

AMERICAN BANKRUPTCY INSTITUTE JOURNAL

Issues and Information for Today's Busy Insolvency Professional

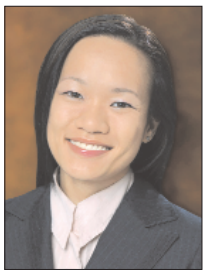
Bankruptcy as a Strategy to Modify Pension, Medical Benefits: Role of the Financial Advisor

Written by:

Colleen Lowmiller
Bridge Associates LLC; Chicago
clowmiller@bridgellc.com

Lynn Yap
Bridge Associates LLC; New York
lyap@bridgellc.com

Many companies with legacy pension and post-retirement medical costs are finding it critical to modify these benefits in order to remain cost-competitive. Chapter 11 bankruptcy protection is becoming an increasingly popular strategy for companies attempting such modifications. Retiree costs have become a crisis for many U.S. companies. The combination of several trends in recent years—prolonged life expectancy of retirees, rising medical care costs and increased ratios of retirees to active employees—have caused an enormous surge in several companies' retiree obligations, thus resulting in underfunded defined benefit pension and post-retirement medical plans.



Lynn Yap

Retiree cost concerns are not only central to the obvious candidates currently in the news, such as the steel, auto and airline industries, but additional industries are affected by large pension and post-retirement medical costs as well. According to a study released by the Henry J. Kaiser Family Foundation and Hewitt Associates in September 2007, many employers indicate that they expect to make significant changes to their health plans and benefits in 2008. Overall, 21 percent of firms say they are "very likely" to raise workers' premium contributions next

About the Author

Colleen Lowmiller is a director with Bridge Associates LLC in Chicago. Lynn Yap is an associate with Bridge Associates LLC in New York.



Colleen Lowmiller

year. Some firms also say they are "very likely" to increase office visit cost-sharing (13 percent), increase deductibles (12 percent) and increase prescription drug cost-sharing (11 percent). Very few firms say they are "very likely" to restrict eligibility for coverage or drop health coverage altogether. Premiums for employer-sponsored health insurance rose an average of 6.1 percent in 2007, less than the 7.7 percent increase reported last year, but still higher than the increase in workers' wages (3.7 percent) or the overall inflation rate (2.6 percent). The volatility, unpredictability and magnitude of the dollars involved have put pension and retiree medical costs at the forefront of many major restructurings and bankruptcy cases, especially for debtor employers such as Delphi Corporation, Delta Air Lines Inc., Northwest Airlines Corp., Dana Corp., Tower Automotive Inc and UAL Corp., with heavily unionized workforces and a high ratio of retirees to active employees. Such large, unionized companies believe that they must terminate or modify these benefits in order to remain cost-competitive. Employers are looking not only to reduce current retiree costs, but to contain future cost increases as well. As a result, in many corporate restructurings

pension and medical benefit modifications are key issues.

While often not the most efficient alternative, many benefits exist for a company seeking to reduce its pension and post-retirement medical costs by addressing the reduction of these costs in a formal bankruptcy court proceeding. Sections 1113 and 1114 of the Bankruptcy Code can offer the debtors relief from such cost burdens:

Pension Plan Liabilities

Section 1113 of the Bankruptcy Code allows a debtor to seek modification of its collective bargaining agreements (CBAs) in order to eliminate the debtor's pension plan funding obligations. This section of the Code prohibits a debtor from unilaterally terminating a pension plan and sets forth specific procedural and substantive prerequisites that must be satisfied. Under §1113, the debtor must prove to the court that *unless it terminates or reduces these benefits, the debtor will be forced to liquidate*. The burden of proof is on the sponsor of the pension plan. Where a collective bargaining agreement provision requires the maintenance of a defined benefit pension plan, a debtor must not only comply with the requirements of ERISA before terminating the plan, but also follow the process established by §1113. Specifically, the Bankruptcy Code requires that "unless the plan is terminated, the entity will be unable to pay its debts pursuant to a reorganization plan and will be unable to continue business outside a chapter 11 reorganization process." These criteria must be satisfied in order to successfully terminate or modify a pension plan.

Post-retirement Medical Liabilities

Termination or modification of *retiree* benefits is governed by §1114 of the Code, which permits a debtor to reject its continuing obligations for retiree health and insurance related benefits that have vested pre-petition. These benefits are usually referred to as “Other Post Employment Benefits” (OPEB). Again, as in §1113, specific procedural and substantive prerequisites must be satisfied. A debtor is required to continue to pay all retiree benefits on time during its bankruptcy case unless the court authorizes modifications or the debtor and the union (or another designated authorized representative chosen to negotiate on behalf of the retirees regarding the modification of retiree benefits) agree to modify such payments. Under §1114, a debtor must prove to the court that the modifications are *fair and equitable* (among the retiree groups and compared to other creditors of the debtor) and that *the reductions are necessary for the debtor to reorganize*. Again, the burden of proof is on the sponsor of the retiree benefit plan.

Procedural Prerequisites

The courts have developed a nine-part test to determine whether the specific procedural requirements of §1113 and §1114 have been satisfied:

1. An initial proposal must be made by the debtor to the union/retirees to modify the CBA or retiree benefits. This must take place *after* the commencement of the chapter 11 case, but *before* the motion to reject the CBAs and the proposed modification of retiree benefits.
2. The proposal must be based on the most complete and reliable information available to the debtor at the time the proposal is submitted.
3. The proposed modifications must be *necessary* to permit the reorganization of the debtor.
4. The proposed modifications must provide that all of the debtor’s creditors and all affected parties are treated fair and equitably. The court will consider whether the modification burden is to be shared by the debtor’s ownership, management and non-union personnel, and also consider the similarity of the treatment of non-union vs. union employees/retirees.
5. The debtor must provide the union/retirees with enough relevant

information to properly evaluate the proposal. However, the debtor does not have to make available *all* financial records to the union/retirees. 6. The debtor must meet at reasonable times with the union/retirees between the initial presentation of the proposal and the hearing on the motions to reject the CBAs and modify retiree benefits. There is no set number of meetings required, but the debtor must be available and must make reasonable efforts to meet as requested. The debtor may set deadlines for a response to the proposal, and the debtor does not need to bargain to impasse.

7. The debtor must confer in good faith in attempting to reach mutually satisfactory modifications to the CBAs and retiree benefits. The court will consider whether the proposed modifications include concessions from both parties.

8. The union/retirees must have refused to accept the proposal without good cause. In other words, once the debtor has established that its proposal meets the requirements of §1113 and §1114, the burden shifts to the union/retiree to articulate reasons for rejecting the debtor’s proposal.

9. The balance of the equities must clearly favor rejection of the CBAs or modification of retiree benefits. In determining this, the courts will consider the following factors: (a) The likelihood and consequences of liquidation if the rejection or modification is not permitted, (b) the likely reduction in the value of the creditors’ claims if the CBAs remain in place; (c) the likelihood and consequences of a strike if the CBA is terminated; (d) the possibility and likely effect of any employee claims for breach of contract if rejection is approved; (e) the cost spreading abilities of the various parties, taking into account the number of employees covered by the CBAs and the comparison of the wages and benefits to those of others in the industry, (f) the good or bad faith of the parties in dealing with the debtor’s financial dilemma and (g) the willingness of the union to compromise.

Given these procedures, under §1113, how do a debtor and its creditors, employees, retirees or other interested parties determine whether the lack of such benefit modifications is *the* factor that will cause the

debtor to liquidate? Or, under §1114, how would a lack of modifications *prevent* the debtor from reorganizing? Should the debtor approach pension or retiree health-benefit modifications first? Not only are these issues interrelated, but they significantly impact the overall restructuring process and create a need for complex analysis from a financial perspective.

Role of the Financial Advisor

In many cases, the debtor and/or one of the interested parties (unions, non-union employee representative, other creditors, etc.) need to engage a financial advisor to answer these questions completely and form a basis for negotiation. Whether the pertinent issues relate to pension benefits (§1113) or retiree benefits (§1114), the analysis required is very similar. Significant areas requiring analysis in defending or challenging both pension and retiree benefit modifications include the following.

Understanding the debtor’s comprehensive benefit plans. It is important to first identify and catalogue the provisions and benefits provided under all benefit plans as well as to analyze the actual costs related to providing such benefits. This analysis requires identifying the actual underfunded amount as actuarially calculated. Questions to be answered include:

- What is the debtor’s current comprehensive employee and retiree benefits package?
- What changes has the debtor made to the employee and retiree benefits over the past five years?
- What concessions has each group of employees/retirees made over the past five years?
- How does the debtor’s current employee and retiree benefits package compare to the industry and to similar size companies?
- What are discretionary costs, such as administrative, business and corporate overhead allocated to the plans?
- What is the debtor’s accounting and actuarial methodology related to the plans and has there been any recent change?
- Which historical FAS 106 and FAS 87 financial statement disclosures, and financial statement line items and financial ratios, are impacted by changes in pension and medical benefits?
- What are the underlying FAS 106 and FAS 87 assumptions? Is the

actuarial calculation supporting the financial-statement liability amount valid and reasonable?

- What are the life expectancy, claims experience, IBNR calculation, health care cost trend rate, discount rate, and plan asset rate of return assumptions? How do these compare to the industry?

- How do changes in the actuarial assumptions affect the required annual cash-funding and expense recorded by the debtor in the financial statements?

- How are the debtor's projections and financial ratios affected by sensitivity analysis of the actuarial assumptions versus benefit modifications using the current actuarial assumptions?

Analyzing the debtor's business/reorganization plan. To determine the necessity of the benefit modifications, it is critical to thoroughly understand the debtor's business plan. This allows interested parties to determine whether the modifications are necessary to the debtor's reorganization (§1114) or whether the continuation of existing benefit agreements will cause the debtor to liquidate (§1113). Such analysis will most likely require the use of both bankruptcy and industry experts. Areas of concern and inquiry include:

- What are the debtor's five-year financial projections and key underlying assumptions?
- What are the outstanding issues with respect to finalizing the debtor's reorganization plan?
- How do the debtor's assumptions for key inputs such as raw material prices compare to industry forecasts?
- Where do the debtor's negotiations with various creditors stand? How will the possible outcomes prior to confirmation affect the projections?
- What is the expected recovery to the various classes of creditors in the case?
- What are the pension and medical benefit assumptions included in the business plan projections?
- Are all current business developments, both cash-flow positive and negative (*i.e.*, new customers, new products, legislation), included in the business plan?
- What is the sensitivity related to the actuarial assumptions reflected in the projected benefit costs?
- Are there any other areas where the debtor may have additional sources

of cash or reduced expenses that are not reflected in the business plan?

- Do the potential exit financing sponsors directly require the benefit modifications?

- How do the benefit modifications affect the debtor's reorganization value and resulting equity value?

Overall analysis of benefit modifications. The benefit modifications must be understood not only in terms of the changes made to the benefit plans, but also in terms of the impact that they will have on the debtor's financial viability post reorganization:

- What is the overall cash and expense impact of modifications/termination on the debtor's projections?

- What are the quantitative and qualitative effects at the overall plan level, as well as at the individual employee/retiree group level?

- What is the value of the debtor's proposed benefit reduction compared to the estimated recovery of other creditors in the case?

Alternative sources of benefit plan funding. It is important to determine whether alternative sources may be available to fund the pension or retiree benefit plans other than those identified by the debtor:

- Are the current pension and retiree benefit plan annual funding requirements accurate?

- Are there discretionary disbursements in the plan that, if deferred, could be available for funding of retiree benefit commitments?

- Is there "over-funding" of executive compensation plans that can be construed as excessive and that could be subject to challenge?

- Are there other plan assets that can be contributed to the plan?

Evaluate and identify alternative pension and medical plan funding scenarios. Another critical aspect of the analysis is to determine whether "all stones have been turned" in evaluating whether all possible funding options have been considered:

- Are there alternative plan designs that would allow for the funding of benefits?

- Are there noncore assets or businesses that can be sold with proceeds contributed to the plan?

- Are there unencumbered assets that can be contributed to the plans?

- Do nondebtor entities exist that may be of value to the plans?

Identify alternative reorganization plan scenarios or sponsors. The analysis also requires performing due diligence in order to identify alternative reorganization plan scenarios or sponsors that could allow for less radical benefit reductions and for funding of the pension or retiree benefit plans:

- What alternative reorganization plan scenarios have been analyzed by the debtor or other parties to date? Do any other feasible scenarios exist?

- Do alternative plan of reorganization sponsors exist? Has the debtor been in discussions with third-party plan sponsors?

- Have the debtor's investment bankers, OCC and management evaluated all funding possibilities?

- Are there alternative post-confirmation capital structure options?

The steps outlined above are a nonexhaustive sample of some of the key issues that need to be thoroughly analyzed by counsel and the financial advisor over a short period of time when addressing either termination or modification of employee pension or retiree health benefits. Given the enormous amounts of data that accompany the analyses, in conjunction with the typically tight timeframe set by bankruptcy courts to resolve these issues, it is critical that sufficient time above and beyond the financial-analyses period is allowed for negotiations among the parties. Qualitative information gathered and quantitative financial analyses performed serve as the foundation for such negotiations that the judge typically expects to be resolved among the debtor and all constituents. If litigation results, however, the analyses performed will culminate with the financial advisor preparing an expert report setting forth his/her opinion as to the necessity of the proposed modifications. ■

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