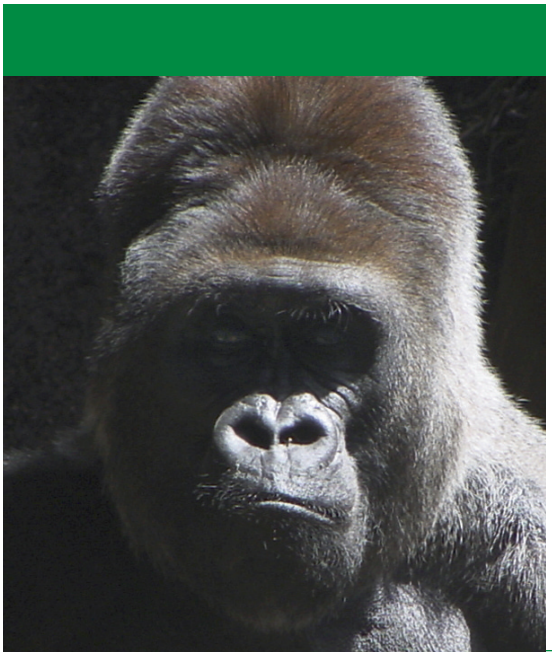

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MANAGING EMPLOYEE RELATIONS

Dealing with the 800-Pound Gorilla

Understanding PBGC's Role in Bankruptcy

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Recent news articles discussing actions by the Pension Benefit Guaranty Corporation (PBGC) in large bankruptcies, such as US Airways and United Airlines, have made turnaround professionals more cognizant of defined benefit pension plans in bankruptcy cases. Two frequently asked questions are:

1. How will the pension plan impact the outcome of the case?
2. How will PBGC decide what role to play in the case?

This article provides some tools for turnaround professionals in dealing with defined benefit pension plans and the PBGC.

The first contact in a case generally is made by the debtor.[5] The Employee Retirement Income Security Act (ERISA) requires that a plan administrator or contributing sponsor — usually the company in both cases — notify the PBGC, the federal insurer of defined benefit pension plan, within 30 days of a bankruptcy filing.[2] Notification requirements include the submission of certain information, including a copy of the bankruptcy petition, the bar date if it is known, a discussion of the debtor's controlled group,[3] and a list of pension plans in the controlled group, along with each actuarial valuation report.

At times, a debtor and its advisors are so busy with the initial activities of the bankruptcy that they are unprepared to provide the required information to the PBGC. In those cases, it is best to submit the Form 10, along with as much information as is available, rather than to wait and submit a complete report late. In response to its notification, a debtor probably will receive a letter or telephone call from the PBGC asking whether the plan sponsor intends to continue or terminate one or more pension plans in the restructuring. Additionally, the PBGC is likely to ask for a schedule of required pension payments, called minimum funding payments, for each plan for the next 12 months.

Some debtors, particularly those that want their pension plans to survive the bankruptcy, treat funding the plans as ordinary course expenses and make all scheduled pension payments. Others take the opposite view and withhold payment. The PBGC or the U.S. Department of Labor may ask a Bankruptcy Court to compel a debtor to make these scheduled payments.

While courts generally have agreed to do so, they also have limited the size of required payments. Minimum funding payments consist of the cost of benefits earned, called normal cost; an interest expense component; and an amortization of previous periods' liabilities. Courts have directed debtors to contribute just the normal cost component (accrued post-petition), which is usually the smallest of the items.

Under ERISA, all controlled group members are jointly and severally liable for minimum funding payments and termination liability. If a debtor has one or more controlled group members that are not in bankruptcy, those entities must make the pension plan whole with respect to minimum funding payments or face the non-bankrupt consequences. In other words, a Bankruptcy Court can direct a debtor to contribute a specific amount of money to its plans, but it cannot direct non-debtor entities.

If these controlled group members fail to satisfy minimum funding contributions in a timely manner and the missed payments to any one plan aggregate at least $1 million, the PBGC will file Internal Revenue Code Section 412(n) liens against all assets of all non-debtor controlled group members for the amount of the delinquent payment.[4] To head off such a move, pension advisors frequently recommend that all controlled group members file for bankruptcy protection if minimum funding payments are scheduled and are not likely to be made.

Funding Status

Another area subject to significant confusion involves the funded status of a pension plan — that is, the difference between a plan's assets and liabilities. Often financial and legal advisors, as well as company officials, find pension accounting confusing because of the different methodologies used for calculating the funded status of a pension plan for different purposes.

For financial reporting (GAAP) purposes, companies follow guidance from the Financial Accounting Standards Board (FASB). The GAAP formula is used to book a pension liability — or an asset, if the plan is overfunded — on a company's balance sheet and assumes an ongoing pension plan. The plan sponsor can select the interest rate used to discount the liabilities,[5] along with assumed mortality rates, salary increases, return on

plan assets, and other variables, provided each assumption is reasonable.

By regulation, the PBGC's valuation approach assumes the plan is terminated — that no additional benefits are earned by participants. While at first blush it might seem that the PBGC's methodology would yield a smaller liability since additional benefits will not be earned, that is not the case. Primarily this is because of the interaction between the interest rates and mortality assumptions regulations require the PBGC to use. The interest rates the PBGC uses to discount liabilities are generally below the rates plan sponsors use for GAAP purposes, which results in a larger liability.

The PBGC regulations also specify expected early retirement ages and mortality assumptions for plan participants. However, these may differ from the assumptions used by the plan sponsor for financial reporting purposes, causing differences between the liabilities calculated by the plan sponsor and those computed by the PBGC.

Finally, the PBGC grosses up liabilities with an expense load factor. Because the plan is deemed to terminate, no additional contributions are assumed and no additional interest income or capital gains are included in the assets under the PBGC's approach. This is because the PBGC becomes the trustee of the pension plan once it is terminated.

Adjusting a plan's funded basis from a GAAP methodology to a PBGC termination basis can turn a slightly underfunded plan or even an overfunded plan into a significantly underfunded plan in the eyes of the PBGC. While Bankruptcy Courts do not agree on the appropriate methodology to use in determining funding status, turnaround professionals should recognize that PBGC will participate in a bankruptcy based on its findings. Furthermore, trying to convince the PBGC that its methodology is not appropriate is a waste of time. A judge, however, may be more receptive to that argument.

If the underfunding is expected to be significant, the PBGC likely will request appointment to the unsecured creditors' committee. Seeking such an appointment does not indicate that the PBGC believes that a plan termination is likely; in fact, it is usually too early in the case for any determination to be made.

Technically, while a plan remains ongoing, the PBGC has a contingent, as opposed to a mature, claim.[6] Nonetheless, applicable law permits the PBGC to sit on an unsecured creditors committee on the basis of its contingent claim.[7] Having the PBGC represented on a committee can be helpful, particularly if the other creditors are new to the bankruptcy process. PBGC officials have extensive experience as a full member and an ex officio member of committees and bring a level of sophistication and knowledge to the table.

What if the underfunding is expected to be large but the PBGC doesn't request a seat on the unsecured creditors' committee? One cannot necessarily glean a strategy from this. The PBGC's workload often restricts the number of committees it can staff. Participating on a committee is time-consuming, requiring travel, long meetings, and reviewing significant amounts of information. The PBGC tries to participate actively on committees rather than serving in name only, so it sometimes has no personnel available to staff a committee.

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Even if the PBGC isn't represented on a committee, turnaround professionals should expect the agency to be active with respect to pension issues and other matters that may impact the pension situation during a bankruptcy case. For example, as mentioned earlier, each controlled group member is jointly and severally liable for pension termination liability. A motion for substantive consolidation, if granted, could dramatically reduce the PBGC's recoveries, so the agency would oppose such a motion vigorously.

At minimum, the PBGC will file claims in a case, even if a plan is wildly overfunded. It also will do so even if a plan sponsor intends for the plan to survive the bankruptcy. The PBGC files claims for unpaid premiums, unpaid minimum funding missed pre- and post-petition, and total pension underfunding.

Sometimes the PBGC files its claims with the liability amounts noted. At other times it initially files unliquidated claims. A turnaround professional shouldn't read too much into the difference. Often it is just a matter of workload — an actuary may not have had a chance to compute the underfunding prior to the bar date.

Termination

A plan can be terminated in a reorganization case in two ways — through a distress termination, which is initiated by the plan sponsor, or an involuntary termination, which is initiated by the PBGC.

To terminate a plan in a distress manner in a bankruptcy, a plan sponsor must make a financial affordability demonstration so that "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 [C]hapter 11 reorganization process and approves the termination."[8]

Regarding distress criteria, the PBGC first requires that each plan be tested separately. Aggregating plans as one unit is unacceptable.[9] For example, a sponsor of multiple plans may have one large underfunded plan that meets the termination test, but a second small underfunded plan that may be affordable and therefore will not be terminated.

Secondly, each controlled group member entity must meet at least one of the four distress termination criteria, but it need not meet the same criteria as another control group member. The PBGC views each controlled group member on a stand-alone basis — profitable subsidiaries cannot be netted against negative entities to reach a net negative. If a healthy controlled group member can support the plan and make minimum funding payments, the PBGC will expect that entity do so.

Third, a plan cannot be terminated in violation of a collective bargaining agreement (CBA). A debtor may need to initiate a Bankruptcy Code Section 1113 action to reject a CBA first before pursuing a distress termination. This restriction does not apply to the PBGC's involuntary termination actions.

Finally, the PBGC believes that Bankruptcy Courts have jurisdiction only over those controlled group members that are debtors. In other words, its position is that each non-debtor controlled group member must satisfy at least one of the distress criteria to the PBGC's — not a court's — satisfaction. In Chapter 11 reorganizations, the key is the

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Bankruptcy Court's determination that a debtor cannot reorganize without the termination of a plan.

The PBGC also can terminate an underfunded plan over objections of a plan sponsor who wants the plan to remain ongoing. There are several possible reasons the PBGC purposely would incur additional liabilities by pursuing an involuntary termination. The agency may believe a debtor plan sponsor eventually will file a distress termination application, while making only normal cost contributions to the plan and paying out significant benefits in the meantime.[10] As a result, the plan's funded status would deteriorate. To prevent that, the PBGC may move to terminate the plan to preserve the remaining plan assets and limit the liabilities.

The PBGC also may pursue an involuntarily termination if it believes an action today may increase the risk that plan termination will be required later, resulting in the agency's future recoveries being less than they would be today. This is known as the "long-run loss" theory.

In the bankruptcy context, the PBGC may apply this theory if, for example, a plan of reorganization provides for existing unsecured creditors — but not the ongoing underfunded pension plan — to receive security interests in the reorganized company. If the plan were to terminate post-emergence under such a scenario, there would be few or no unencumbered assets for the PBGC to receive in a recovery.

To prevent such an outcome, the PBGC might initiate a termination action prior to plan confirmation. In reality, however, the PBGC's goal in employing this tactic might be to force the parties to renegotiate the deal. If so, the PBGC would simply dismiss its termination action once it was satisfied of its treatment vis-à-vis similarly situated creditors, and the plan, now protected, would remain ongoing.

The PBGC previously has moved to terminate one or more pension plans when a debtor has agreed to sell a subsidiary (controlled group) and place the proceeds at the holding company level. Because a pension plan claim is joint and several to each controlled group member, the PBGC may believe its recovery will suffer from the movement of value from one controlled group member to another, even though no value has left the estate. In such cases, the PBGC and debtors have agreed to place the proceeds in escrow and allow the sales to go forward. In this way, the PBGC's creditor position can be preserved for a later argument.

Assuming that a plan will be terminated in a bankruptcy and that the PBGC has mature claims for which it will seek recoveries in the plan of reorganization, two variables must be addressed — the amount of the agency's claim and the amount of its recoveries.

For a turnaround professional to manage this process efficiently and effectively, it may make sense at times to focus on minimizing the amount of the PBGC's claims. At other times, it may be more productive to concentrate on the agency's recoveries. At still others, a turnaround professional may need to address both claims and recoveries.

As mentioned earlier, there is disagreement among courts on the appropriate methodology for measuring pension liabilities. The 6th U.S. Circuit Court of Appeals, for example, has adopted the "prudent investor" rate as the appropriate interest rate to use in discounting pension liabilities. This is a rate at which a reasonably prudent investor would invest in the current situation, and it implies a risk-adjusted rate. This rate can be significantly higher than the PBGC's statutory rate, creating a substantially lower liability and lower (or no) underfunding amounts. Conversely, the judge in the US Airways case in the U.S. Bankruptcy Court for the Eastern District of Virginia affirmed the PBGC's methodology as appropriate.

If a successful argument can be made that the prudent interest rate is the appropriate theory to apply, the estate and creditors will benefit from a ruling that the higher rate must be used in the pension calculations. As a result, a claims estimation hearing may be critical to a bankruptcy case, depending on the venue.

At times it can be more productive to ignore the size of the PBGC's claims and concentrate instead on the recovery amounts. In cases in which the PBGC's claim overwhelms those of all other creditors, a straight priority code recovery analysis would give the agency significantly all the value, which may not be acceptable to other creditors. In these situations, the PBGC in the past has shown a willingness to put some of its recovery back into the pot for other creditors as a compromise to achieve confirmation.

Skipping a claims fight and negotiating a recovery arrangement with the PBGC can lead to a quicker result for everyone. This can be accomplished by putting the PBGC's unsecured claim in a separate class. Usually the PBGC requests that its claim be valued according to its regulations. This is a non-economic issue for the estate and other creditors because the recovery amount will not be based on this figure.

Historically, the PBGC has preferred to have its claim recognized in full and receive a lower percentage recovery than other unsecured creditors rather than have its claim banged up in a prudent investor rate fight and show a higher recovery percentage later. In other words, the PBGC tends to focus on the economics of the deal. This is sometimes overlooked by turnaround professionals. However, the PBGC does consider how any compromise may affect future situations, and it is reluctant to enter into a negotiated arrangement that may set a negative precedent.

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Final Thoughts

When negotiating with the PBGC, turnaround professionals should recognize that the PBGC staff has significant reorganization experience. A party in a bankruptcy case should negotiate in good faith, treating the PBGC as it would other creditors. If a debtor loses credibility with the PBGC, it is difficult to regain it.

The PBGC should not be expected to incur the lion's share of the economic compromise in a bankruptcy case. Rather, the agency analyzes how other creditors are treated to ensure that they "share the pain." Also, the PBGC considers how a compromise will affect not just the case at hand, but future cases as well. As a governmental entity, the PBGC must interpret how policy may be impacted.

Finally, one should expect the process to take time. It may be weeks before a meeting can be scheduled. The PBGC staff will need time to analyze the facts and prepare briefings, counterproposals, and other positions. ■

[1] Certain large companies have annual reporting requirements to PBGC under ERISA Section 4010.

[2] See ERISA Section 4043, post-event notices of reportable events. The notice is to be submitted on a PBGC Form 10.

[3] There are two general types of controlled groups: parent-subsidiary and brother-sister. A parent-subsidiary controlled group exists when a parent owns directly or indirectly at least 80 percent of a subsidiary. A brother-sister controlled group exists when the same five or fewer shareholders own at least 80 percent or more of companies.

[4] ERISA requires that PBGC be given notice of missed minimum funding payments within 10 days of the due date. The notice is to be submitted on a PBGC Form 200.

[5] Financial accounting requires that the interest rate reflect current rates at which the liabilities could be "settled." The Securities and Exchange Commission has indicated that this rate should not be higher than the yield on a portfolio of bonds rated AA or higher whose cash flows match the predicted schedule of benefit payments.

[6] The claim belongs to the pension plan and is enforced by the plan's fiduciary. In the United Airlines case, the PBGC and U.S. Department of Labor insisted on an independent fiduciary to enforce the plan's claim for minimum funding. Increasingly, bankrupt companies are appointing independent fiduciaries.

[7] The Retirement Protection Act of 1994 (RPA) (under separate bankruptcy reform) allowed PBGC to sit on creditors' committees. Prior to RPA, many trustees were uncomfortable appointing a governmental agency or a creditor with a contingent claim to a creditors' committee, so PBGC usually participated as an ex officio member.

[8] There are four distress termination criteria (see ERISA Section 4041(c)).The second test, discussed in the this article, is applicable for debtors that are reorganizing.

[9] The concept is being tested in the Kaiser Aluminum and Falcon Products cases, in which the judges permitted the distress test on an aggregate basis.

[10] PBGC's guarantee covers basic pension benefits only, and the agency limits the amount of pension benefits participants can receive. For plans terminating in 2006, the maximum annual benefit PBGC will pay a plan participant retiring at age 65 is $47,659. Additionally, PBGC does not pay lump sum benefits in excess of $5,000.

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