERISA. Only the PBGC or, at its direction, the plan sponsor may perfect and enforce the lien. Section 412(n)(5) of the Code. Under Section 4068 of ERISA, and Section 6323(f) of the Code, in order for the lien to be perfected it must be filed in the office designated for the filing of real or personal property liens under the law of the state where the property is situated, or in the case of personal property, where the taxpayer resides at the time the notice is filed. If the employer (or any member of its controlled group) is in chapter 11, the automatic stay of Bankruptcy Code §362 will prevent the lien from being perfected or enforced. Nonetheless, the PBGC has argued that its claim for contributions coming due post-petition for which a lien could have been imposed under Section 412 of the Code is entitled to the same priority status as tax claims under Section 507(a)(8) of the Bankruptcy Code. The PBGC's position was rejected in In re CF&I Fabricators of Utah, Inc., 150 F. 3d 1293, 1298 at note 4 (10th Cir. 1998) cert. denied 119 S. Ct. 2020 (1999). The court held that while a PBGC lien which is created and has been perfected pre-petition would be entitled to the tax priority under Section 507(a)(8) of the Bankruptcy Code, a PBGC claim for contributions which first becomes due post-petition would be treated as a general unsecured claim under In re Chateaugay and In re Finley, Kumble, supra.

F. IRS Excise Tax For Failure to Meet Minimum Funding Requirements
(Code Section 4971)

Under Section 4971 of the Code, the sponsor of a defined benefit pension plan (and each member of its controlled group) which has an accumulated funding deficiency (i.e., failure to meet annual minimum funding requirements) is subject to a 10% tax on the amount of the deficiency. (If not corrected, the employer can also become subject to a second-tier 100%

tax, but the period for correction is held open by the bankruptcy proceeding.) . Although it is characterized as a "tax" under the Code, the Supreme Court held that the IRS' claim for a Section 4971 tax is a penalty, not a tax, for purposes of the Bankruptcy Code. In re CF&I Fabricators of Utah, Inc., 518 U.S. 213 (1996). Therefore, the IRS' claim under Section 4971 of the Code which results from the debtor's failure to make a required contribution will be a pre-petition general unsecured claim if it either (i) relates to a pre-petition year or (ii) is the non-normal cost portion of a required contribution for a post-petition year. The Supreme Court reversed the equitable subordination (under Section 510 (c) of the Bankruptcy Code) of the IRS' claim under Section 4971 of the Code to other creditors, because the lower courts could not automatically subordinate all such IRS claims, but held open the possibility that the IRS claims could be equitably subordinated on other grounds. In re CF&I Fabricators of Utah, supra.

G. IRS Excise Tax on Reversions (IRC Section 4980)

Under Section 4980 of the Code, an excise tax of 50% is imposed on the amount of any reversion to an employer from a qualified plan (unless the employer establishes a replacement plan, in which case the tax is at a lower rate of 20%). The issue of whether the Section 4980 tax on a reversion that occurs post-petition on account of the termination of a plan during the pendency of a bankruptcy proceeding is a tax or a penalty for bankruptcy purposes was addressed by the Internal Revenue Service in Private Letter Ruling 200005001 (2000WL 127521). The IRS, citing In re Juvenile Shoe Corporation of America, 99 F.3d 898 (8th Cir. 1996), concluded that the Section 4980 excise tax is entitled to priority in bankruptcy because, unlike the Section 4971 tax, the purpose of the Section 4980 tax is to support the government rather than to penalize an unlawful act. The IRS also concluded that the tax was an excise tax

incurred by the estate post-petition and thus entitled to administrative claim priority because the tax arose only as a result of a pre-petition event.

H. Joint and Several Liability

As noted above, the minimum funding rules and IRS excise taxes (Section 4971) apply to the plan sponsor and each member of its controlled group on a joint and several basis. If the debtor has controlled group members which are not in a bankruptcy proceeding, the chapter 11 protection afforded the plan sponsor will not protect the non-filed affiliate. Therefore, the other members of the plan sponsor's controlled group who have substantial assets and revenues may have to fund the plan in order to avoid liens and IRS excise taxes, or alternatively file their own chapter 11 case.

III. **TERMINATION OF AN UNDERFUNDED PENSION PLAN**

A. General

An underfunded pension plan can be terminated only by satisfying the distress termination rules of Section 4041 of ERISA or by an involuntary termination by the PBGC pursuant to Section 4042 of ERISA. If the plan is maintained pursuant to collective bargaining, the union's consent is required for a distress termination; union consent is not required for an involuntary termination by the PBGC under Section 4042 of ERISA. Section 4041(a)(3) of ERISA.

B. Grounds for Involuntary Termination (ERISA Section 4042)

The PBGC must terminate a pension plan if it determines that the plan does not have assets available to pay benefits which are currently due under the terms of a plan. The PBGC may, in its discretion, terminate an underfunded plan if, among other things, the employer has not satisfied the minimum funding requirements under the Code, or the possible long-run

loss to the PBGC may reasonably be expected to increase unreasonably if the plan is not terminated. Section 4042(a) of ERISA.

C. Distress Termination (ERISA Section 4041 (c))

An underfunded pension plan may be terminated by the employer only pursuant to the distress termination provisions of Section 4041 of ERISA. Under Section 4041, one of the following conditions must be satisfied for a termination.

1. An employer will qualify for a distress termination if the PBGC finds that the contributing sponsor, and each member of its controlled group, satisfies one of the following provisions:

- i. unless a distress termination occurs, such person will be unable to pay its debts when due and will be unable to continue in business, or
- ii. the cost of providing pension coverage has become unreasonably burdensome solely as a result of a decline of such person's workforce covered as participants under all single-employer plans of which such person is a contributing sponsor.

2. In lieu of satisfying the distress criteria in 1 above, a chapter 11 debtor can qualify for distress termination if the bankruptcy court determines that unless the plan is terminated, such person will be unable to pay all of its debts pursuant to the plan of reorganization and will be unable to continue in business outside of chapter 11. Section 4041(c)(2)(B)(ii) of ERISA. See In re Intellogic Trace, Inc., Case No. 94-52172-C (Bankr. W.D. Tex. 1994). See also In Re US Airways Group, Inc. 296 B.R. 734 (Bankr. E.D. Va., March 7,

2003), finding that the debtor satisfied the financial requirements for a distress termination, but reserving for further consideration the issue of whether or not a distress termination would violate the conditions of the labor agreement covering plan participants, in violation of Section 1113 of the Bankruptcy Code. A bankruptcy court can make this determination prior to the debtor's submission of a plan of reorganization. See In the Matter of Sewall Manufacturing Company, Inc., 195 B.R. 180 (Bankr. N.D. Ga. 1996).

3. Liquidation is a separate predicate for a distress termination. Section 4041 (c)(2)(B)(ii) of ERISA.

4. If the debtor is a member of a controlled group, each member must meet one of the distress criteria described above, (but not necessarily the same distress criteria), in order to satisfy the requirements for a distress termination.

D. Date of Plan Termination

The termination date of a single-employer plan that is terminated by the PBGC in an involuntary termination in accordance with Section 4042 of ERISA, is the date established by the PBGC and agreed to by the plan administrator, or in any case in which there is no agreement between the plan administrator and the PBGC (or the trustee), the date established by the court. Section 4048(a) of ERISA. However, since ERISA does not provide an express standard to guide a court's analysis in establishing the termination date, the criteria for such determination has been developed by caselaw. The termination date "should be selected in order to protect the interests of the participants and avoid any further deterioration of the financial condition of the plan or any unreasonable increase in the liability of the fund." See Pension Benefit Corp. v. Heppenstall Co., 633 F.2d 293, 301-02 (3rd Cir. 1980). The Heppenstall Court utilized a three

part analysis to apply its standard: first identify the interests of all of the plan participants and the PBGC, second establish the earliest and latest dates which maximize those respective interests, and third, set the termination date accordingly. Id. at 302-03. The court in Pension Benefit Guaranty Corp. v. Broadway Maint. Co., 707 F.2d 647 (2d. Cir. 1983), summarized the Heppenstall standard as determining the earliest date when the plan's participants had actual or constructive notice (i.e., notice sufficient to extinguish their reliance interest) and then selecting whatever later date serves the interest of PBGC. 707 F.2d at 652-653.

Most recently issue of determining the appropriate date of termination was examined in Pension Benefit Guaranty Corporation v. Republic Technologies International, LLC, 287 F. Supp. 2d 815 (N.D.O. September 30, 2003), in which the PBGC's proposed termination date would have had the effect of eliminating the shut-down benefits provided under the defined benefit plan. After specifically adopting the Heppenstall standard and Heppenstall's three step analysis, the Republic Technologies Court determined that the Broadway Maintenance two step application of the Heppenstall standard was inadequate to analyze the Republic Technologies situation because shut-down benefits, unlike other benefits subject to contingent events, are totally dependent on the financial health of the employer. After noting the "strong reliance" interests the plan participants maintain in shut-down benefits, the court found that the relative reliance interest greatly exceeds the interests in the traditional pension benefits present in Broadway Maintenance. The Republic Technologies court determined that the unique nature of shut-down benefits and facts presented required the court "to weigh the relative strength of the interests in shut-down benefits in proportion to the interests of the PBGC – rather than to defer to the date PBGC issued notices of determination of the termination of the plans. Id. at 43. After affording some level of deference to the PBGC's

choice of date, the court ultimately selected August 17, 2002 to be the date of plan termination for two of the plans at issue rather than the PBGC's June 14, 2003 date. Id. at 47.

IV. PBGC TERMINATION LIABILITY IN CHAPTER 11

A. Amount of PBGC Claim

The contributing sponsor (and each member of its controlled group) is subject to a termination liability claim of the PBGC upon the termination of an underfunded single employer pension plan equal to the total amount of the unfunded benefits and interest at a reasonable rate from the termination date. Section 4062(b) of ERISA.

B. PBGC Lien for Guaranteed Benefits

Upon termination, a lien arises in favor of the PBGC equal to 30% of the net worth of the employer and each member of its controlled group. The PBGC is entitled to perfect the lien against the sponsor and members of the controlled group at the time of plan termination in the same manner as a tax lien under Section 6323 of the Code. However, as to the debtor and each other member of its controlled group which has filed a petition in bankruptcy, the automatic stay of Section 362 of the Bankruptcy Code will prevent the lien from being perfected or enforced, if it arises post-petition.

C. Status and Amount of PBGC Termination Claim

There are several decisions holding that the PBGC's claim arising from termination of an underfunded pension plan should not be considered an administrative expense claim under Section 507(a)(1) of the Bankruptcy Code (as the PBGC often argues). The cases have held that the mere termination of the plan post-petition does not render the resulting claim an administrative expense, if (and to the extent) the services related to the accrual of the benefits

were performed pre-petition. See Bayly Corporation, Pension Benefit Guar. Corp. v. Skeen, 163 F.3d 1205 (10th Cir. 1998); Amalgamated Ins. Fund v. William B. Kessler, Inc., 55 B.R. 735 (S.D.N.Y. 1985); PBGC v. LTV Corp., 87 B.R. 779 (S.D.N.Y. 1988), aff'd, 875 F.2d 1008 (2d Cir. 1989), rev'd on other grounds, 496 U.S. 633 (1990); and In re Finley, Kumble, supra. See also Trustees of the Amalgamated Ins. Fund v. McFarlin's, 789 F.2d 98 (2d Cir. 1986);

In In re CF&I Fabricators of Utah, Inc., 19 EBC 2371 (Bankr. D. Utah 1995), the Court determined that a "bankruptcy claim" interest rate of 12.3% be utilized to value the amount of the PBGC claim and not the PBGC interest rates. This followed the earlier decision in Chateaugay (LTV) (withdrawn by consent of the parties). Similarly, in In re CSC Industries, Inc., 232 F.3d 505 (6th Cir. 2000), rehearing denied, January 30, 2001, the Sixth Circuit held that the "prudent investor rate" of 10%, rather than the PBGC interest rates, was an appropriate valuation tool for a claim involving unfunded benefit liabilities in a bankruptcy context. In reaching its decision, the Sixth Circuit noted, in accordance with the Supreme Court case of Raleigh v. Illinois Department of Revenue, 530 U.S. 15, 120 S. Ct. 1951, 147 L. Ed.2d 13 (2000), that while the validity of a claim might be a matter of nonbankruptcy law, bankruptcy courts have the statutory authority to determine the allowability and amount of the claim. 232 F.3d 509.

The PBGC's claim for unfunded benefit liabilities arising on the termination of a plan must be reduced on a dollar-for-dollar basis by any allowed claim for minimum funding contributions to the plan to avoid duplication of claims. In re Simetco, Inc., Civ. No. 93-61772, 1996 WL 651001 (Bankr.N.D. Ohio Feb. 15, 1996).

D. Tax Priority

With respect to that portion of the PBGC termination claim which would entitle it to a lien outside of bankruptcy, the PBGC has asserted that such claim is entitled to priority as a tax claim under Section 507(a)(8) of the Bankruptcy Code, because under Section 4068 of ERISA, the PBGC's lien is afforded treatment under the Bankruptcy Code as a tax due and owing to the United States. However, if the PBGC's lien has not been perfected prior to the petition date (as is usually the case), the PBGC's claim should not be entitled to treatment as a Bankruptcy Code Section 507(a)(8) priority tax claim. See In re Tenn-Ero Corp., 14 B.R. 884 (Bankr. D. Mass. 1981), aff'd sub nom; PBGC v. Ouimet Corp., 32 B.R. 65 (D. Mass. 1982); In re Divco Philadelphia Sales Corp., 64 B.R. 232 (Bankr. E.D. Pa. 1986); In re CSC Industries, Inc., 232 F.3d 505. But see PBGC v. The Washington Group, Inc., Civ. No. C-86-665 G, 1987 U.S. Dist. Lexis 5686 (M.D.N.C., Mar. 9, 1987), in which the court held that policy considerations support the PBGC's contention that its claim has priority.

V. **WITHDRAWAL LIABILITY**

A. General

If an employer withdraws from a multiemployer plan in a complete or a partial withdrawal, the employer is liable to the plan for an amount determined to be the withdrawal liability. Section 4201(a) of ERISA. The amount of the withdrawal liability is the amount of the unfunded benefits allocable to the employer determined under Section 4211 of ERISA as adjusted pursuant to Sections 4209, 4206 and 4219 of ERISA. Section 4201(b) of ERISA.

B. Status of Claim for Withdrawal Liability

A multiemployer plan's claim for the payment of withdrawal liability is not considered an administrative expense claim under Section 507(a)(1) of the Bankruptcy Code,

even if the withdrawal from the plan, which is the event that triggers the liability, occurs post-petition. Trustees of the Amalgamated Insurance Fund v. McFarlin's, Inc., 789 F.2d 98 (2nd Cir. 1986). Because withdrawal liability relates to contributions to the plan for prior years, the consideration supporting the withdrawal liability (the pre-petition service of the employees) was provided to the employer in prior years and was not provided to the debtor-in-possession. Since the employer's withdrawal liability payment is for benefits earned by the employees' past service, it is not an administrative expense. *Id.* at 103-104.

The right to payment of withdrawal liability incurred upon the post-confirmation withdrawal from a multiemployer plan was discharged upon the confirmation of a plan of reorganization, because the claim was a contingent claim and thus among the debts discharged. In re CD Realty Partners, 205 B.R. 651 (D. Mass. 1997). Because the debtor's employees held vested claims for pension benefits under the multiemployer plan, ERISA required all employers (whether or not withdrawn) to bear their share of the underfunding liability. The court in CD Realty held that in light of the fact that a near term withdrawal could have been contemplated at the confirmation of the plan of organization, the debtor's withdrawal liability was a claim when the debtor's plan of reorganization was confirmed and thus was discharged and no longer enforceable. *Id.* at 20-24.

VI. SEVERANCE PAYMENTS IN BANKRUPTCY

As described in paragraph II.B above, claims for unpaid contributions to employee benefit plans arising from services during the 180-day period prior to the petition date are entitled to a limited priority pursuant to Section 507(a)(4) of the Bankruptcy Code. The treatment of claims for severance benefits related to the post-petition termination of an employee's service will depend upon the basis of the calculation of the amount of severance and the circuit in which the chapter 11 petition is filed.

The minority view, followed only in the Second Circuit, is that severance payable on the post-petition termination of an employee is an administrative expense because it is compensation for the post-petition termination of employment. Straus-Duparquet, Inc. v. Local Union No. 3 International Brotherhood of Electrical Workers, AF of L, CIO, 386 F.2d 649 (2nd Cir. 1967); W.T. Grant Company v. Rinier, 620 F.2d 319 (2nd Cir. 1980). The majority view, followed by the First, Third, Ninth and Tenth Circuits, is that the priority status of severance depends on the severance plan or agreement. See, Matter of Health Maintenance Foundation, 680 F.2d 619 (9th Cir. 1982). Under the majority view, when the amount of severance is determined with reference to length of service, the severance is deemed to be earned over the entire period of employment and is entitled to administrative priority only to the extent accrued post-petition. In re Mammoth Mart, Inc., 536 F.2d 950, 955 (1st Cir. 1976); In re Redco, Inc., 2003 Bankr Lexis 259 (Bankr. C.D. Illinois, April 2, 2003). See also, In Re Acoustiseal, Inc. 30 E.B.C. 1071 (Bankr. W.D. Mo. 2003) (first finding that certain employee claims for severance which were not based on length of service and arose under pre-petition retention agreements were pre-petition general unsecured claims, and then finding that certain other employee claims for severance benefits which were based on length of service were partially pre-petition claims, partially 507(a)(3) priority claims and partially administrative claims depending on whether the claim was based on pre-petition service more than 90 days before the filing of the petition, service within 90 days of the filing of the petition or on post-petition service). However, severance in lieu of notice with respect to a post-petition termination of service is entitled to administrative expense priority under the majority view, because the severance was earned upon the termination without notice. In re Tuscon Yellow Cab Co., 789 F.2d 701, 704 (9th Cir. 1986); In re Public Ledger, Inc., 161 F.2d 762 (3rd Cir. 1947).

The priority of severance which is neither in lieu of notice nor based on length of service is determined based on the general rules governing the granting of administrative expense priority, i.e. whether (i) it results from a transaction between the claimant and debtor-in-possession and (ii) the benefit to the debtor accrues post-petition. In In re Phones For All, Inc. et.al., 262 B.R. 914 (N.D.Tex. 2001), aff'd 288 F.3d 730 (4th Cir. 2002). In order for a claim for severance to be recognized as an administrative expense, the liability must arise post-petition from a transaction with a debtor-in-possession and be in exchange for consideration supplied to and beneficial to the debtor-in-possession in the operation of its business. In re Amarex, Inc., 853 F.2d 1526, 1530 (10th Cir. 1988); In re Commercial Financial Services, Inc., 246 F.3d 1291-1294-1296 (10th Cir. 2001). If the consideration supporting a severance claim is rendered pre-petition, the claim is not entitled to priority. In re FBI Distribution Corp., 330 F.3d 36 (1st Cir. 2003) (administrative priority was denied to a claim for severance benefits because the consideration for the severance benefits was found by the court to be the pre-petition foregoing of other employment opportunities.)

VII. RETIREE HEALTH AND WELFARE BENEFITS IN BANKRUPTCY

Under Section 1114 of the Bankruptcy Code, payments to retired employees, their spouses and dependents for "medical, surgical or hospital care benefits or benefits in the event of sickness, accident, disability or death" under a plan maintained or established by a debtor prior to the filing of a chapter 11 petition must be continued until a proceeding is commenced under Section 1114 and the bankruptcy court enters an order modifying or terminating such benefits. In effect, retiree medical benefits are a "super priority" administrative expense in a chapter 11 proceeding, until they are modified or terminated pursuant to the statutory procedures of Section 1114 of the Bankruptcy Code.

A. Termination of Benefits

Some courts have held that if benefits could otherwise be modified or terminated outside of a bankruptcy, because of a valid reservation of rights, a debtor may exercise such right to modify or terminate the plan without proceeding under Section 1114. See In re Doskocil Companies, Inc., 130 B.R. 870 (Bankr. D. Kan. 1991); In re New Valley Corp., No. Civ, A-92-4884, 1993 WL 818245 (D.N.J. Jan. 28, 1993); In re North American Royalties, Inc., 276 B.R. 860 (Bankr. E.D. Tenn. 2002). See also Ames Dept. Stores, Inc. v. Zayre Central Corp., 76 F.3d 66 (2d Cir. 1996) (holding that the issue of whether Section 1114 defeats reservation of rights language is open to debate). But, see In re Farmland Industries, Inc., 294 B.R. 903 (Bankr. W.D. Mo. 2003) (denying debtors' motion to terminate retiree life insurance benefits provided under pre-bankruptcy plan documents which included the debtors' reservation of the absolute right to unilaterally terminate benefits).

A plan of reorganization must provide for the continuation of retiree medical benefits coming out of bankruptcy at the level established under Section 1114. See Bankruptcy Code Section 1129(a)(13). However, Section 1129 does not vest any retiree medical benefits which were not otherwise treated as vested under the retiree medical plan. Matter of Federated Department Stores, Inc., 132 B.R. 572 (Bankr. S.D. Ohio 1991).

B. Payments Covered

In addition to payments to retired employees, their spouses and beneficiaries, and payments to medical providers and medical facilities that provided services to such retirees, spouses and beneficiaries, Section 1114 has been found to apply to contributions to a multiemployer health fund mandated by a collective bargaining agreement because such contributions are "retiree benefits" within the meaning of Section 1114(a). In re Certified Air

Technologies, Inc., 300 B.R. 355, 370-371 (S.D. Calif. 2003) (debtor's contributions to a multiemployer health fund for retirees are covered by Section 1114(a) even though the debtor may not currently have retired employees receiving benefits from the health fund).

C. Lack of Free Funds

Notwithstanding Section 1114, retiree benefits need not be paid if the debtor does not have any unencumbered funds available. See In re GF Corp., 120 B.R. 421 (Bankr. N.D. Ohio 1990); In re Jones and Lamson Mach. Co., Inc., 102 B.R. 12 (Bankr. D. Conn. 1989).

D. Liquidating Chapter 11 Cases

Section 1114 does not apply to a chapter 7 liquidation. However, Section 1114 has been held to apply to liquidating chapter 11 cases. See In re Garfinckels, Inc., 124 B.R. 3 (Bankr. D.D.C. 1991); In re Ionosphere Clubs, Inc., 134 B.R. 515 (Bankr. S.D.N.Y. 1991).

E. Expiring Benefits

Section 1114 does not require a continuation of benefits which are no longer an obligation of the debtor under the terms of the relevant plan or contract without regard to the chapter 11 case. See In re Chateaugay, 945 F.2d 1205 (2d Cir. 1991), cert. denied, 112 S. Ct. 1167 (1992) in which the obligation to make contributions ceased at the expiration of the union contract. See also, In re CF&I Fabricators of Utah, Inc., 163 B.R. 858 (Bankr. D. Utah 1994).

VIII. COBRA LIABILITY IN BANKRUPTCY

A. Generally

The Consolidated Omnibus Budget Reconciliation Act of 1986 as amended (“COBRA”) added companion provisions to the Code and ERISA, requiring employers who maintain group health plans to offer continuation coverage to former employees and their

dependents in certain circumstances. Section 601-606 of ERISA and Section 4980B of the Code. In general, an employer who maintains a group health plan must offer each “qualified beneficiary” (i.e., employee, covered spouse and dependents) who would otherwise lose coverage as a result of a “qualifying event” (e.g., termination of employment, divorce, death or disability) the opportunity to elect continuation of the coverage received immediately before the qualifying event. Section 4980B(f)(2)(A), 4980B(f)(3) and 4980B(g)(1) of the Code. The employer may charge the qualified beneficiary a monthly premium of up to 102% of the cost of coverage. Generally, COBRA coverage may be elected for periods of eighteen months by terminated employees, twenty-nine months by disabled employees, and thirty-six months by covered spouses and dependents. Section 4980(B)(f)(2)(B) of the Code. However, coverage may be terminated prior to its usual expiration in certain circumstances commonly referred to as COBRA “cut-off events”. Id. Cut-off events include (i) a recipient's Medicare entitlement, (ii) an employer's cessation of all group health coverage for all of its employees and (iii) failure of the qualified beneficiary to pay required premiums. Id. For purposes of COBRA, the “employer” that is obligated to provide COBRA coverage is not only the employer for whom an employee provides services but includes any person or entity that is part of such employer’s “controlled group” (as described in I.A., above) and any successor entity. Treas. Reg. §54.4980 B-2 Q&A2 and §54.4980B-9 Q&A8.

There are several classes of potential COBRA recipients to consider with respect to the termination and modification of medical benefits provided by a chapter 11 debtor to active employees and retirees, including (i) current COBRA recipients, (ii) all employees whose employment will not be continuing with the debtor and (iii) all current retirees.

B. COBRA Beneficiaries.

If a debtor terminates all of its medical plans, the employer no longer has any obligation to provide COBRA coverage to active employees or retirees. However, if a debtor terminates its medical plan for active employees and replaces it with a new medical plan, former employees who were receiving COBRA benefits under the terminated plan, as well as those employees who will be terminated prior to the effective date of the new plan, will have COBRA rights vis-à-vis the new plan. Treasury Regulations indicate that COBRA coverage will not expire if an employer maintains a "successor plan". Treas. Reg. § 54.4980B-7 Q&A 1(a)(3). Although there is no definition of successor plan in the regulations or other guidance indicating the time lapse required before a new plan is not deemed to be a successor plan, it seems clear that the simultaneous provision of a new group health plan would qualify as a successor plan. Therefore, the termination of debtor's old coverage for active employees would not appear to constitute a cut-off event and pre-confirmation COBRA beneficiaries should have continuing rights against the debtor for the balance of their period of coverage. However, since the coverage provided must only be identical to the coverage provided to similarly situated employees with respect to whom a qualifying event has not occurred, their COBRA rights will be limited to the amount of the modified benefit provided to continuing employees.

C. Current Retirees.

The elimination of medical coverage by an employer who filed a chapter 11 petition or the "substantial elimination" of medical benefits within one year before or after the institution of chapter 11 proceedings with respect to the employer from whose employment the covered employee retired, constitutes a COBRA qualifying event for retirees, their covered spouses and their dependents. Section 4980(B)(f)(3)(F) of the Code. A retiree may elect such

COBRA continuation coverage for life (i.e., no time limit) and is not subject to cut-off on account of Medicare entitlement. Section 4980B(f)(2)(B) of the Code. Once the retiree dies, his or her surviving spouse and dependant children, if any, are also entitled to elect and pay for 36 months of coverage from the date of the covered retiree's death. Id.

There is an additional issue as to what kind of coverage must be offered to a retiree whose retiree medical coverage has been eliminated or substantially reduced and how the annual premium is to be calculated. Ordinarily, each qualified beneficiary must be offered the opportunity to elect to continue the same health benefit coverage that was available to him immediately before the qualifying event. Section 4980B(f)(2)(A) of the Code; Treas. Reg. § 54.4980B(Q&A 4). Similarly, the premium for COBRA coverage cannot exceed 102% of the cost to the plan for similarly situated beneficiaries for whom no qualifying event has occurred. Section 4980B(f)(4)(A) of the Code. If there are no similarly situated employees or retirees for whom no qualifying event will have occurred, the determination of COBRA coverage to be offered pre-confirmation retirees is not so simple.

If retirees will either receive a reduced benefit or no coverage there could be a question as to what coverage must be offered. Neither COBRA nor its legislative history contemplate how to treat retirees in this situation. However, since the only potential answer would be to permit such retirees to elect the same coverage as will be provided to active employees by the debtor or not to allow them to elect continuation coverage at all, it would appear that retirees would be entitled to elect to receive coverage similar to the coverage provided to active employees.

D. Business Reorganizations

Unless the obligation for providing COBRA coverage is specifically allocated in a purchase agreement, in the case of either a stock or asset sale, the controlled group (of corporations or trades or business) that prior to the sale included the employer (the “selling group”) has the obligation to provide COBRA coverage to beneficiaries whose qualifying event occurred prior to or in connection with the sale (the “M&A qualifying beneficiaries”), unless no member of the selling group maintains a health plan after the sale. Treas. Reg. § 54.4980B-9. If the selling group ceases to provide any group health plan to any employee after the sale, the controlled group (of corporations or trades or business) that has acquired the stock or assets (the “buying group”) has the obligation to provide COBRA coverage to M&A qualifying beneficiaries for as long as any member of the buying group maintains a group health plan. In the case of an asset sale, the obligation to provide COBRA coverage applies to the buying group as a successor employer, but only if the buying group continues without interruption or substantial change the business operations associated with the purchased assets. The buying group will be a successor employer for this purpose even if the assets are purchased in connection with a chapter 11 proceeding. Treas. Reg. § 54.5980B-9 Q&A 8(c)(1).

IX. BENEFITS PROVIDED UNDER A COLLECTIVE BARGAINING AGREEMENT

Section 1113 of the Bankruptcy Code sets forth the procedures and standards for the rejection of a collective bargaining agreement (“CBA”) by a debtor in a chapter 11 proceeding. Section 1113 requires that the debtor adhere to the terms of a CBA pending authorization to reject or modify the CBA in accordance with Section 1113. A debtor is required to comply with all the provisions of a CBA unless and until rejection is permitted by the court. United Steelworkers of America v. Unimet Corporation, 842 F.2d 879, 882 (6th Cir. 1988), cert. denied, 488 U.S. 828 (1988). The courts are split as to whether Section 1113 compels the

payment post-petition of a claim which arose pre-petition or a “super priority” status, for wage and benefit obligations under a debtor’s CBA. The majority view is that claims arising under a CBA are subject to the priority scheme established by Section 507 of the Bankruptcy Code. In re Roth American, Inc., 975 F.2d 949, 954-58 (3rd Cir. 1992); In re Armstrong Store Fixtures Corp., 135 B.R. 18, 22 (Bankr. W.D.Pa. 1992); Adventure Res., Inc. v. Holland, 137 F. 3d 786, 797 (4th Cir. 1998) . Under this view, although a debtor cannot unilaterally modify or terminate a CBA or avoid its obligations for benefits thereunder, the financial obligations related to the benefits are accorded priority only to the extent consistent with Section 507 of the Bankruptcy Code. In re Ionosphere Clubs, Inc., 22 F.3d 403, 407 (2nd Cir. 1994). Since Section 1113 does not address the priority to be accorded claims arising for a debtor’s obligations under a CBA, it does not create a super priority status for such claims. Id. See also, In re Jones Truck Lines, Inc., 130 F. 3d 323 (8th Cir. 1997) (Section 1113 does not supersede the Bankruptcy Code’s avoidable preference provisions); In re Certified Air Technologies, Inc., 300 B.R. 355 (pre-petition claims for wages and benefits due under a CBA are not entitled to treatment as administrative expenses but are to be accorded priority consistent with Section 507).

However, the District Court for the Northern District of Ohio has held that Section 1113 provides a super priority status to collectively bargained claims over and above the priorities set forth in Sections 503 and 507 of the Bankruptcy Code. United Steelworkers of America v. Ohio Corrugating Co., 1991 U.S. Dist. Lexis 18815 (N.D. Ohio 1991).

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**RECENT DEVELOPMENTS IN
VALUATION OF PBGC CLAIMS IN BANKRUPTCY**

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The amount of unfunded benefit liabilities of a pension plan terminated in either a distress termination by a plan sponsor¹ or an involuntary termination by the Pension Benefit Guaranty Corporation (“PBGC”)² can vary greatly depending on the actuarial assumptions used to calculate the liability. As a result, disagreement over the PBGC claim for unfunded benefit liabilities can arise in a bankruptcy proceeding. Generally, the unfunded benefit liabilities are calculated by subtracting the value of the plan’s assets as of the plan’s termination date from the total benefit liabilities, fixed and contingent, as of the date of the plan’s termination.³ All benefit liabilities are included in the PBGC’s claim even though the PBGC is only obligated to provide guaranteed benefits (as defined by ERISA) to the participants in a terminated plan. If the PBGC actually collects amounts that exceed the guaranteed benefits, the PBGC will allocate a portion of the additional amounts to each participant.⁴ Note that while the PBGC’s claim equals the total unfunded benefit liabilities, the PBGC can only obtain a lien for the lesser of the unfunded benefit liabilities or 30% of the collective net worth of the plan sponsor and its controlled group members.⁵

¹ ERISA § 4041(c).

² ERISA § 4042.

³ ERISA § 4001(a)(18).

⁴ ERISA § 4022(c).

⁵ ERISA § 4062.

The PBGC will determine the actuarial present value of the unfunded benefit liabilities using the PBGC assumptions set forth in its regulations.⁶ Because the PBGC's interest rate assumption is usually lower than a "prudent investor rate" (discussed below), its claim may initially be much higher than what the bankruptcy court may ultimately permit.

Both the Sixth and Tenth Circuits have held that the prudent investor rate, not the PBGC's interest rate, is the appropriate interest rate to use in calculating the PBGC's claim under the Bankruptcy Code.⁷ In these cases, to ensure that creditors were treated fairly within each class, courts valued the amount of the PBGC's claim using a prudent investor rate, resulting in a more equitable sharing of recovery by all unsecured creditors. *In re CF&I Fabricators*, 150 F.3d 1293 (10th Cir. 1998), *cert. denied* 526 U.S. 1145 (1999) (holding that the unfunded benefit liability definition applied by its terms solely to ERISA and did not therefore obligate the Bankruptcy Court to defer to the PBGC valuation for purposes of claims allowance); *In re CSC Industries*, 232 F.3d 505 (6th Cir. 2000), *cert. denied* 534 U.S. 819 (2001) (finding that the authority of the Bankruptcy Court extends to valuation of unfunded benefit liabilities); *In re Chateaugay Corp.*, 126 B.R. 165 (Bankr. S.D.N.Y. 1991), vacated, *op. withdrawn sub nom.* *The LTV Corp. v. PBGC*, 1993 WL 388809 (S.D.N.Y. 1993) (valuing benefits in a bankruptcy case under prudent investor rate due to the Bankruptcy Court's stated authority to set the applicable discount rate for cash payments subsequent to the filing date). A prudent investor rate is the rate that an average investor earning average returns would earn when invested in a prudent and diversified portfolio designed to minimize risk. *Chateaugay*, 129 B.R. at 176. The PBGC

⁶ ERISA § 4001(a)(18), PBGC Reg. § 4044.

⁷ *In re: CSC Indust., Inc.*, 232 F.3d at 509; *In re: CF&I Fabricators of Utah, Inc.*, 150 F.3d 1293, 1302 (10th Cir. 1998).

termination rates for valuation of unfunded benefit liabilities are lower than most current projections for a rate of return over time. Using PBGC rates, there is a likelihood that the PBGC would earn more than its estimated rate of return, a result unfair to other unsecured creditors.

The Copperweld Steel Corporation's bankruptcy illustrates the significant difference between claims based on the assumptions used to calculate the claim. In that bankruptcy, the PBGC calculated the present value of its claim for unfunded benefit liabilities at \$49,658,702 using an investment return rate of 6.4% for the first twenty years and 5.75% for years thereafter.⁸ Calculating the same claim using a prudent investor rate of 10% resulted in the present value of the claim being \$1,822,075.⁹

More recently, however the United States Bankruptcy Court for the Eastern District of Virginia ruled that PBGC claims for the unfunded benefit liabilities of a terminated pension plan should be calculated using the lower PBGC termination rates rather than the higher prudent investor rate.¹⁰ In *US Airways*, unfunded benefit liabilities equaled \$2.219 billion under the PBGC valuation, and under US Airways' calculation of the prudent investor rate, unfunded benefit liabilities were valued at \$894 million. Use of the PBGC rate could result in a larger recovery to the PBGC at the expense of US Air's other unsecured creditors.

The court addressed the question of whether the Bankruptcy Court has the authority to determine the rate at which the PBGC's claim for unfunded future benefits would be paid. According to the court's analysis, the amount of a creditor's claim is determined under the law giving rise to the claim. Bankruptcy law ultimately has equitable jurisdiction to determine how

⁸ *In re: CSC Indust., Inc.*, 232 F.3d 505, 507-08 (6th Cir. 2000).

⁹ *Id.*

¹⁰ *In re US Airways Group*, No. 02-CV-153-H(M), 2003 WL 23105469 (E.D. Va. 2003).

and whether the claim will be paid, but only after the applicable law, ERISA, sets the amount of the claim. Generally, the Bankruptcy Court will discount future damages to present value, however PBGC's claim is not a simple valuation of a contingent future loss. The court read ERISA to indicate that Congress expressly granted a "*present* right to recover an amount determined in accordance with the valuation regulation." *In re US Airways Group*, 2003 WL 23105469, at *8. Determination of the unfunded benefit liabilities is, according to the court, a determination of the amount owed under non-bankruptcy law, and therefore, the court did not have the discretion to set its own rate, but rather must use the rate provided in PBGC Regulations Sections 4044.41 to 4044.75 (the "Valuation Regulation").¹¹

In addition, the court examined whether the retirement rate used by the PBGC was the wrong rate to use in the calculation. The court found that while the estimated age of retirement was incorrect, the basis for setting the rate was the correct one, and that there was insufficient difference as a result of the incorrect age to warrant an independent investigation by the court.

The Valuation Regulation examines the cost of purchasing the benefits, rather than the predicted rate of return on investments. The PBGC surveys annuity providers to determine current rates. The court ruled that valuation on the basis of an accurate reflection of market rate annuity pricing was appropriate, as it limited the risk to the PBGC. It should be noted that the court cited returns on the PBGC trust fund assets from 1985 to 2002 at approximately 10% annually. Regardless, the court agreed with the PBGC's argument that it does not have the ability to require companies with terminated plans to increase contributions in years in which investment returns are limited.¹² *Id.*

¹¹ *Id.*

¹² *Id.*

Finally, the court examined whether the Valuation Regulation is valid. In a plan termination, the Valuation Regulation controls employer liability, therefore, according to the court, the Valuation Regulation should be used with respect to claim allowance. Further, unfunded benefit liabilities in the statute are defined in relation to the Valuation Regulation. ERISA § 4001(18).¹³ At the time that the employer liability provisions of ERISA were amended to their present form, the Valuation Regulation was already in effect, indicating Congressional intent to use this definition. While the court agreed that the age used in application of the Valuation Regulation was too young, and admitted that it did not know the financial result of this error, it refused to invalidate the calculation because, “the difference would not appear so great as to warrant ignoring the valuation regulation in favor of an independent computation by the court.” Id.

¹³ ERISA § 4001 (18) provides:

“amount of unfunded benefit liabilities” means, as of any date, the excess (if any) of —

(A) the value of the benefit liabilities under the plan (determined as of such date on the basis of assumptions prescribed by the corporation for purposes of section 4044 [29 USCS § 1344]), over

(B) the current value (as of such date) of the assets of the plan.

ERISA § 4001(18).

ERISA § 4044 provides for the allocation of assets in a plan termination.