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Distress Termination of Pension Plans Under ERISA: Managing the Risks Associated With Non-Debtor Foreign Affiliates

Lynette C. Kelly, Counsel, and Solomon J. Noh, Associate, Bankruptcy & Reorganization Group, Shearman & Sterling LLP, New York, USA

Introduction

As US companies strive to adapt to an increasingly competitive marketplace, a new focus has been placed on defined benefit pension plans.[1] For years, these pension plans were commonly offered to US workers, particularly in the manufacturing industry, and, due in large part to the clout of labor unions, often provided generous benefit payments. Today, however, pension plans have become too costly to maintain for many employers. The retiree base for many existing plans continues to expand due to both the increased life expectancy of participants and the 'baby boom' generation reaching retirement age. As a result, companies that are saddled with ballooning pension obligations have had difficulty competing against the increasing number of businesses that do not offer pension plans, and, therefore, are not burdened with the attendant costs and expenses. To illustrate the extent of this problem, General Motors Corporation revealed in 2004 that its pension expenses added $675 to the price of each vehicle sold, in contrast to its Japanese rivals who had no such costs.[2] For those reasons, among others, many employers in the United States have sought to terminate their pension plans in recent years.

Under US law, a company seeking to terminate its pension plan without fully funding the often enormous cost of that obligation is required to satisfy a stringent test in which it must demonstrate, among other things, that it is unable to remain in business without terminating its pension obligations. This standard, generally referred to as the 'financial distress' requirement, must be met by all members of the 'controlled group' – composed of the legal entity that officially sponsors the pension plan and the sponsor's corporate affiliates that are jointly and severally liable for the pension obligations (which is any affiliate, whether foreign or domestic, with at least 80% common ownership[3]). When a company seeks to terminate its pension obligations in the course of a chapter 11 bankruptcy proceeding, as is often the case, the bankruptcy court has the authority to determine whether the financial distress requirement has been met by the debtor-entities. The bankruptcy court, however, lacks the jurisdiction to make any such finding regarding any non-debtor member of the controlled group. Instead, whether a non-debtor satisfies the financial distress requirement is a determination that must be made by the Pension Benefit Guaranty Corporation (the 'PBGC'), a US government agency that has a vested interest in the pension system, as discussed below.

This statutory framework incentivizes companies to cause chapter 11 cases to be commenced with respect to each controlled group member so that the decision relating to the satisfaction of the financial distress requirement can be made entirely by the bankruptcy court – a body that regularly oversees the rehabilitation of troubled companies. By contrast, if any controlled group member is left out of chapter 11, the PBGC could potentially stall the debtor's pension termination process by making an adverse determination regarding a non-debtor. An additional issue arises when members of the controlled group are foreign affiliates of the US-based debtor, because a chapter 11 filing often is not a viable option for such affiliates. As a result, US companies seeking pension termination have struggled to devise an effective strategy for dealing with foreign affiliates.

A recent decision, *In re Falcon Products, Inc.*,[4] suggests a way in which the risks associated with non-debtor foreign affiliates might be managed. Although the district

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1 Defined benefit pension plans provide payments to participants based on a predetermined formula that typically takes account of years of service and average salary. Defined contribution plans, in contrast, provide payments based solely on contributions made to the accounts of participants. 'Pension plan' or 'plan' as used in this article will refer to defined benefit pension plans.

2 S. Hirsh, 'Plant Makes Its Final Run GM: Workers Watch the Last Van Roll By As the Decades-Old Factory in Baltimore Closes Its Doors', *Baltimore Sun*, 14 May 2005.

3 ERISA, § 4001(a)(14).

4 354 B.R. 889 (E.D. Mo. 2006).

court in *Falcon* acknowledged that bankruptcy courts lack the jurisdiction to determine whether the financial distress requirement has been met by non-debtors, the court expressly held that, for the sole purpose of determining whether the debtors can afford their pension obligations, it is permissible for bankruptcy courts to consider the financial condition of non-debtor affiliates (and their ability to upstream dividends to their debtor parents), and to make factual findings regarding these issues.

As discussed below, the *Falcon* court declined to reach the question of whether the bankruptcy court's factual findings would have a preclusive effect in subsequent proceedings to determine whether the non-debtor controlled group entities themselves met the financial distress requirement. Thus, a key issue raised in *Falcon* regarding non-debtor foreign affiliates remains open. However, if such findings ultimately are determined to bind the PBGC, the approach adopted by the bankruptcy court in *Falcon* may provide a way to mitigate the risks associated with non-debtor foreign affiliates in the distress termination process.

Discussion

The distress termination process and the benefits of chapter 11

Under the Employee Retirement Income Security Act of 1974 (as amended, 'ERISA'), a US federal statute that governs pension plans, an employer is permitted to terminate its pension obligations if it satisfies the criteria for either a 'standard' or a 'distress' termination. The standard termination option, which does not require any court or government agency approval, is available only with respect to pension plans that are fully-funded – where plan assets are sufficient to pay all pension benefit commitments. A voluntary termination of under-funded pension plans can be effectuated only through the process of distress termination.

A company that pursues a distress termination of its pension obligations is required to satisfy certain procedural requirements. For example, the company must provide adequate notice to the PBGC and the participants under the pension plans that it seeks to terminate.[5] In addition to the various administrative requirements, the company must demonstrate that each member of the controlled group meets at least one of the following tests for financial distress:[6]

– the 'reorganization in bankruptcy' test, which is satisfied if the entity at issue files for chapter 11 reorganization, and the bankruptcy court finds that the entity is unable to continue in business without terminating its pension obligations;[7]

– the 'inability to continue in business' test, which essentially requires the same showing as the 'reorganization in bankruptcy' test, but for which the showing must be made to the independent satisfaction of the PBGC rather than the bankruptcy court;[8]

– the 'liquidation in bankruptcy' test, which is satisfied if the entity at issue liquidates in bankruptcy; and[9]

– the 'unreasonably burdensome pension costs' test, which is met if the entity at issue demonstrates to the PBGC that the costs of providing pension coverage have become unreasonably burdensome solely as a result of declining covered employment under all single-employer plans for which such entity is a contributing sponsor.[10]

As is evident from these descriptions, any company that contemplates remaining in business following the termination of its pension plan is limited in the tests it can seek to satisfy. The 'liquidation in bankruptcy' option obviously is unavailable for the corporate entities that need to remain in existence, and the 'unreasonably burdensome pension costs' test is not generally applicable. Therefore, for most companies, the only options are the 'reorganization in bankruptcy' test, which is available to debtors undergoing chapter 11 reorganization, and the 'inability to continue in business' test, for which a bankruptcy filing is not a prerequisite.

As noted above, in order to satisfy either the 'reorganization in bankruptcy' test or the 'inability to continue in business' test, an entity must establish that it is unable to continue in business without the termination of the pension plan. One significant difference exists between those two tests, however. Under the 'reorganization in bankruptcy' test, the decision as to whether an entity satisfies the financial distress requirement is made by the bankruptcy court – a body that regularly oversees the rehabilitation of troubled companies. In contrast, under the 'inability to continue in business' test, the role of decision-maker is played by the PBGC. The PBGC is a US government agency that was established under Title IV of ERISA to insure pension benefits. Therefore, upon the successful 'distress' termination of a pension

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5 *See* ERISA, § 4041(c)(1).
6 *Id.* at § 4041(c)(1)(B), (c)(2)(B).
7 *Id.* at § 4041(c)(2)(B)(ii).
8 *Id.* at § 4041(c)(2)(B)(iii)(I).
9 *Id.* at § 4041(c)(2)(B)(i).
10 *Id.* at § 4041(c)(2)(B)(iii)(II).

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plan, the agency is required to assume the terminated pension obligations up to a statutory limit. The PBGC, moreover, is charged with the task of 'encourag[ing] the continuation and maintenance of [pension plans] for the benefit of their participants.' Given these circumstances, a company that seeks to satisfy the 'inability to continue in business' test with respect to any of its corporate entities places itself in an awkward position of being evaluated by the party that arguably stands to lose the most in the application process – the PBGC. Therefore, a debtor-applicant for distress termination has a strong incentive to keep the issue before the bankruptcy court, generally by causing chapter 11 cases to be filed for each controlled group member and seeking to satisfy the 'reorganization in bankruptcy' test with respect to each such entity.

Complications presented by foreign affiliates

Notwithstanding the clear incentive in the ERISA statutory scheme to file chapter 11 cases for all of the controlled group entities, a bankruptcy filing often is not a viable option for foreign affiliates of US-based corporations. Although foreign entities are permitted to seek bankruptcy protection under title 11 of the United States Code (the 'Bankruptcy Code')[11] – provided the jurisdictional requirement contained in section 109(a) of the Bankruptcy Code is met[12] – there frequently are business or other reasons that preclude a bankruptcy filing for foreign affiliates. For example, a foreign entity may be party to a foreign credit facility in which a bankruptcy filing constitutes an 'event of default.' While a chapter 11 bankruptcy filing technically operates as an 'automatic stay' of most efforts to collect against the debtor entity,[13] some foreign creditors may be outside the practical reach of the bankruptcy court's jurisdiction. Therefore, a foreign entity that files for chapter 11 bankruptcy protection may nevertheless be subject to various enforcement actions, such as foreclosure. In addition, because chapter 11 reorganization cases are erroneously equated with liquidation proceedings in many jurisdictions outside of the United States, a foreign affiliate that files a chapter 11 case may experience a business slowdown. For these reasons, among others, a company may be unable to cause chapter 11 cases to be commenced for foreign controlled group members, notwithstanding the need to terminate its pension plan.

Depending on the financial condition of the foreign affiliate, the decision to leave the entity out of the chapter 11 process may not constitute a material gamble. If, for example, the affiliate's enterprise value is far below that which anyone could reasonably consider to be sufficient to support the sum of the pension obligations, the fact that the PBGC will make the determination regarding the financial distress requirement may not carry any material risk from the applicant's perspective. Moreover, pursuant to the Administrative Procedures Act[14] – the US federal statute that governs the actions of federal agencies – agency decisions that are determined to be 'arbitrary, capricious, [or] an abuse of discretion' are subject to reversal on appeal.[15] The issue, of course, is of greater concern where the question regarding the foreign affiliate's ability to support the pension obligations is subject to reasonable debate.

In re Falcon Products, Inc.

A recent decision of the United States District Court for the Eastern District of Missouri, *In re Falcon Products, Inc.*,[16] suggests a way in which the risks associated with non-debtor foreign affiliates of a distress termination applicant might be managed. Falcon Products, Inc. ('Falcon'), a furniture manufacturer, filed for chapter 11 bankruptcy protection in January 2005 in the United States Bankruptcy Court for the Eastern District of Missouri. Falcon's chapter 11 case was jointly administered with the cases of eight of its affiliates (together with Falcon, the 'Falcon Debtors'). In the course of their chapter 11 cases, the Falcon Debtors filed a motion with the bankruptcy court seeking the distress termination of three of their pension plans under ERISA.[17] As part of the application process, each of the Falcon Debtors, being either a pension plan sponsor or

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11 11 U.S.C. §§ 101 *et seq*.
12 Section 109(a) of the Bankruptcy Code provides as follows:

> 'Notwithstanding any other provision of this section, only a person that resides or has a domicile, a place of business, or property in the United States, or a municipality, may be a debtor under [the Bankruptcy Code].'

11 U.S.C. § 109(a). The jurisdictional requirement under section 109(a) can be met in various ways, such as by maintaining a US bank account.
13 *See id.* at § 362(a).
14 5 U.S.C. §§ 551-559, 701-706.
15 *Id.* at § 706(2)(A).
16 354 B.R. 889 (E.D. Mo. 2006).
17 *See* Debtors' Motion Seeking (1) a Determination That They Satisfy the Financial Requirements For a Distress Termination of Three Employee Retirement Income Plans; and (2) Approval of Termination of Such Pension Plans, dated as of 2 September 2005, Case No.: 05-41108-399, Docket No.: 873.

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a member of the sponsor's controlled group, sought to satisfy the 'reorganization in bankruptcy' test.[18] In order to demonstrate to the bankruptcy court that their businesses would not survive without the relief requested, the Falcon Debtors presented evidence concerning the financial burden of their pension funding obligations, as well as the severity of their financial distress.[19]

The Falcon Debtors also presented evidence regarding the financial condition of their non-debtor foreign affiliates, each of whom was a controlled group member for purposes of the pension termination application. In particular, the Falcon Debtors sought to demonstrate that: (i) four of the nine non-debtor foreign affiliates were inactive, had no meaningful assets and had no ability to support the pension plans; (ii) one of the five active non-debtor foreign affiliates was in the process of being sold; and (iii) the remaining active non-debtor entities generally were unable to support the Falcon Debtors' pension plan obligations.[20] The Falcon Debtors argued that the bankruptcy court must consider the financial state of the non-debtor foreign affiliates in order to determine whether those entities could enable the Falcon Debtors to perform their pension obligations – for example, by upstreaming the necessary cash.[21] In other words, the inability of the non-debtor foreign affiliates to support the pension obligations was offered as additional proof that the Falcon Debtors were unable to afford the pension plans.

Based on the evidence submitted by the Falcon Debtors, the bankruptcy court approved the distress termination of the three pension plans. In the approval order, the bankruptcy court explicitly found that:

> '[T]he non-debtor foreign subsidiaries (i) individually or together with other members of the controlled group, could not support the continuation of the [three pension plans], (ii) all need access to their available cash to sustain their own businesses, and (iii) have never been able, and are not expected to become able to, upstream any material cash to the [Falcon Debtors] or otherwise provide direct or indirect material support to the [three pension plans].'[22]

The PBGC appealed the bankruptcy court's ruling, partly on the basis that, under ERISA, the bankruptcy court lacked the jurisdiction to make findings with respect to the financial condition of non-debtor entities.

The United States District Court for the Eastern District of Missouri affirmed the decision of the bankruptcy court.[23] Rejecting the PBGC's argument that the bankruptcy court lacked the jurisdiction to make findings concerning the non-debtors, the district court held that it was wholly appropriate for the bankruptcy court to make such findings as a way to consider all sources of income available to the debtors to support their pension obligations.[24] Indeed, the district court suggested that bankruptcy courts are required to consider the financial condition of non-debtor entities to determine whether the financial distress requirement had been met by the debtors.[25] The district court noted that the bankruptcy court did not issue findings regarding any foreign subsidiary's ability to meet the 'inability to continue in business' test – the test that the PBGC ultimately would apply in determining whether the non-debtors met the requirements for distress termination.

The district court further noted that the PBGC's main concern on appeal was not that the bankruptcy court considered the financial position of the non-debtor entities, but rather the potential preclusive effect of the bankruptcy court's findings concerning the non-debtor foreign affiliates in subsequent proceedings. The district court declined to reach this issue as it was beyond the scope of the appeal.[26]

Conclusion

In light of the decision in *Falcon*, a debtor that applies to terminate its pension obligations, but is unable to cause chapter 11 cases to be filed for its foreign controlled group members, nevertheless may seek a finding from the bankruptcy court that the non-debtor foreign affiliates are unable to support the debtor's pension obligations. As the *Falcon* court recognized, and as the PBGC conceded,[27] bankruptcy courts must be permitted to assess the financial condition of non-debtor affiliates

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18 *See id.* at ¶ 59.
19 *See id.* at ¶ 13.
20 *See id.* at ¶ 55.
21 *See* Brief of Reorganized Debtors-Appellees, dated 13 January 2006, Case No.: 4:05cv2247 CAS, Docket No.: 12, § IV(D)(2).
22 Findings of Fact and Conclusions of Law Regarding Debtors' Motion Seeking (1) a Determination That They Satisfy the Financial Requirements for a Distress Termination of Three Pension Plans; and (2) Approval of Termination of Such Plans, dated 26 October 2005, Case No.: 05-41108-399, Docket No.: 1014, ¶ 49.
23 354 B.R. 889, 899 (E.D. Mo. 2006).
24 *Id.*
25 *Id.* ('The PBGC concedes that the Bankruptcy Court must consider all sources of income that might be available to the [Falcon Debtors], including funds from the non-debtor foreign affiliates.')
26 *Id.*
27 *Id.*

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(and their ability to upstream dividends to their debtor parents) because those factors directly affect the analysis bankruptcy courts are required to conduct under ERISA.

Of greater interest to debtors with non-debtor controlled group affiliates, and to those affiliates themselves, is the issue left open in *Falcon*: whether a bankruptcy court's factual findings regarding the affiliates' financial condition would bind the PBGC in subsequent proceedings, and thereby preclude the agency from making any contrary determinations in connection with the 'inability to continue in business' test. The answer may turn less on questions of jurisdiction and statutory interpretation (issues emphasized by the PBGC in *Falcon*) and more on the doctrine of collateral estoppel.[28] From a practical standpoint, it is difficult to imagine that Congress intended for the PBGC to disregard the bankruptcy court's prior factual findings in making a determination under the 'inability to continue in business' test, notwithstanding that these findings may impact the decision to be made by the PBGC regarding non-debtors.

If a bankruptcy court's factual findings such as those in *Falcon* are determined to have a preclusive effect upon the PBGC, debtors seeking to terminate their pension obligations may be able to manage the risks associated with non-debtor controlled group members by seeking from the bankruptcy court specific findings regarding the inability of such entities to support their debtor affiliates' pension obligations.

Notes

28 Under the doctrine of collateral estoppel, a plaintiff is permitted to use a prior court holding to bar a defendant from relitigating an issue that already has been decided, provided certain conditions are met. The United States Court of Appeals for the Second Circuit, in *Central Hudson Gas & Elec. Corp. v. Empresa Naviera Santa S.A.*, 56 F.3d 359, 368 (2d Cir. 1995), held that the doctrine of collateral estoppel is applicable where the following four factors are met: (i) the issues of both proceedings are identical; (ii) the relevant issues were actually litigated and decided in the prior proceeding; (iii) there was 'full and fair opportunity' for the litigation of the issues in the prior proceeding; and (iv) the issues were necessary to support a valid and final judgment on the merits.

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