Verge of Retirement Firings
Do Not Nullify Section 1114 Protections

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Retiree benefit plans have featured prominently in recent headlines as cash-strapped airlines such as United Airlines, US Air, Midwest Air and Delta struggle to manage skyrocketing retiree liabilities in an effort to emerge from or stave off bankruptcy. United Airlines recently became the biggest company in the nation's history to renege on its pension and employee benefit obligations, having been allowed by a bankruptcy judge to avoid paying more than $3 billion in plan contributions over the next five years to about 120,000 employees and retirees. Delta's plans are currently underfunded by $5 billion and Northwest's by $3.8 billion. Moreover, the crisis is not limited to the airlines — pension and benefit plan underfunding nationwide was recently estimated at $450 billion, nearly a quarter of which may have to be assumed by the Pension Benefit Guaranty Corp., whose current deficit already exceeds $23 billion.

These and related developments provoke questions concerning the effect of a bankruptcy filing upon a debtor employer's obligation to continue paying insurance benefits to retired employees under any pre-bankruptcy benefit program. It is widely recognized that the Bankruptcy Code can provide relief to a debtor staggering under the load of a retiree benefit plan by allowing the debtor to modify, or in some cases even terminate, the agreement. Less understood, however, are the circumstances under which a bankruptcy court can authorize these modifications.

Special protections for retiree benefits were added to the Bankruptcy Code in 1988, four years after the statute was amended to include roughly comparable safeguards applicable to current employees under collective bargaining agreements. In both cases, the changes were deemed necessary because of widespread perception among labor advocates that a higher standard than the business judgment test governing the ability of a trustee or chapter 11 debtor ("DIP") to disavow the terms of most contracts should be applied to collective bargaining agreements and retiree benefit plans. In keeping with the important policy considerations underlying these protections, courts often cast a critical eye on debtors, who by means of strategic planning, attempt to circumvent the retiree benefit provisions contained in the Bankruptcy Code. This approach is exemplified by a ruling recently handed down by the Third Circuit Court of Appeals in the chapter 11 case of General Datacomm Industries, Inc.

Retiree Benefits in Bankruptcy

Entitled "Payment of insurance benefits to retired employees," section 1114 of the Bankruptcy Code prohibits a DIP or trustee from unilaterally terminating or modifying retiree benefits unless the bankruptcy court orders the modification, or the trustee and an authorized representative of retirees agree to the modification. Section 1114's "clear purpose" is to give the bankruptcy court the ability "to resolve the competing interests of retirees, debtors and creditors, if agreement as to continuation and level of benefits cannot be reached."

"Retiree benefits" is defined in the statute to mean "payments to any entity or person for the purpose of providing or reimbursing payments for retired employees and their spouses or dependents, for medical, surgical, or hospital care benefits in the event of sickness, accident, disability, or death under any plan, fund, or program (through the purchase of insurance or otherwise)" maintained by the debtor before filing for bankruptcy. The "authorized representative" of a company's unionized retirees is generally the union, unless it elects not to serve. Where retirees are not unionized, the court may appoint a representative committee of retired employees to serve in that capacity.

Before seeking court authority to modify retiree benefit payments, the DIP is obligated to negotiate with the retiree's representative, accompanied by disclosure of the most complete and reliable information available, toward modifications "that are necessary to permit the reorganization of the debtor and assure[] that all creditors, the debtor and all of the affected parties are treated fairly and equitably." If the authorized representative rejects a modification proposal that meets these requirements "without good cause," the bankruptcy court is empowered to authorize the modification, so long as it finds that it is "necessary to permit the reorganization of the debtor and assures that all creditors, the debtor, and all affected parties are treated fairly and equitably, and is clearly favored by the balance of the equities." The court also has the power to order temporary modifications where such relief is "essential to the continuation of the debtor's business, or in order to avoid irreparable damage to the estate."

Other protections for retirees contained in section 1114 include the ability under certain circumstances to be represented by a committee officially sanctioned by the court with the right to employ lawyers and other professionals compensated by the estate, administrative status for benefit payments required to be made during the course of the bankruptcy case, and a short time frame — generally 90 days — governing the court's determination on any request to modify benefit payments. In addition, retiree benefit claims are not subject to the restrictions placed on damage claims resulting from the termination of employment contracts. However, section 1114 expressly excludes certain retirees from its scope — it generally does not apply to retirees whose gross annual income exceeds $250,000.

The language of section 1114 gives the bankruptcy courts considerable discretion to fashion appropriate relief based upon the particular circumstances of the case. Still, not all courts are of the same view concerning the scope of that discretion. For example, courts sometimes disagree on what modifications to a benefit plan qualify as "necessary" within the meaning of the statute. Also, the statute's admonition that relief must comport with the "balance of the equities" gives a court wide latitude to grant relief according to its own subjective view of fairness.

Courts generally look to cases involving collective bargaining agreements under section 1113 when construing what qualifies as "necessary" modifications to retiree benefits under section 1114 because the relevant language of the two provisions is almost identical. Under section 1113, there are two opposing views on this issue. In *Wheeling-Pittsburgh Steel Corp. v. United Steelworkers of America,* the Third Circuit ruled that the term "necessary" includes only those minimum modifications that the debtor "is constrained to accept because they are directly related to the Company's financial condition and its reorganization," thereby ultimately holding that the terms "necessary" and "essential" are synonymous. In addition, in determining the object of the modifications, the Court of Appeals held that in keeping with section 1113's purpose, the objective of the modifications should be the short-term "goal of preventing the debtor's liquidation."

The Second Circuit rejected this approach in *Truck Drivers Local 807 v. Carey Transportation, Inc.* There, the Court of Appeals held that, in determining the degree and purpose of "necessary" modifications, "the necessity requirement places on the debtor the burden of proving that its proposal is made in good faith, and that it contains necessary, but not absolutely minimum, changes that will enable the debtor to complete the reorganization process successfully." In adopting this approach, the court focused on the long-term goal of reorganization, rather than the short-term goal of preventing liquidation. This approach was adopted by the Tenth Circuit in *In re Mile Hi Metal System, Inc.* Lower courts have lined up on both sides of the issue.

Another controversial aspect of section 1114 concerns whether a debtor-employer is obligated to comply with the procedures delineated in the statute even if a pre-bankruptcy benefit plan gives the debtor the right to terminate the plan unilaterally. A related issue — whether the debtor can circumvent section 1114 by dismissing employees before they retire — was the subject of the Third Circuit's decision in *General DataComm*.

General DataComm

Four years before General DataComm Industries, Inc. ("DataComm") sought chapter 11 protection in 2001, the company's board approved a benefit agreement for senior executives and employees providing for the payment of long-term care insurance coverage and health insurance benefits. The plan listed certain actions that would lead to discharge and the forfeiture of all benefits, including violation of confidentiality, disclosure of proprietary information, refusal to cooperate in litigation brought by DataComm, employment by a competitor, and suing

DataComm for matters unrelated to the plan. Dismissal without cause was not among the events triggering forfeiture.

Shortly after filing its chapter 11 petition, DataComm notified four of its executives that they (and the benefit plan) would be terminated in approximately ten days. It then sought court authority to reject the benefit plan under section 365 of the Bankruptcy Code. DataComm acknowledged that the terminations were without cause. At the time, the executives were all over 65 years of age.

The executives objected to DataComm's request to reject the benefit plan, claiming that it was subject to the strictures of section 1114. The bankruptcy court agreed, denying DataComm's rejection motion. That determination was upheld on appeal by the district court, which ruled that the executives were retirees within the scope of section 1114 because DataComm's action in firing them the day after it purported to reject the benefit plan constituted "forced retirement." DataComm appealed to the Third Circuit.

It fared no better with the Court of Appeals. After explaining that retiree benefit plan modifications are governed by different rules than those applicable to other kinds of executory contracts under section 365, the Third Circuit observed that "the overarching question . . . is whether the [executives] constitute 'retired employees' for purposes of invoking the precautions of the statute." The Court concluded that the executives were retired employees even though they were dismissed before retiring.

The Third Circuit rejected DataComm's contention that section 1114 does not apply because the executives never retired, having been terminated, albeit without cause. Remarking that "this contention elevated form over substance" and that DataComm's deliberate actions were "designed to thwart the purposes of § 1114," the Court of Appeals ruled that DataComm's termination of employees on the verge of retirement in an effort to nullify section 1114 was illegitimate. The Court was careful, however, to emphasize that its decision was motivated by the particular circumstances of the case before it, which it characterized as "compelling enough to warrant" expansion of section 1114 to embrace employees forced into retirement by termination without cause. According to the Court, the "deliberate and involuntary termination of an employee on the verge of retirement, where the employee has otherwise met all qualifications for retirement, cannot deprive such an employee of the procedural protections of § 1114."

Outlook

The protections to retirees and retiree benefits built into the Bankruptcy Code are premised on important policy considerations. *General DataComm* is a testament to the practical significance of those considerations, particularly in a situation where a bankruptcy court, as a court of equity, is convinced that a debtor's strategic machinations will result in injustice even if technically within the letter of the law. Under less compelling circumstances, another court might well conclude differently. In fact, a Pennsylvania district court previously did so in *Hourly Employees/Retirees of Debtor v. Erie Forge & Steel, Inc.*, dismissing as a "novel legal argument" without any support the contention that dismissed employees qualify for section 1114 protection as "constructive retirees."

The problem is that section 1114 by its terms only applies to "plan, fund or program" payments to "retired employees and their spouses and dependents." Although employees dismissed with or without cause prior to retirement may have other avenues of redress, they are not technically protected by section 1114. This leaves the door open to strategic planning — a company considering a chapter 11 filing may want to consider downsizing its workforce prior to filing for bankruptcy, or even afterward, to avoid having to comply with section 1114. Even the Third Circuit refused to categorically prohibit such conduct in *General Datacomm*, observing that "[t]he contours of such a concept as 'forced retirement' may receive appropriate interpretation, when it occurs, by a case-by-case development."

Interestingly, in a concurring opinion, District Judge Louis H. Pollak, sitting by designation on the Third Circuit, agreed with the result reached by the majority, but for a different reason. According to him, DataComm's motion to terminate the benefit plan should not be denied because it improperly abridged the executives' rights as retirees because they were fired prior to retiring. Rather, Judge Pollak explained, the benefit plan was not an executory contract capable of being rejected under section 365, due, among other things, to the absence of any material ongoing obligations remaining unperformed at the time that DataComm filed for bankruptcy. This approach would appear to misconstrue the relationship between sections 365 and 1114. DataComm clearly had a benefit plan in force at the time it filed for chapter 11, executory or otherwise. That plan provided for payments to retirees, even if it did not apply to the executives. Thus, any attempt by DataComm to modify payments under the plan (termination being a form of modification) was governed by section 1114. Section 365 simply does not apply.

General DataComm illustrates that retiree benefits is a sensitive issue in the realm of bankruptcy, as elsewhere. Moreover, the landmark bankruptcy legislation enacted on April 20, 2005 will make the rules regarding retiree and employee benefits even more stringent. The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (the "Act") amends the Code to provide that if a debtor was a plan administrator of an employee benefit plan prior to filing for bankruptcy, it is obligated to continue to serve in that capacity during the bankruptcy case, unless a trustee is serving in the case. As a result, the debtor will be required to continue to perform various statutory duties imposed on an administrator by ERISA. It is unclear whether an administrator that also has fiduciary duties to the plan under ERISA must continue to perform those fiduciary duties notwithstanding the bankruptcy filing. This could subject the debtor, and potentially the officers and directors through whom the debtor acts, to conflicting or at least competing loyalties in exercising their duties as a debtor-in-possession, or the representatives thereof, in a chapter 11 case and as plan fiduciaries.

The Act also adds subsection 1114(l) to the Bankruptcy Code, which provides that if a debtor modifies retiree benefits in the 180 days before a bankruptcy filing while it was insolvent, the bankruptcy court must reinstate such benefits as they existed before modification and retroactive to such date unless it finds that the "balance of equities" clearly favors the prior modification. This amendment creates a significant risk that courts will retroactively reinstate modified retiree health benefits, causing the estate to incur both a substantial lump-sum obligation as well as additional ongoing costs. Unlike most of the rest of the Act, which has a delayed effective date, this amendment applies to any case filed on or after April 20, 2005.

The amendment leaves several questions unanswered. For instance, what exactly are the "balance of equities," and at what time should they be viewed — when the modifications were made or when the court is making its decision? Also, how does the provision interact with a debtor's general ability to modify retiree health benefits under section 1114 of the Code? Finally, what role does section 1114 play if the contract itself provides that benefits may be modified unilaterally?

General Datacomm Industries, Inc. v. Arcara (In re General Datacomm Industries, Inc.), 407 F.3d 616 (3d Cir. 2005).

In re Ormet Corp., 2005 WL 775448 (Bkrtcy. S.D. Ohio Mar. 24 2005).

In re Horsehead Industries, Inc., 300 B.R. 573 (Bankr. S.D.N.Y. 2003).

In re Horizon Natural Resources Co., 316 B.R. 268 (Bankr. E.D. Ky. 2004).

In re Farmland Industries, Inc., 294 B.R. 903 (Bankr. W.D. Mo. 2003).

Hourly Employees/Retirees of Debtor v. Erie Forge & Steel, Inc., 2004 WL 385023 (W.D. Pa. Feb. 2, 2004).