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BANKRUPTCY AND BENEFIT PLANS

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- How does a corporate bankruptcy affect benefit plans?
- What are the obligations?
- Where do benefit plans stand in line?
- Collectively bargained benefits
- The LTV case

MR. LAWRENCE J. SHER: This is Section 61. We're going to be speaking about bankruptcy and benefit plans. I'm Larry Sher, and I'm a partner with Kwasha Lipton in Ft. Lee, New Jersey. My experience with bankruptcy matters has been what I'd describe as a crash course. I got involved a couple of years ago in the LTV case. One of the creditor committees decided that it would make sense to have an actuary. I'm not so sure that turned out to be a good decision, but it did give me a chance to work with many bankruptcy professionals. One of them is Mark Wintner, who's the copanelist. Mark is an attorney with Strook, Strook & Lavan in New York. He's a partner of the firm, and heads up its ERISA practice. Mark's experience is very extensive in the bankruptcy area.

Why is this subject important? Well, I think it's clear, as we've all seen, that there are an awful lot of companies that have had to resort to one form or another of bankruptcy. We probably all have clients that are, if not in bankruptcy, then having financial difficulties. I think it behooves us to understand how bankruptcy works, and to help our clients understand how it affects employee benefits and what steps they might take to help avoid bankruptcy.

Another common situation your client might be facing is the purchase of a business from a bankrupt company. Again, we should be prepared to assist our clients in that situation.

Our focus will be on benefits to retirees because those benefits tend to be, to one degree or another, not fully protected. That is, there are no assets that have been set aside, or not enough assets, to secure those benefit promises.

Certainly, in the postretirement medical area, in most cases there are either no assets or little assets. In the pension area, there may be plans that have significant unfunded liabilities. Certainly LTV is a prime example of that, as are many of the other companies that have gone Chapter 11 recently.

Another element that's important for us to understand, from a more personal perspective is how our work and fees are dealt with when a client goes into bankruptcy.

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What types of work can the actuary continue to do and get paid for? What about fees that have been billed or that have been accrued and have not yet been collected at the time bankruptcy commences? Also, if you're hired in connection with the bankruptcy to do work for either the company or one of the creditor committees, how do you get paid? Basically, in this case you have to get approved by the bankruptcy court and your fees are scrutinized very carefully by the court.

Before we get into the benefit issues, Mark is going to take us through a description of the bankruptcy process. I know, when I first got thrown in the middle of the LTV situation, my first exposure was sitting at a creditor's committee meeting hearing all kinds of terms being thrown around. I had absolutely no idea what anybody was saying. I gradually assimilated some of the basics with the help of people like Mark. I hope this background will facilitate your ability to pick up this stuff when you're faced with it.

MR. MARK S. WINTNER: A lot of the normal rules simply don't apply in a bankruptcy setting or a prebankruptcy setting. Or its not so much that they don't apply, but they sort of apply in a zero-gravity type of setting -- the rules may still be there, but the orientation is entirely different.

As Larry indicated, I have been involved -- some would say sentenced -- to the LTV case for almost six years now. During that time, I've also been involved in the Federated case and Pan Am and am currently involved in Orion and Wheeling-Pittsburgh. In fact, a lot of bankruptcy people refer to these as the megacases.

I was in the U.S. Bankruptcy Court in New York the other day, and I saw a sign for the room to go to for megacases, so I think it's actually become an official title. But there are also small cases, and just because you may not be involved in a megacase, doesn't mean that it's unlikely bankruptcy will ever happen to you or your clients. It increasingly comes up with small employers as well as large. Nonetheless, a lot of the interest in the area certainly does come from the high publicity surrounding the megacases. Those tend to be in the industries which the PBGC has identified as having the concentration of underfunding in the pension area, primarily auto, steel, airline, and tire manufacturers.

I'm not a bankruptcy attorney, although I can't pretend not to know anything about it anymore, and because a lot of the issues that we talk about are issues where my clients are currently in litigation, I will not always be necessarily stating views that can be attributed to myself or to my clients. I will try to indicate when a particular view is the view of the bankruptcy bar and when it's a view of the PBGC, but we'll just have to handle that as we go along.

Prior to the bankruptcy itself, we have what is called the prebankruptcy stage. This doesn't always apply, but you may have seen a lot in the papers of prepackaged bankruptcies, restructuring, and other steps that are taken prior to a bankruptcy. All this refers to is the fact that bankruptcies are terribly expensive and time consuming, and once a company goes into bankruptcy, it sometimes may lose control of the process, because there are a lot of other players in it. So, in some circumstances, it is worth considering whether or not you can restructure or do a prepackaged bankruptcy in order to simplify matters, and in effect, take a couple of short cuts, without having to go through Chapter 11. This only makes sense, though, if you understand the rules in Chapter 11. What really happens is a company comes to its creditors and says, look, it's going to do neither of us any good to go through the Chapter 11 process. We both know what our rights will be. Why don't we work it out? In effect, this is much like an out-of-court divorce settlement – why give it all to the attorneys?

It works in some cases, particularly where you're dealing primarily with bonds, junk bonds, and leveraged buyout (LBO) financial structuring problems but there's really no business problem – it's just the financial aspect of the company that must be restructured. Again, this has gotten a lot of publicity from some of Trump's casinos in Atlantic City, from Western Union a couple of years ago, and many other LBO or junk-bond-type deals. The only thing you should be aware of, again, is that this is an alternative to Chapter 11 to be considered. It doesn't always fit, and you don't always have control of the situation as to whether you can try it.

With that, let's turn to the bankruptcy scenario. First, we will define a couple of terms that we'll use over and over again. All areas have their own jargon, and their own acronyms, certainly none more than ERISA, so we can't afford to cast any stones in the bankruptcy direction. Nonetheless, there are terms of art in the bankruptcy setting.

Chapter 11 of the Bankruptcy Code enables business entities to attempt to reorganize their business. That can be done in a Chapter 11. You can also have a liquidation, that is, a company either decides it cannot reorganize its business, or it tries to but ultimately fails. A liquidation, as opposed to a reorganization, can take place either in Chapter 7, which is solely for liquidation proceedings, or in a Chapter 11, that is, you can have a liquidating Chapter 11. If that sounds confusing, it is, but it's sort of like having a defined-contribution pension plan – you have to get used to the fact that nothing is pure in this world in any area of the law.

If you are dealing with a Chapter 11 situation, and most of the big cases, and even most of the small cases are indeed Chapter 11s, we start with the fact that, in most situations, management remains in control of the business. And those are situations where we talk about a debtor in possession, or a DIP. DIP is not a pejorative word in this case; it is simply the acronym that is used to connote the fact that, notwithstanding that the company is in a bankruptcy proceeding, management is running the show. There may be an examiner, but there is no trustee who has taken over management. And management simply continues much the same way as outside the Chapter 11, with regard to business decisions. Management is very constrained with regard to other decisions, but in terms of day-to-day management, it remains the same.

Now, you can have a trustee and/or an examiner in a Chapter 11. This is not automatic. Most Chapter 11s proceed without them. There is a provision, however, which says that upon application to the court, the court, in certain circumstances, shall appoint the trustee if there's a showing of fraud or other circumstances indicating bad faith or incompetence on the part of management, conflict of interest, or the like. Probably the best known was the Eastern Airlines case with Martin Shugrue, who probably was on TV more than anybody except Joe DiMaggio. He was the court-appointed trustee who took over for management at a certain point. The reason was the notion that because Eastern was affiliated with Continental Airlines, Eastern's management had a conflict, and that particularly because of, among other things, the interlocking pension obligations, there was a feeling there was a need for a trustee. There were other issues that also called for it.

There are also situations in which you may have an examiner. An examiner is not instead of management, that is, you can have an examiner in a case where the management remains in control, or you can have an examiner in a case where you have a trustee in control. An examiner is appointed to look into one or more specific issues, which, for one reason or another, the court or the creditors feel call for an outside expert. Indeed, there was a call at one point in the LTV case, that an examiner be appointed in order to look specifically at the pension obligations, and how they ought to be split up among the various entities. That ultimately went nowhere, but it was at least filed, and that is a situation where an examiner might be considered.

Now, one of my favorite players in the Chapter 11 setting is the official committee of unsecured creditors, because more often than not, that's who we represent. The official committee of unsecured creditors is just that, that is, the Bankruptcy Code provides that in any Chapter 11, the U.S. Trustee shall appoint this official committee. And it is the committee members' role to represent creditor interests. It is ordinarily made up of the largest creditors, although not always. There is an attempt to have not only the largest creditors, but also a cross section of creditor interests.

There can be more than one committee. That depends on the case, it depends on the preferences of the particular judge and the particular U.S. Trustee. In some cases, you have a single committee. In some cases, you have an equity committee, representing the stockholders. In some cases you have multiple creditor committees. You can have multiple creditor committees as in LTV or Federated, where you have very different business enterprises that are affiliated with each other. Larry indicated earlier that he is working with the parent company creditor committee in LTV, whereas I'm working with the LTV steel company creditor committee.

Federated was another well-known instance in which there were different committees for the Federated chain and for the Allied chain. And within those two groupings, there was a further division between trade creditors and bond holders. There too, the notion is sometimes that the different interests and the different legal rights of those two groups are so great, that to house them within a single committee is going to cause chaos. In other cases, the feeling is, it's better to work them out in a single committee. It depends on the facts and circumstances.

The last player is the U.S. Trustee; although he sounds like the most important, he's probably the least important. There is an official U.S. Trustee, not to be confused with a trustee such as Martin Shugrue, who's been appointed with regard to a particular company. It's the U.S. Trustee's job to appoint people to creditor committees, to review fee applications, and to object when he thinks it's appropriate, and otherwise to work with the bankruptcy judges in terms of making sure the system works.

Moving away from the players, we now have the notion of the estate. The estate is simply the assets of the company that is in a proceeding.

The automatic stay is a notion that is central to the bankruptcy process. The notion is that once there is a Chapter 11 filing, or, indeed, a Chapter 7 filing, that everything that's happened before then by way of legal proceedings, collection proceedings, and disputes, gets stayed and gets brought into the bankruptcy court. In a sense, it is to avoid a run on the bank, not that this is a bank, necessarily, but it is to avoid a run to the courthouse steps, and to avoid inconsistent legal proceedings that may be spread out throughout the United States. The notion is that we now have a company for which there is reason to believe can't pay everybody. And rather than have a mad scramble to see who gets paid first and who's left at the end of the line with nothing left, we're going to put a halt to everything.

The automatic stay provisions focus on things that have happened prior to the filing date, or the petition date, that is, the filing of the Chapter 11 petition. What is stayed, again, is lawsuits in progress, lawsuits that could have been brought because they refer to prepetition events, administrative proceedings involving prepetition events, unless they involve a government regulatory process, any acts to create or perfect a lien that haven't been previously created and perfected, and any act to collect or assess upon the property of the debtor.

The effect of the automatic stay is very important, and it accounts for a lot of what goes on in Chapter 11 cases. There was a lot of publicity surrounding the filing of first, the Federated chain, and more recently, the Macy's chain, that people were reluctant to ship goods to these chains, because they didn't know when they were going to get paid. However, once the chains had filed and were in Chapter 11, any new goods that were shipped afterwards could be charged and paid out as a regular expense, an administrative expense, in fact, of the estate.

The fact is that the automatic stay prevents you from getting paid on something that occurred prior to the Chapter 11. Once you're in the Chapter 11, you're okay. That gets back to something that Larry said, putting aside your representing your clients and focusing on representing yourselves for a second. If you are doing work for a company that is in trouble, try and shorten up on those bills. Obviously, if you can, it's even better to either be paid from the plan, if the plan is well funded, or at least get a retainer arrangement with your client. But whatever you do, don't treat it as business as usual, and you'll bill them every six months or whatever your cycle is. Once that company goes in, you are stayed from collecting on that, and it's just another claim. You may get paid, you may not get paid, but you won't get paid for a while.

MR. SHER: Mark, is there an issue even if fees, say, are paid from plan? If the company goes into Chapter 11, could the creditors try to get a halt on paying those expenses?

MR. WINTNER: They can try, and undoubtedly probably would, if it were an underfunded plan, because obviously the outflow of assets from the plan simply increases the underfunding. My personal view, however, would be to the extent that decision is made by a fiduciary of the plan, and it's with regard to some function that properly belongs to the plan, that is, doing the annual reports, doing the minimum funding calculations, that you should be okay. Obviously, you don't want to charge the plan for actuarial work that would more properly belong to the company in its settlor function. If it's considering amending the plan or doing things like that, you probably don't want to be charging the plan in that context.

MR. SHER: What if, say, previously, all of these fees have been paid directly by the company, and then the company decides, now that it is in Chapter 11, to start paying the fees out of the trust?

MR. WINTNER: If the document allows for it, again, my view would be, there's no problem with switching, as long as it's properly authorized. If the document does not allow for it, then you probably want to go through the creditors and the court in order to do that switch. Bear in mind, if it's really essential, the creditors would probably welcome having the money go out from the plan, rather than from the estate. The real thing is, the creditors may decide the work shouldn't be done. But in most cases, if you're dealing with really essential work, they'll be delighted. In fact, they may almost insist that you switch over to the plan. They're not harmed. If it has to be replaced in the plan, they're no worse off than if it came out of the estate. If it doesn't have to be replaced in the plan, dollar for dollar, they're only better off.

Now let's discuss priority of expenses and claims. This refers to the prioritization of claims in a Chapter 11 proceeding. It is very important because most of the conflicts, what somebody referred to as the collision between ERISA and bankruptcy law, occurs because the way bankruptcy law prioritizes things is based on a very different notion than the way ERISA calls for contributions and other payments to be made. And, you ought to think of bankruptcy in terms of what we said about the automatic stay. What bankruptcy is trying to do is to conserve limited assets. If the company had enough to pay everybody, it probably wouldn't be in Chapter 11 to begin with. Somebody's not going to be paid in full. And the focus is, it is in everybody's interest to reorganize. That means new goods and services have to be paid for upfront, or nobody will provide them. Old goods and services will be paid for out of a pool to the extent the company can do so.

Within that, though, we do have these priorities, some of which are, in effect, a logical outgrowth of that concept, and some of which are purely political compromises. And, increasingly, the latter is the larger group, not surprisingly.

At the top of the list, we have secured claims and perfected liens. This is as good as you can get in terms of a bankruptcy proceeding. A valid security right means it is documented; if Uniform Commercial Code (UCC) are necessary, all the filings have been made. If you're talking about a lien, the lien has been perfected and filed properly. If you have a valid security right, then you are at the top of the ladder. Now your only concern is that the assets to which your security claim or your lien attach are sufficient to support it. If you have $1 billion lien, but it's secured by something worth $100 million, you have a $100 million secured claim and a $900 million unsecured claim. So, that's not the end of the analysis, but at least it's the end of the legal analysis until we find out whether or not you're fully secured.

The next is administrative expenses. Administrative expenses are expenses that are the actual, necessary costs and expenses of preserving the estate, including wages, salaries, commissions, fees, and the like. It also includes postpetition taxes. This is what we're talking about when we say, somebody who ships to Macy's the day after it filed is better off than somebody who shipped to Macy's the day before it filed. The former has now provided a new service. The cost of that is an administrative expense. The debtor in possession, or the trustee, can pay him in full, no problem. The same thing would apply to any wages and any other remuneration for new services which are provided postpetition. The same applies to professional fees, such as Larry's fees, such as my fees, such as the multiple fees that a case generates. And cases are expensive, make no mistake about it. Although, you know, when you're talking about a large company, a large company has these fees whether it's in the bankruptcy or out of the bankruptcy.

Administrative expenses are sometimes referred to as an A-1 priority, simply because it happens to be covered in section 507(a)(1) of the Bankruptcy Code. Sometimes, for similar reasons, it is referred to as a first-level priority.

The next one, certain unpaid wages and vacation for the 90 days before filing, is what's referred to as an A-3 or third-level priority, and it is what it says. The main thing, and it's implied, but not stated, is that it comprises amounts for unpaid wages, etc., arising from services provided during the 90 days prior to filing. The maximum is $2,000 per employee. Usually that limit gets eaten up pretty quickly, simply by the fact that you're between payroll cycles, and that takes up a large part of it. If you file today, and you're in the two-week cycle, and this Friday is the end of the two-week cycle, eight of the 10 days are prepetition, or at least seven of the 10 days are prepetition. And, those will get paid as an A-3 claim, but it will use up a significant portion of that $2,000.

Next, the A-4, or fourth level, is for benefit plan contributions growing out of services rendered during the 180 days before filing. This can include delinquent contributions to plans, whether they be qualified plans or otherwise. However, it's a maximum of $2,000 per employee, and it is offset or reduced by the A-3 claim. These are not cumulative – you don't get $2,000 per employee on the A-3 and another $2,000 on the A-4. So, if you've used up your $2,000 per employee at the A-3 level, there's nothing left over at the A-4 level. That is typical in large cases. There's either nothing or very little which drops down to this.

The next is for taxes for the three-year period prior to the filing. And although this is not a tax session, the reason we mention that is because there are excise taxes for failure to make minimum funding contributions. And one of the active disputes in this area is whether that is, indeed, a tax, which, if it is treated as a tax, may get A-7 priority, or whether it is a penalty, in which case it drops down two notches to a level below that of general unsecured claims. There is a significant difference between the bankruptcy bar and the IRS, one which is frequently litigated.

The other reason we mentioned taxes for three years before filing is that the PBGC's claim, as we'll see later on, for underfunding, at least in part, cross-references this A-7 category.

Another area of active dispute, which we'll touch upon later, is whether or not, indeed, the PBGC's claim for underfunding, in the case of a termination, enjoys a priority at the A-7 level, or is simply a general unsecured claim.

Now, general unsecured claims usually take in most prepetition claims that don't fall within one of these other priorities. In fact, sometimes people switch back and forth between the notion of general unsecured claims and prepetition claims. The overlap is substantial, and I think for this purpose you can ignore any differences.

Equity comprises the stockholders. In many, if not most cases, they either get wiped out entirely, or they get warrants, or they get very little with regard to their holdings. This result is not a necessity, obviously, if a company could do well enough to perhaps rebound during the course of a Chapter 11, pay all its creditors, and still have something left for equity. But it's not often.

Now, these priorities, if you took them literally, would suggest that if you can't pay one level or another in its entirety, nothing goes below it. In a strict sense, that is the legal ordering of the priority of these claims. However, in a real Chapter 11, a lot of this gets negotiated out, and therefore, because of litigation risks, this really tells you who has a strong hand and who has a weak hand. But, it may very well be that general unsecured creditors, even though they're not getting 100 cents, will still give something to equity rather than litigate for three years over one claim or another.

Before we leave this there is a category that doesn't quite fit, but it's probably more or less within administrative expenses. And that is the continued payment of prepetition retiree medical and life insurance claims. Those are protected by section 1114 of the Bankruptcy Code, and have to be continued subject to the rules of 1114. Until 1114 allows you to discontinue them, they are paid on an ongoing basis, much like administrative claims, but they're not quite administrative claims.

At the end of the Chapter 11 case is a process leading up to what is hopefully going to be a confirmed plan of reorganization, or POR. That is the document that ultimately will be voted upon by creditors, and will determine who gets what out of the reorganization plan. And all of the litigation that takes place within a Bankruptcy Court involving the validity of one claim or another, and all of the negotiation that takes place, leads up to this document, this POR. If the Bankruptcy Court has determined that your claim is worth only $15 million, that's what's going to get reflected here. If you've negotiated a settlement with the PBGC, it's going to be reflected here. This is going to be the blueprint for who gets what out of the case, and what the post-Chapter 11 company is going to look like.

As it indicates, there is a disclosure and solicitation process by which the terms have to be disclosed to people. It gets mailed out, much like an SEC-looking document. There is a voting procedure. Each class of claimant gets to vote. In order to accept, a class has to approve the POR by at least two-thirds in dollar amount, and more than 50% of the creditors within a particular class. If a class does not agree, it can be subject to cram-down. Cram-down is a concept beyond the scope of this session, but in certain circumstances, a dissenting class can be crammed down, even though the class voted against the POR. The major conditions to that are that any lower priority class cannot get anything if a class is not being fully paid, and is being crammed down over its objection. In addition, at least one impaired class must vote to accept the POR. That leads to a lot of gerrymandering of classes. Sometimes we've even had very nice discussions with the PBGC as to whether it would like to be an agreeable class. So, bankruptcy makes strange bedfellows.

Feasibility is a very important concept, because it suggests that a Chapter 11 POR can only be approved by a judge, even after it's been voted upon, if, among other things, he finds, and he must make this finding, that the confirmed plan is not likely to be followed by liquidation or a need for a further financial reorganization of the company, unless it's planned that will happen, which is not a very common circumstance. The judge must find that there is enough, on an ongoing basis, that the company isn't a basket case or a cripple, and won't be back into Chapter 11 within a foreseeable future. If, for instance, one were to try to reorganize, but with such heavy pension claims, or such heavy retiree claims, that it's unlikely that the postconfirmation company can support it, any more than the preconfirmation company, you may not be able to confirm the case.

Treatment of retiree benefits we will leave until later in the session. The discharge of claims is that, to the extent that somebody does not get paid in full through the confirmed plan, because, for instance, the POR only provides that creditors will be paid 30% of the face amount of their claim, or 60% or 80%, or, unfortunately, sometimes 10%, the balance of that claim is discharged, it's gone. It's not that you get paid in the Chapter 11 and the balance is still hanging around to be the subject of a lawsuit later on. If it is a claim that was brought or could have been brought, because it arose prior to the filing of the Chapter 11, then it either gets paid in the Chapter 11, or it's discharged forever.

MR. SHER: At this point, we'll start discussing some of the specific benefit issues. I'm going to go through some of the pension issues, starting off with what happens in an ongoing pension plan. We'll talk about terminations and an interesting provision of ERISA called plan restoration. Then we'll get into the status of PBGC claims and finally a discussion of some other pension issues.

When funding a plan, particularly a plan that has unfunded obligations and where the company is either in a distress situation and not yet in bankruptcy or actually in bankruptcy, you have the minimum funding rules to worry about, the quarterly contributions, and the requirement to make the final payment for the year by eight and a half months after the end of the year.

There is a very important concept that shows up in several places – the controlled group liability concept. This shows up not only in funding and related excise taxes, but also it becomes very important for plans that terminate. Basically the concept is that not only is the contributing sponsor responsible for making contributions to a plan, and for paying excise taxes in the event those contributions are missed, but also any member of the controlled group, of which that contributing sponsor is a member, is financially responsible. So, if you have a company that is in Chapter 11 where other affiliated companies that are related under the section 414 definition are not in Chapter 11, what will the result be? The healthy companies are going to become liable. You can't just focus on the particular company that's in Chapter 11.

Now, in many cases, it'll turn out that if a company is in Chapter 11, many or all of its affiliated companies are also in Chapter 11. All of these rules were made much more clear in the Omnibus Budget Reconciliation Act (OBRA) of 1987, the Pension Protection Act.

MR. WINTNER: This ties in, by the way, again, with the automatic stay. This can be illustrated again by Eastern. For a year or two Eastern was controlled by the same parent who owned Continental. And Continental was attempting to stay outside of Chapter 11. Eventually it got dragged in anyway. PBGC simply turned to Continental and said, you currently have to pay the funding Eastern is precluded from doing, and eventually Continental had to file, so that resolved that situation.

But what the situation really means is that, if you have several companies that are under common control and you have a very serious pension underfunding, recognize that, if you don't file all of them, all you're doing is shifting the burden from one pocket to another.

MR. SHER: Another important provision that was introduced in the Pension Protection Act is the lien on unpaid contributions, Section 412(n) of the Code. There is a $1 million threshold. For large plans even a quarterly contribution that's missed might exceed $1 million. If you have a plan that has a current liability funded percentage of less than 100%, and missed contributions totaling at least $1 million, a lien can be asserted and perfected 60 days after that contribution is missed, or when you first go over the $1 million threshold. It would be perfected by the PBGC.

An interesting question here is what happens if you've missed contributions, the 60 days have not yet elapsed, and the company goes into Chapter 11? Consistent with what Mark was saying before regarding the automatic stays in bankruptcy, the lien could not be perfected, if it hasn't already been perfected when the bankruptcy is filed. So, from the PBGC's perspective, it would want to act right away to try not to get closed out by the filing of Chapter 11.

There's another provision, Section 401(a)(29), which was also introduced in the Pension Protection Act. This involves having to put up security if a plan that is funded at less than 60% of current liability is amended. Here there's a $10 million threshold. This provision has rarely become operative in practice, because of the very liberal, probably unintended, grandfathering provision, where, effectively, you can disregard unfunded current liabilities attributable to pre-1988 periods. But, in the future, as that grandfathering wears out, this provision could have more applicability.

If you're in a situation where a company is not able to make a contribution, it can apply for a funding waiver. As I'm sure you'll recall, those rules were tightened up significantly in the Pension Protection Act. You now have to have a temporary substantial hardship. The theory is that you've got to be able to demonstrate that the company is likely to turn around, that this is not a long-term problem that can't be fixed over the near future.

There is a controlled group test, so, if you go in for a funding waiver, you've got to show that all members of the controlled group are collectively experiencing temporary substantial hardship. You can only get three of these waivers in 15 years, and now you have to amortize waivers over five years, rather than 15 years. You have to amortize them at a very high interest rate, 150% of the federal midterm rate, which is generally a lot higher than the valuation assumption. Security is required, to the extent of amounts over $1 million. This, again, was added in the Pension Protection Act. So, if you're going to get a funding waiver, you better have some type of security of value to put up. And, the IRS can, in order to agree to the waiver, throw in some other requirements.

You can't amend a plan to improve benefits while a funding waiver is in effect.

So, these are all things that you have to be aware of, whether your client is already in Chapter 11, or having financial difficulties and trying to avoid going into Chapter 11.

Next, we deal with what happens to an ongoing plan when you go into Chapter 11. Can you just continue to maintain the plan? Well, the answer generally is yes. There's nothing that requires you to terminate a plan, just because you're in Chapter 11. An interesting question, however, is, can contributions be made to a plan while in Chapter 11? The one thing that seems very clear is that normal cost contributions, or contributions attributable to service rendered while the company is in Chapter 11, will be treated as an administrative claim, and therefore can be paid right away.

The question becomes, what about the remainder? If you have a plan that has a large unfunded liability, a significant portion of the minimum funding contribution is amortization of that unfunded liability. The fact that most or all of that unfunded liability relates to prepetition service, might lead one to the conclusion that you couldn't make that contribution, since, remember, one of the basic aspects of bankruptcy is all of the prepetition obligations are put on hold. This is something that has been a contention between the PBGC and debtors and between debtors and creditors. Most recently, in the LTV case, the basic conclusion of the Bankruptcy Court was that only the normal cost can be paid. In the LTV case, that created a very serious problem, in that one of its plans was running out of money. And if contributions weren't made to that plan very soon, the plan would crash and have to be taken over by the PBGC. There ended up being a compromise among all of the parties to allow limited interim contributions to be made so that the plan wouldn't run out of money at least for a while.

Now let's discuss the status of liens for an ongoing plan once you're in Chapter 11. Any liens that might have been placed on contributions, say prepetition contributions, would have effect if they were perfected prior to going into Chapter 11. Whereas if contributions were missed but a lien had not yet been perfected, the lien cannot be perfected once Chapter 11 proceedings start.

What about the status of prior funding waivers? The IRS, in some cases, has attempted to revoke those waivers, effectively making them null and void, retroactively. In some cases the IRS has attempted to impose excise taxes retroactively. I believe that the cases have generally gone against the IRS. Very recently, in the LTV case, the IRS was asserting that the excise taxes should be given the status of tax priority. Everybody else in the case was saying, no, these are penalties, which at the very most should be given a subordinated type of unsecured status, that would put them towards the bottom of the list. The bankruptcy judge has ruled that those claims should be given the subordinated treatment. Very possibly, this will be appealed by the IRS. The amount of money involved in these situations can be huge, particularly if the IRS attempts to assert the second-tier excise tax, that is, the 100% amount.

MR. WINTNER: Let me interrupt for a second. The 100% is actually one of those things that gets stayed for the balance of the Chapter 11. So, if eventually you're going to pay off the contribution, the second-tier excise taxes go away by themselves. But if not, the IRS does say that at the end of the case, those claims are there.

An aggravating part about the retroactive revocation of waivers can be illustrated in LTV. There was a waiver that had been granted for 1984, which was in place at the date of the filing. The contribution for 1985 was not yet due at the date of the filing, and 1986 was a postpetition year anyway, or at least it straddled the filing. So that, as of the date of the filing, LTV was in compliance with minimum funding. We now say, okay, but postpetition, we can't make payment on the waiver, because that's from a prepetition year. And we can't fund the past-service liability of either 1985 or 1986. The IRS says, okay, but we're revoking your waiver, and we think you owe excise taxes for all these years. Recognize what happens, because the IRS goes back and revokes it retroactively to the year of the waiver, and that's the IRS's position, not only that it can revoke the waiver, but also that the revocation has this throwback effect. In fact, it winds up being not just a 10% tax under current law. It can become much more than that. In LTV itself, for instance, at a time when the first-tier tax was 5%, the first-year tax works out to be about 9% of the actual amounts missed, because it's a year-after-year retroactive basis.

On the 100% claim it's twice the amount of the contributions that were actually missed in those years. We've seen cases where the claim can be as much as four to 10 times the actual amount of missed contributions. So, the retroactivity doesn't create the problem, but it certainly aggravates it considerably. Now, in a lot of these cases, we also argue that, if bankruptcy law is what prevented you from making the contribution, not only should it be treated as a penalty but also the Bankruptcy Court should disallow this as a claim in the first place and not recognize it at all. Because what kind of government tells you that you can't make the contribution, but you owe some and that, in itself, creates a claim in favor of the IRS, when the pension plan isn't being paid and the PBGC isn't being helped? But that's an area of litigation.

MR. SHER: There's a provision in the bankruptcy code called Section 1113 that provides at least the possibility of the debtor being able to apply to the Bankruptcy Court for, in effect, a revocation or at least a modification of collective bargaining agreements. An issue comes up here if you have a collective bargaining agreement that actually provides that the plan will, during the term of the agreement, be funded in accordance with ERISA minimum requirements. The question then becomes, will that have an overriding effect on this general provision in bankruptcy that would seem to suggest that you can't fund at least the amount attributable to service rendered prior to bankruptcy? That's an issue that I think is not really resolved. It would have to be addressed in each particular situation.

Regarding some of the requirements of a standard termination, you can apply, in a bankruptcy, for a standard termination. Certainly, if your plan is overfunded, or at least 100% funded for benefit liabilities, you go through the normal procedures including advance notices and actuarial certifications. The interesting issue here is, what happens if there are excess assets? Do they just become part of the estate? Probably. But what happens if the government has a claim, for example, if the company was doing some defense contract work, the government generally comes in and attempts to claim some of those excess assets. So there are interesting issues that may come up as far as, where exactly do those assets go?

Distress termination may be a more likely scenario in a distress situation. The company may want to apply for a distress termination. If you have a collectively bargained plan, you're going to have to get the union's consent to do that. Here the plan would be less than 100% funded.

It isn't necessarily a sufficient condition, to just be in Chapter 11, in order to be able to get a distress termination. Again, the controlled group concept comes into play. Each controlled group member must meet at least one of these criteria. So, if you have a member or two that does not meet one of the criteria, for example, because they're not in Chapter 11, you may not be able to get the distress termination. The Bankruptcy Court must determine that the company would not be able to successfully emerge without the plan being terminated. In effect, the implication is that the termination of the plan would help allow for a reorganization. Now, outside of a bankruptcy scenario, the PBGC could determine that the company would be unable to pay its debts and stay in business. So, that might apply in the pre-Chapter 11 situation, but it could also apply, for example, if you had some members of the controlled group that were not in Chapter 11, but if you didn't terminate the plan that would force the other companies into Chapter 11.

Another ground for distress termination is that pension costs have become too burdensome due to declining work force. That's a provision in the statute.

MR. WINTNER: That last one, the PBGC determination, is not mutually exclusive with Chapter 11. In other words, you can meet the second criteria – you can also have the PBGC make this determination, even as to a Chapter 11 company. It may not have much incentive to do so, but if, during the course of your Chapter 11, you've shrunk from 10,000 employees to 100 employees, the PBGC could make that determination without your ever having to go to the Chapter 11 Bankruptcy Court for the approval.

MR. SHER: Okay. Once you get past that point, and get approvals for a distress termination, you need to have an asset allocation performed under Section 4044 of ERISA. That actually can involve allocation of some assets to nonguaranteed benefits because, under priority category three, you are allocating assets to nonguaranteed benefits.

PBGC would then have a claim for any unfunded benefit liabilities, not just the unfunded guaranteed benefits. Benefit liabilities are essentially the same as current liabilities, whatever that means. Employees will often end up getting more benefits than what are guaranteed, to the extent that they are allocated in priority category three or to the extent that there is ultimately a recovery. That recovery might occur in the bankruptcy, when all of the assets of the estate are divvied up.

Regarding involuntary termination, the PBGC can initiate in some circumstances, a termination that looks very much like a distress termination. The grounds for doing so are failure to meet minimum funding, if the plan will be unable to pay benefits when due, that is, the PBGC determines that the plan is in the process of running out of money in the foreseeable future, if a substantial owner receives a distribution of over $10,000, or if the PBGC determines that there is a long-term risk to the insurance system if the plan continues. Another situation that is very important, and came up in the LTV situation that I mentioned before, is that if a plan actually does run out of money, the PBGC must terminate it. In this case there is no choice. In order to get an involuntary termination, the PBGC must get approval of the district court. There might be a trustee that is appointed by the court. All the elements, including the employer liabilities, PBGC guarantees and claims, turn out to be the same as in a distress termination.

There's a section in ERISA, 4047, which gives the PBGC the right to restore a plan that has either already gone through termination proceedings, or is in the process of being terminated. PBGC has the right to return all or part of the remaining assets and liabilities. So, if it determines that it would be appropriate to restore a plan, the PBGC could restore the whole plan, or it could restore a portion of the plan. The PBGC has not exercised its authority very often in this area. As a matter of fact, the only time it has exercised it, to date, is in the LTV situation, where the PBGC restored, ultimately after much litigation, three of the plans. As many of you probably recall, the lower courts originally did not go along with PBGC's restoration orders. Ultimately the Supreme Court ruled that, at least in this particular situation, the PBGC had the right to restore the plans.

One interesting issue that came up in the LTV situation was the fact that plans were originally involuntarily terminated by the PBGC at the beginning of 1987, later on that year, the PBGC came in and attempted the restoration. What really got PBGC upset and caused it to take that action was LTV's decision, through the collective bargaining process, to implement what PBGC ended up calling abusive follow-on plans. In effect, what the company negotiated with the union was a substantial makeup of the benefits that were lost when the plan terminated. Remember, the PBGC was only picking up guaranteed benefits. The follow-on plans provided about 80-90% of the lost benefits through nonqualified arrangements. The company felt that by doing so through a nonqualified plan, it would make it less likely that the PBGC would object.

The PBGC went bonkers, and basically decided that this was a sham. The PBGC felt that it should not have to pick up all of those unfunded guarantee benefits, while the company is still managing to fund a portion of benefits that were not guaranteed. Ultimately, the Supreme Court agreed with the PBGC.

An interesting question in retrospect is, what could LTV have done differently to avoid this situation? Certainly, if it had just implemented a straight defined-contribution plan, there almost certainly would not have been a problem. Even if it had loaded up that plan to provide higher benefits for employees with longer service, the PBGC would have had a hard time objecting. But anything that resembled defined-benefit past-service benefits was going to create a problem here.

MR. WINTNER: Well, LTV could have done some of that, with regard to ongoing, active employees. But there was no way around it with regard to trying to make up the lost benefits for retirees, and benefits that were nonguaranteed, primarily, pre-1965 supplements from shutdowns.

It's not that people were unaware as to the fact that the PBGC was going to go bonkers. We didn't know the PBGC would take the case to the Supreme Court, but we knew the PBGC was going to go bonkers. However, it's not just a matter of knowing the pension rules and the bankruptcy rules. There were other factors in the universe, such as the steel workers. And the steel workers, rightly or wrongly, took the position, either you adopt the follow-on plans or we strike. That was another kind of risk. And, in this circumstance, the company and the creditors decided to not take on the threatened strike. It's with 20-20 hindsight we know the Supreme Court didn't like the follow-on plans. The District Court agreed that there was no problem with the follow-on plans. Three judges of the Second Circuit agreed there was no problem with the follow-on plans. Unfortunately, that's why they're called the Supreme Court. You can't appeal from them.

MR. SHER: They make mistakes once in a while, too.

MR. WINTNER: Yes.

MR. SHER: One of the other possible justifications for restoring a plan is if a company's financial condition improves. An interesting question, then, is what happens if a company's financial condition has improved to the point while still in Chapter 11 that the PBGC believes that the plans can again be afforded? Or, even taking it a step further, let's say the company emerges from Chapter 11, and a year or two later, it's doing great. Could the PBGC come in and say, well, I think you guys can now afford to pick up where you left off, we're going to restore this plan? It's unlikely, at least in the second scenario, I think, that the PBGC would attempt to do that. And for that matter, I think it's unlikely that the PBGC will exercise its right to restore a plan again, period. I think the experience was so negative in the LTV situation that the PBGC will avoid it in the future.

It is more likely that the PBGC would threaten to terminate plans in the first place, rather than to go in and terminate them with the idea of restoring them later.

A very interesting thing that the PBGC and IRS did was to issue regulations under section 412, which provided for a fresh-start funding for plans that are restored. So, in the LTV's case, since the plan had been in a terminated status for many years with no contributions being made, the unfunded liability continued to grow. The regulations allow the entire unfunded liability at the time the restoration finally takes effect, to be funded over as long as 30 years.

There is nothing you can really point to in section 412 that provides for this. You could argue that 412 is silent on this issue, and therefore, in those situations, the IRS has the authority to fill in the legislative intent. That's what it did here. It certainly surprised me. We had come up with all kinds of other things we thought the IRS might do.

In the LTV case, the IRS gave the PBGC the authority to spread out the funding over a very long period of time, thereby making it more feasible, making restoration work, at least in the IRS's eyes. Had the IRS been more restrictive, the whole thing would have unraveled, and then effectively the PBGC may have had to reterminate one or more of the plans. So, this was a way to get what the PBGC's objective was, and that was to not have these plans come back to it. Particularly not after all that the PBGC went through, going all the way through the Supreme Court.

MR. WINTNER: Okay, we've now supposed that, through either a voluntary or involuntary termination of an underfunded plan that's been terminated in the course of a bankruptcy, and we're not talking about restoration, the PBGC now has a series of claims, and the priority, or the dispute over the priority gets broken down into different categories.

Everybody would agree that the PBGC is entitled to secured treatment with regard to some things. If there's a funding waiver for which a security interest was originally given and perfected, then theoretically, that's a good security interest. I shouldn't say everybody will agree. In most cases, that is the case. There is, in fact, a real, live situation involving Pan Am, or what's left of Pan Am, where there was a waiver given to Pan Am in the months preceding its Chapter 11 filing, and the PBGC did, indeed, take a security interest in stock of the shuttle. However, there is litigation involving even that.

Regarding post-1987 contributions of over $1 million, as Larry indicated before, at the end of a 10-day notice and 60-day cure procedure, if the contribution hasn't been made, the PBGC can perfect its lien by filing it in the proper courthouse. If all of that has taken place, including the perfection of the lien prepetition, there's a good lien. Rarely will that happen. But if it happens, fine.

Now, the termination liability of up to 30% of the controlled group net worth is an item that is a subject of considerable litigation, or at least dispute. In the first instance, the 30% of net worth itself is the subject of a half-hour debate as to what is net worth. It is beyond the scope of this. However, if the company's in Chapter 11, how can it have any net worth? PBGC has a list of eight factors, the gist of which is it's not a balance sheet test. And I think that's fair. However, the PBGC can pick any of eight factors, which include comparable company sales or the assumed reorganization value in a Chapter 11 (which means, it's not a question of whether you have $100 million in assets and owe $200 million in liabilities, if you're only going to pay $80 million on that $200 million of claims, PBGC says, well, you have $20 million net worth after you're done discharging the $120 million that you didn't pay to those creditors). So, the PBGC can find value in a lot of places, and there's a catch-all that it can pick any other factor and, on a case-by-case basis, the PBGC reserves to itself the right to pick whichever factor is best for it.

Having gotten past that, let's suppose there is a net worth somewhere in that controlled group. Under the current statute, that gives the PBGC a purported priority claim, under 4068. However, there is a drafting glitch between 4068 of ERISA and the bankruptcy code priority categories that we spoke about before. And although, at first glance, it appears to reference the tax categories, because it says that the PBGC is entitled to a lien having the same priority as a tax lien, the problem is that the lien, which if the tax lien came into being as of the date of the planned termination, and we're now assuming the planned termination is after the filing of the Chapter 11 petition, can't be created as of that date. PBGC argues, well, that's a drafting glitch. What was clearly meant was that we're entitled to the priority of the tax claim, even though we don't get the lien. And, the bankruptcy bar says, that's nice, but we have our code, you have your ERISA. There are no ERISA courts, there are bankruptcy courts, you either have a priority or you don't. And in our view, there's nothing in bankruptcy law or in ERISA that would give you that priority. That has been debated over five or ten years.

Once again, the LTV case is the one that's come the closest to addressing it head on. And, both Judge Lifland and District Court Judge Duffy indicated that they agree that it is not a priority in and of itself, and to the extent it is characterized by the fact that all the liabilities arose by reason of prepetition service, that it is just a general unsecured claim. PBGC doesn't agree. It will litigate the claim in every other court but Lifland's. It's an open issue, and ultimately the PBGC wants to deal with it in legislation.

On the other claims, we have the similar type of dispute over and over again, to the extent that when a plan such as this terminates, it probably has delinquent contributions. Again, there's going to be a debate as to whether those contributions are entitled to priority or not.

Last, involving the PBGC claims, the PBGC starts with the fact that its claim is measured by the amount of the underfunding, and according to the PBGC, the amount of the underfunding is measured by its published rates. As you know, it publishes rates theoretically monthly, although it can go a couple of months without a change.

In the LTV case, however, the company and the creditors argued that once the plan is terminated, and this was referring to not the restored plans, but a plan which was terminated and never restored, the PBGC has a claim. Like any other claimant, the value of its claim ought to be determined by the bankruptcy court, and not by artificially low interest rates and other assumptions set by the PBGC itself. The bankruptcy court and the district court agreed with the notion that it is up to the bankruptcy court to determine how to reasonably value that claim, ignoring the PBGC's published rates.

Although the particular rate chosen by a bankruptcy court will vary depending upon the time period you're looking at, and all the facts and circumstances, in this particular case, the bankruptcy court selected an 11.5% discount rate, as reflecting a true market rate at a point in time when the PBGC's published rate was 8.5%, and of course, that's just the immediate annuity rate. The PBGC's blended rate was considerably lower than that. Suffice it to say the PBGC doesn't like the LTV decision too much.

I did want to emphasize the joint and several nature of the PBGC claims. We said at various times that the PBGC claim, as well as the funding claim, is joint and several. I want to emphasize both words of that. It is not just that all members of the group are liable for it, but that once it's reduced to a claim, that claim can be asserted against all members of the group. That means, for instance, that if there are two members of the group, and the underfunding claim is $100 million, it can be asserted in full against company A, and again against company B.

So, in LTV, for instance, with regard to what was a $2 billion underfunding, as of the date the plans were originally terminated, PBGC wound up filing claims for $128 billion. That got everybody's attention, the reason being, with 64 filed companies, they just filed a $2 billion claim 64 different times. But that also means that if in company C, which is a separate legal entity, there happens to be a pocket of $10 million of value and the PBGC is the only creditor against company C, it can pull out that $10 million of value and then go hunting for value elsewhere. The only way to avoid that result is a bankruptcy concept called substantive consolidation, under which, under very rare circumstances, one can, in effect, collapse the different legal entities into a single pot for creditors of the various entities. But, joint and several is a very powerful tool that the PBGC has, or that plans have, if we're talking about funding.

FROM THE FLOOR: I was just wondering, who is responsible at that point when the plan has not been terminated and there is no longer a sponsor due to liquidation?

MR. WINTNER: There really is no answer. I have a case very much like that. We haven't yet converted, but we can see that coming. I have to tell the Chapter 7 trustee that he doesn't want to become a fiduciary. He was hired to run a bankruptcy proceeding, not to take on fiduciary liabilities. And we have suggested to the PBGC this would be an appropriate time for it to take over the plan and protect the employees, because it's going to become an orphaned plan. The PBGC has, in my case, and it sounds like your case, viewed that as sort of the last resort, not a first resort. And, have not made it a priority. At the end of the day, sooner or later, that will happen. Because the PBGC will not let a plan be totally abandoned, but it will play a little bit of brinkmanship, and hunt around to see if there's any other solvent company hiding in the woodwork that the PBGC can shift fiduciary liability to. The PBGC has also indicated that it thinks that perhaps a Chapter 7 trustee, by reason of being the de facto employer, becomes a fiduciary. We totally disagree, and we're certainly not going to take any actions that would compromise our position. The IRS has not helped matters, in a totally separate area, by suggesting that plans that don't have sponsors become disqualified. It raises a perhaps unnecessary additional complication. What happens if the company disappears, and the plan could really sustain itself for a while because it has enough assets that, maybe through reinvestment, it can survive.

MR. DOUGLAS L. THOMPSON: I find the split between future expenses and past expenses, prebankruptcy expenses, interesting, especially with a determination of normal cost as being the only contribution that is allowable during the bankruptcy. Is there any restriction, at least in terms of what's applied in the past, to the method that would be used for determining normal cost? I mean, if you had a plan that was using the aggregate cost method, you get a vastly different result.

MR. SHER: You should probably change methods. Is that what you are suggesting?

MR. THOMPSON: I have no experience with this, so I'm just curious about whether or not that's come up before.

MR. WINTNER: Well, it has. I also don't want to leave you with the impression that there's only one answer. The PBGC will say, indeed, that the entire funding is an administrative expense, because the maintenance of the plan is an administrative expense, and the PBGC often points to the fact that you can't really strip the two out so well, because it depends on the funding method. There is a case called Columbia Packing, in which the judge seemed to come out and at least partially bought the PBGC's argument that even the past service liability is partially the cost of maintaining the plan currently, and is an administrative expense. The real problem is, it's hard to come up with a clean answer that fits all cases. One of the LTV plans is a salaried plan where all benefits were frozen before the filing of the Chapter 11. So, one would say, there, that's a clean case. Nothing's being earned postpetition by reason of any postpetition services.

But you're right, the legal issues are somewhat framed by the factual setting, and it can be little blurry, depending on which way you're going. I also want to emphasize that there are cases where the company and the creditors will say, notwithstanding their potential ability to block funding of past-service liability, that for one reason or another, they don't want to block it. And, if the company and all the creditor groups agree that it's in everybody's interest to fund it, a lot of plans get funded during the course of a Chapter 11. If no creditor objects, then there's no reason to prevent that from happening. However, the point is, in most cases, one or more of the creditor groups will object. There are reasons why you might want to do that. Maybe you want to avoid the PBGC forcing a termination. Maybe, for one reason or another, the company really wants to fund its benefits currently. By the way, in LTV, there was also a healthy LTV pension plan, where, because it was subject to funding under defense department contracts, everybody agreed that funding ought to be continued because, even if the funding was for past service, it was being paid for by the government contract. So all of this is always a negotiation. What we've given you here are the legal positions which frame the negotiation.

MR. THOMPSON: If a plan was being terminated with a surplus, would the IRS lose its excise tax on the reversion, because that would be pretty far down in the priority process, for the bankruptcy?

MR. WINTNER: Let me be careful here. There is one case which suggested that it is treated as a penalty and therefore equitably subordinate to general and unsecured claimant. I think it's only been considered by that one case. I would suggest that that's a harder argument than the excise tax for not meeting the minimum funding contribution. Because if you look at the legislative history, the IRS simply says well it's called an excise tax, that's the end of it, it's a tax. But the legislative history of 4971 is very rich, in terms of every Congressional panel which dealt with it, and made it clear that it's to penalize the employer that doesn't make a contribution. On the other hand, the legislative history involving the reversionary excise tax makes it a lot fuzzier, and suggests that it's taking back into tax revenues the unintended benefits of a surplus. And therefore I'm not sure that it's going to be as easy an argument. But it is unresolved. That tax, by the way, is generally 50%, but it drops down to 20% in a Chapter 7, not a Chapter 11. That, unfortunately, also suggests that, by making that distinction, that Congress probably thought it was a tax, and not a penalty.