First Impressions: Portion of Withdrawal Liability Entitled to Administrative Priority

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Until 2011, no federal circuit court of appeals had ever directly addressed whether multi-employer pension plan withdrawal liability incurred by a debtor-employer that continues to employ workers during a bankruptcy case is entitled (in whole or in part) to administrative-expense status. That changed on June 16, when the Third Circuit handed down its ruling in *In re Marcal Paper Mills, Inc.*, 650 F.3d 311 (3d Cir. 2011). Addressing the issue as a matter of first impression, the court of appeals affirmed a district court's reversal of a bankruptcy-court order denying administrative-expense status to a withdrawal-liability claim against a chapter 11 debtor in possession ("DIP") that continued to participate in a multi-employer defined-benefit pension plan until it sold substantially all of its assets to a successor entity. According to the Third Circuit, because part of the withdrawal liability was attributable to the postpetition time period and the debtor clearly benefited from postpetition labor provided by its unionized employees, the portion of the claim relating to postpetition services constituted a priority administrative expense.

Defined-Benefit Pension Plan Withdrawal Liability

The Employee Retirement Income Security Act of 1974 ("ERISA"), as amended by the Multiemployer Pension Plan Amendments Act of 1980 ("MPPAA"), imposes "withdrawal liability" on participating employers that withdraw from a multi-employer defined-benefit pension plan insured by the Pension Benefit Guaranty Corporation ("PBGC") for the employer's proportionate share of the pension plan's "unfunded vested benefits" at the time of withdrawal. In *PBGC v. R.A. Gray & Co.*, 467 U.S. 717 (1984), the U.S. Supreme Court explained that

unfunded vested benefits are "calculated as the difference between the present value of vested benefits and the current value of the plan's assets."

The MPPAA imposed withdrawal liability in response to a shortcoming in the original ERISA statute that allowed employers to withdraw from defined-benefit plans and shirk their obligations to provide benefits, effectively crippling the plan and harming covered employees. An employer triggers a "complete withdrawal" from a plan when it no longer has any obligation to contribute to the plan, including by terminating all employees under the plan. Withdrawal liability is generally calculated as if the withdrawal occurred on the last day of the plan year preceding withdrawal. Although the details of the calculation are complex, withdrawal liability is generally calculated on the basis of the employer's contributions to the plan during the preceding five years.

Withdrawal Liability Entitled to Administrative Status in Bankruptcy?

If a complete withdrawal occurs after the employer files for bankruptcy, the handful of courts that have addressed the issue to date disagree as to whether the claim based upon withdrawal liability should be classified (in whole or in part) as an administrative claim or a general unsecured claim. Section 507(a)(2) of the Bankruptcy Code provides that administrative expenses allowed under section 503(b) are entitled to priority over general unsecured claims. Section 503(b)(1)(A) defines "administrative expenses" to include "the actual, necessary costs and expenses of preserving the estate, including . . . wages, salaries, and commissions for services rendered after the commencement of the case."

In *In re McFarlin's, Inc.*, 789 F.2d 98 (2d Cir. 1986), the Second Circuit Court of Appeals suggested (but did not rule) that postpetition withdrawal liability to a multi-employer pension plan could be entitled to priority as an administrative expense. The court ultimately declined to classify the withdrawal-liability claim in the case before it as an administrative expense because the claim was based on "a period pre-dating the McFarlin's Chapter 11 proceeding and cannot therefore be treated as an administrative expense." Other (albeit lower) courts, however, have ruled that, to the extent that withdrawal liability is attributable to *postpetition* employment, the resulting claim is entitled to administrative status. *See, e.g.*, *In re Great Northeastern Lumber & Millwork Corp.*, 64 B.R. 426 (Bankr. E.D. Pa. 1986); *In re Cott Corp.*, 47 B.R. 487 (Bankr. D. Conn. 1984).

In *United Mine Workers of Amer. v. Lexington Coal Co., LLC (In re HNRC Dissolution Co.)*, 396 B.R. 461 (Bankr. 6th Cir. 2008), a bankruptcy appellate panel for the Sixth Circuit ruled that withdrawal-liability claims against debtor-employers that withdrew from a multi-employer pension plan two years after filing for chapter 11 protection lacked the causal relationship to the work performed by the debtors' employees necessary for the claims to be treated as an administrative expense. According to the court, unlike other cases that have applied the narrow exception stated in *Reading Co. v. Brown*, 391 U.S. 471 (1968), for conferring administrative status in the absence of benefit to the estate, the withdrawal-liability claims did not stem from tortious or deliberate misconduct by the debtors.

Until *Marcal Paper*, *McFarlin's* was the only decision at the circuit level to consider the issue.

Marcal Paper

New Jersey-based paper products manufacturer Marcal Paper Mills, Inc. ("Marcal"), operated a fleet of trucks to distribute its wares. The truck drivers employed by Marcal were members of a teamsters' union ("Local 560") that acted as the collective bargaining representative for those employees. Pursuant to collective bargaining agreements with Local 560, Marcal participated in a multi-employer defined-benefit pension fund known as the Trucking Employees of North Jersey/Welfare Pension Fund (the "Pension Fund").

On November 30, 2006, Marcal filed for chapter 11 protection in New Jersey. After the bankruptcy filing, but before the bargaining agreements with Local 560 were due to expire in August 2007, Marcal and Local 560 agreed to continue to abide by the terms of the bargaining agreements until a new contract was executed (which never ultimately occurred). Due to this extension, covered employees continued to accrue pension benefits and Marcal continued to make contributions to the Pension Fund.

Marcal stopped making such contributions, however, on May 30, 2008, when Marcal Paper Mills, LLC ("Marcal LLC"), purchased substantially all of the company's assets, in addition to assuming Marcal's liabilities. Marcal LLC never employed the Local 560 truck drivers formerly employed by Marcal.

After the sale, the Pension Fund concluded that Marcal had made a "complete withdrawal" from the fund for the purposes of ERISA and MPPAA. It accordingly assessed Marcal with $5.9 million in total withdrawal liability and filed an administrative claim in Marcal's chapter 11 case for that amount. Marcal objected to the claim on the basis that it should be classified as a general

unsecured claim. The Pension Fund responded by requesting administrative status for only the portion of the withdrawal liability attributable to postpetition services provided to Marcal by the covered employees.

The bankruptcy court ruled in favor of Marcal, directing that the withdrawal-liability claim be classified and treated as a general unsecured claim. The district court reversed on appeal, holding that the portion of the withdrawal liability attributable to the postpetition period was entitled to administrative priority. It remanded the case below to determine the appropriate apportionment. Marcal appealed to the Third Circuit Court of Appeals.

The Third Circuit's Ruling

Addressing the issue as a matter of first impression, a three-judge panel of the Third Circuit affirmed the district court's ruling, holding that the withdrawal liability should be apportioned between the pre- and postpetition periods and that the postpetition portion should be classified as an administrative expense.

On the basis of its previous ruling in *In re O'Brien Environmental Energy, Inc.*, 181 F.3d 527 (3d Cir. 1999), the Third Circuit explained that to qualify for administrative status, an expense must: (i) arise from a postpetition transaction; (ii) be beneficial to the operation of the debtor's business; and (iii) be actual and necessary. Therefore, the court examined whether any part of Marcal's withdrawal liability represented a postpetition expense incurred for services that were actual, necessary, and beneficial to Marcal's business.

According to the Third Circuit, the work performed by Marcal's employees conferred a benefit on the estate, and under the collective bargaining agreements, Marcal was obligated to provide certain pension benefits on account of that postpetition labor. Thus, the Third Circuit concluded that allowing the portion of the withdrawal liability relating to postpetition labor as an administrative expense is consistent with the criteria for administrative-expense status under section 503(b). Whereas this conclusion seems at first blush to cut against *McFarlin's,* the Third Circuit explicitly reconciled its holding with the Second Circuit's ruling in that case, observing that "[the Second Circuit's] analysis clearly supports a conclusion that post-petition withdrawal liability can be considered an administrative expense."

The Third Circuit expressly rejected the reasoning articulated in *HNRC Dissolution*, explaining that its holding in *Marcal Paper* is entirely consistent with and harmonizes the purposes of both the Bankruptcy Code and ERISA, as amended by MPPAA:

> [T]he narrowly tailored definition of administrative expense contained in the Bankruptcy Code is designed to balance two goals: the continued functioning of the debtor-in-possession and preservation of the estate for downstream creditors. By allowing only that portion of withdrawal liability attributable to the post-petition work to be classified as an administrative expense, we ensure that workers are provided the full benefit of the bargain promised to them in the continued-CBA, incentivizing their work for the DIP and ensuring its continued functioning. At the same time, by limiting what constitutes an administrative expense to only that portion of the withdrawal liability which can be fairly allocated to the post-petition period, we help preserve the estate and prevent it from being devoured by the entire withdrawal liability claim. . . . Perhaps even more importantly, by permitting the post-petition portion of the withdrawal liability to be classified as an administrative expense, Congress' objectives in passing the MPPAA are fulfilled. If withdrawal liability in its entirety were automatically classified as a general unsecured claim, it would greatly undercut the purpose of the MPPAA to secure the finances of pension funds and prevent an employer's withdrawal from negatively affecting the plan and its employee beneficiaries.

The Third Circuit rejected Marcal LLC's arguments that withdrawal liability could not qualify as an administrative expense because, among other things, such liability: (i) was not based solely on postpetition work; (ii) was not designed to benefit employees who provided postpetition services; and (iii) could not be accurately apportioned between the pre- and postpetition periods. Other courts, the Third Circuit observed, have similarly classified postpetition withdrawal liability as an administrative expense, and it has itself apportioned benefits between pre- and postpetition periods for purposes of administrative priority in other contexts. *See, e.g.*, *In re Hechinger Inv. Co. of Del.*, 298 F.3d 219 (3d Cir. 2002) ("stay-on benefits" to entice employees to continue working while the employer liquidated its assets); *In re Roth American, Inc.*, 975 F.2d 949 (3d Cir. 1992) (vacation and severance benefits based on the length of employment).

Outlook

Marcal Paper is an important development and, for some debtor-employers, an unwelcome one. Withdrawal-liability claims can be very large. The possibility that a portion of such claims could be entitled to administrative priority if a DIP or trustee continues to employ workers covered by a multi-employer PBGC-guaranteed pension fund should figure prominently in a prospective debtor's strategic planning.

It remains to be seen at this juncture whether other courts will adopt the *Marcal Paper* approach to this issue. In light of the rulings by the Third Circuit in *Marcal Paper* and the Second Circuit in *McFarlin's*, courts in those circuits at a minimum are likely to follow suit.

Finally, few courts have developed a methodology to allocate withdrawal-liability claims between pre- and postpetition components. It will be instructive to see the particular method employed by the bankruptcy court on remand in *Marcal Paper*.

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