Another Circuit Considers the "Aggregate Approach" in Applying the "Reorganization Test" to Distress Terminations of Multiple Pension Plans in Chapter 11

November/December 2007

Mark G. Douglas

The perceived ease with which financially-strapped companies such as Delta Air Lines, Inc. and Collins & Aikman Corp. were able to jettison more than $1 billion in pension liabilities has figured prominently in recent headlines. Assumption of these obligations by the Pension Benefit Guaranty Corporation ("PBGC") contributed to a PBGC deficit that aggregated nearly $18.1 billion at the end of fiscal year 2006 (for the single-employer insurance program), although that was an improvement from the deficit of nearly $23 billion in fiscal year 2005. Airline relief provisions contained in recently-enacted pension reform helped to stanch the flow of PBGC assets, but the agency's overall financial outlook is anything but rosy given a nationwide underfunding of defined benefit pension plans that, depending on whose accounting is more accurate, ranges anywhere from $300 billion to $450 billion.

Termination of one or more defined benefit pension plans has increasingly become a significant aspect of a debtor-employer's reorganization strategy under chapter 11 of the Bankruptcy Code, providing a way to contain spiraling labor costs and facilitate the transition from defined benefit-based programs to defined contribution programs such as 401(k) plans. The circumstances under which a chapter 11 debtor can effect a "distress termination" of its pension plans were the subject of a pair of rulings handed down by the federal circuit courts of appeal in the last 18 months. In 2006, the Third Circuit held in *In re Kaiser Aluminum Corp.* that when an employer in chapter

11 seeks to terminate more than one pension plan, the plans must be considered in the aggregate rather than on a plan-by-plan basis. The Eighth Circuit had an opportunity to address the same issue in 2007. In *Pension Benefit Guaranty Corporation v. Falcon Products, Inc. (In re Falcon Products, Inc.)*, the court ruled that it need not decide whether the "reorganization test" requires a plan-by-plan or aggregate analysis in light of a bankruptcy court's findings that the debtor could not survive outside of chapter 11 without a $50 million investment conditioned on termination of all three of its pension plans.

ERISA and PBGC

The respective rights and obligations of employers and retirees vis-à-vis pension benefits are governed not by the Bankruptcy Code, but by the Employee Retirement Income Security Act ("ERISA"), which provides the primary regulatory framework and protection for pension benefits. Enacted in 1974, ERISA is a comprehensive regulatory scheme intended to protect the interests of pension plan and welfare benefit participants and beneficiaries and to preserve the integrity of trust assets. On a basic level, it establishes minimum participation, vesting and funding standards and contains detailed reporting and disclosure requirements. ERISA also created the PBGC to act as both the regulatory watchdog and the guarantor, at least to a certain extent, for the pension and related rights of the U.S. workforce.

Companies pay insurance premiums to PBGC, and if an employer can no longer support its pension plan, PBGC takes over the assets and liabilities and pays promised benefits to retirees up to certain limits. The maximum annual benefit for plans assumed by the agency in 2007 was $49,500 for workers who wait until 65 to retire. For plans assumed in 2008, the maximum

yearly benefit amount will be $51,750. PBGC self-finances payments to employees under terminated plans through five sources of income: (i) insurance premiums paid by current sponsors of active plans (in 2008, $33 per year per participant, although companies posing high risks of underfunding must pay an additional variable rate premium equal to $9 for every $1,000 of unfunded vested benefits); (ii) assets from terminated plans taken over by PBGC; (iii) recoveries from former sponsors of terminated plans; (iv) PBGC's own investments; and (v) in connection with certain distress and involuntary plan terminations occurring on or after January 1, 2006, termination premiums of $1,250 per participant payable for three years after the termination.

PBGC insures only "defined benefit" plans. These are plans under which an employer determines the benefits it will pay its employees and contributes the necessary amounts to a pension fund. The amount of retirement income an employee will receive generally depends on the employee's length of service. ERISA and the Internal Revenue Code determine the amount of the required minimum periodic funding contributions the employer must make. Not all plans are defined benefit plans. Many employers have "defined contribution" plans instead. In these plans, the employer may contribute a certain amount for each participant (who typically contributes most of the funds to the plan), but the employer makes no promise regarding the ultimate benefit or amount that each participant will receive. Defined contribution plans, such as 401(k) plans, are not guaranteed by PBGC.

There are several ways for a defined benefit plan to terminate under ERISA. In a "standard termination," an employer can voluntarily terminate its plan so long as the plan has sufficient

assets to pay all future benefits. The employer remains liable to PBGC for all plan benefit liabilities. An employer can also voluntarily act to terminate its plan in a "distress termination" under the following circumstances: (i) liquidation in bankruptcy; (ii) a reorganization in bankruptcy in which the court approves the termination after determining "that, unless the plan is terminated, [the employer] 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 (iii) a non-bankruptcy situation where termination is necessary because, unless a distress termination occurs, the employer will be unable to pay its debts when they mature and will be unable to continue in business, or the costs of providing pension coverage have become unreasonably burdensome solely as a result of a decline in the employer's workforce. The standard set forth in (ii) above is commonly referred to as the "reorganization test."

Upon termination of a plan, PBGC assumes responsibility for guaranteed benefits while attempting to collect funds from the employer. An employer cannot effectuate either a standard or distress termination if terminating the plan would violate the terms and conditions of an existing collective bargaining agreement. However, a plan sponsor seeking a distress termination while in bankruptcy may nullify a contractual bar to plan termination by obtaining court authority to reject or modify the bargaining agreement under section 1113 of the Bankruptcy Code. Finally, PBGC itself can move to terminate a company's pension plan if the company defaults on its minimum funding requirements and PBGC determines that it will be exposed to unreasonable risk in the long run if the plan continues. PBGC need not consult with union representatives before terminating a plan on its own initiative.

2006 Pension Reforms

President George W. Bush gave his imprimatur on August 17, 2006, to the most sweeping pension reform in 30 years. Among other things, the Pension Protection Act of 2006 includes provisions that:

- Require employers to make sufficient contributions to their single-employer defined benefit pension plans over the next seven years to achieve 100 percent funding;
- Prohibit employers and unions from increasing pension benefits from single-employer plans that are less than 80 percent funded, unless the additional benefits are paid for immediately;
- Increase the flat-rate premiums payable per participant each year from $19 to $30 (adjusted upward to $33 for 2008);
- Make permanent the $1,250 per participant penalty premium payable in the event of certain distress and involuntary plan terminations (first implemented as a temporary measure as part of the Federal Deficit Reduction Act of 2005); and
- Allow airlines that freeze all benefit accruals in their pension plans an additional 10 years to meet their funding obligations, while allowing airlines that freeze new plan participants but allow current participants to accrue new benefits three additional years to meet their funding obligations.

The reforms are unlikely to restore PBGC to solvency, but, according to PBGC, the airline relief provisions have improved the embattled insurer's short term financial outlook by reducing the agency's deficit by nearly $5 billion in fiscal year 2006. However, as more and more employers make the transition away from defined benefit plans because of stricter funding requirements, PBGC's premium base may actually diminish in the long run. Moreover, the rules governing pension plan funding are not the only factors influencing PBGC's troubled financial condition — legislation can do little to stave off major business failures that are inevitable in a volatile economy.

Distress Termination of Multiple Pension Plans: The Circuits Weigh In

Until recently, the circuit courts of appeal had not considered how the "reorganization test" should be applied when a chapter 11 debtor-employer seeks court authority to implement a distress termination of multiple pension plans. The Third Circuit Court of Appeals was the first to do so in 2006.

Kaiser Aluminum

Aluminum mining, refining, and manufacturing giant Kaiser Aluminum Corp. and 25 of its affiliates (collectively, "Kaiser"), with Jones Day's assistance as reorganization counsel, filed for chapter 11 protection between February 2002 and January 2003. As part of Kaiser's attempt to reorganize, the company moved to terminate voluntarily six of its seven pension plans, all of which had been established pursuant to collective bargaining agreements with various unions. The plans covered nearly 13,500 active employees and retirees. The plans were underfunded by nearly $48 million for the 2003 plan year, and Kaiser projected that it would be required to make $230 million in minimum contributions to the plans between 2004 and 2009.

PBGC opposed Kaiser's motion to terminate the plans, arguing that the bankruptcy court should evaluate each proposed plan termination separately under the ERISA "reorganization test." PBGC acknowledged that Kaiser's two largest pension plans would satisfy the reorganization test, but claimed that, when considered on a plan-by-plan basis, Kaiser's four smaller plans did not satisfy the test. The combined minimum funding contributions for these four plans were projected to be roughly $12.8 million between 2004 and 2009 — less than 6 percent of the estimated $230 million required to fund all of Kaiser's pension plans during that time frame.

When these smaller plans were considered on a plan-by-plan basis, PBGC contended, Kaiser could continue funding some or all of them and still successfully reorganize under chapter 11.

Explaining that ERISA does not explicitly state how the reorganization test is to be applied when an employer seeks to terminate several plans at once, the Third Circuit remarked that "[i]n every case that we have identified in which a debtor sought to terminate multiple pension plans under the reorganization test, bankruptcy courts have applied an aggregate analysis, apparently without protest from the PBGC." The court rejected PBGC's contention that a plan-by-plan analysis is mandated by ERISA because lawmakers used the singular terms "single-employer plan" and "plan" in the relevant portion of the statute. The use of the singular form of "plan" in ERISA, the Third Circuit emphasized, "does not constitute a congressional mandate to the bankruptcy courts to apply a plan-by-plan approach to the reorganization test."

The court agreed with Kaiser that a plan-by-plan approach would be "unworkable" because it would compel bankruptcy courts to make basic assumptions about the order in which plans should be considered and the status of other plans that a debtor-employer proposes to terminate. As currently drafted, the Third Circuit observed, ERISA "leaves open too many questions about how to engage in a plan-by-plan analysis for us to conclude that Congress envisioned such an approach in the multiplan context."

Moreover, the court explained, the adoption of a plan-by-plan approach to the reorganization test would disrupt the bankruptcy courts in their traditional role as courts of equity:

> The PBGC would have the Bankruptcy Court terminate some of Kaiser's plans while leaving the others in place, seemingly without a principled basis on which it could make

> the determination of which workers to prefer over others. We will not impose this result, which we believe would treat Kaiser's workers unfairly and inequitably, without a clear congressional mandate.

The Third Circuit rejected PBGC's assertion that a legislative trend tightening restrictions on pension plan terminations indicates that Congress would endorse a plan-by-plan approach. According to the court, "[a]t most, the legislative history demonstrates that Congress had a general intent to make it more difficult for employers to terminate pensions; however, that is hardly determinative of whether, or how, the reorganization test should be applied in the multiplan context."

Finally, the Third Circuit rejected PBGC's argument that the federal courts should defer to PBGC's interpretation of the reorganization test, stating that "deference to the PBGC here is improper because PBGC has neither the expertise nor the authority to determine when a plan should be terminated under the reorganization test." Issues relating to an employer's bankruptcy and reorganization, the court emphasized, "are within the expertise of the bankruptcy courts, not the PBGC."

The Latest Word: *Falcon Products*

Commercial furniture maker Falcon Products, Inc. ("Falcon") filed for chapter 11 protection in St. Louis in 2005. In the fall of that year, Falcon sought court authority to effect a distressed termination of its three pension plans. Considering the three plans in the aggregate, Falcon claimed, it could not afford to pay the required contributions for the pension plans, estimated at nearly $19 million for the period from 2005 through 2012. Moreover, Falcon emphasized, third-party investors, who had agreed to fund Falcon's reorganization and ongoing operations with a $50 million cash infusion, insisted on termination of the plans as a condition to the investment. PBGC countered that ERISA required Falcon to demonstrate that the requirements of the

reorganization test were satisfied on a plan-by-plan basis as opposed to the aggregate basis proposed by Falcon.

The bankruptcy court concluded that the pension plans could be considered in the aggregate, and decided that Falcon had satisfied the reorganization test. The court rejected PBGC's contention that Falcon could afford the minimum payments on at least one of its pension plans based upon Falcon's funding projections, emphasizing that the projections depended upon a $50 million cash investment that would not be made unless all of the plans were terminated. PBGC appealed to the district court, which affirmed, and then to the Eighth Circuit.

The Eighth Circuit affirmed the rulings below. Although urged by PBGC to adopt an approach to the question contrary to the view expressed by the Third Circuit in *Kaiser Aluminum*, the court declined, explaining, however, that it need not choose between a plan-by-plan or aggregate analysis in applying the reorganization test. It rejected PBGC's argument that investors' conditions cannot replace the analysis a bankruptcy court is required to conduct under ERISA, observing that:

> while it is improper to allow an investor to make the decision reserved to the bankruptcy court under ERISA, it is the duty of the bankruptcy judge to look to [the] existential financial reality and try to judge whether the plan provisions are necessary or whether they are merely desired by the entities that would benefit from the termination.

The Eighth Circuit looked to the bankruptcy court's factual findings that: (i) the cash infusion was conditioned upon termination of all three pension plans; and (ii) the investors' insistence upon the condition was "reasonable." It faulted neither:

> Here, the bankruptcy court reviewed the extensive steps Falcon had taken to secure additional funds, it noted that the only investments Falcon was successful in securing were conditioned on a termination of all three pension plans, and the court found that, absent the $50 million in additional funding, Falcon would be forced to liquidate which would result in a termination of all three pension plans. In light of these factual findings, which are not clearly erroneous, it is not necessary for this court to consider the question of whether the pension plans should have been considered in the aggregate or on a plan-by-plan approach.

Outlook

Kaiser Aluminum was not the first case in which a court has applied the aggregate analysis approach in determining whether multiple plan terminations satisfy the reorganization test — at least three bankruptcy courts have employed this approach in applying the test without any commentary concerning the possible application of a competing alternative. Even so, *Kaiser Aluminum* was the first case in which PBGC challenged the application of an aggregate analysis and advocated a competing approach. *Falcon Products* indicates that PBGC will continue to mount vigorous opposition to attempted distress terminations of multiple pension plans if the reorganization test is applied in any way other than on a plan-by-plan basis.

The Third Circuit was the first court at the circuit level to consider the issue. Although the Eighth Circuit declined to decide whether the approach articulated in *Kaiser Aluminum* is the right one, both rulings fortify the "bigger picture" policy underlying the chapter 11 reorganization process. Employers in many financially troubled industries, including airlines, automobile manufacturers and auto parts suppliers, have multiple pension plans that are underfunded. *Kaiser Aluminum* and *Falcon Products* are significant precedents for any employer with multiple plans considering chapter 11 as part of its overall reorganization strategy.

In re Kaiser Aluminum Corp., 456 F.3d 328 (3d Cir. 2006).

Pension Benefit Guaranty Corporation v. Falcon Products, Inc. (In re Falcon Products, Inc.), 497 F.3d 838 (8th Cir. 2007).

In re Aloha Airgroup, Inc., 2005 WL 3487724 (Bankr. D. Haw. Dec. 13, 2005), *vacated as moot*, 2006 WL 695054 (D. Haw. Mar. 14, 2006).

In re Philip Servs. Corp., 310 B.R. 802 (Bankr. S.D. Tex. 2004).

In re Wire Rope Corp. of Am., 287 B.R. 771 (Bankr. W.D. Mo. 2002).

Jones Day acted as counsel to Kaiser Aluminum Corp. and its subsidiaries in connection with their chapter 11 cases.