SOME QUESTIONS AND ANSWERS REGARDING THE CHAPTER 11 BANKRUPTCY PROCESS

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Presented by Ms. Stacey Jernigan, Haynes and Boone, LLC, Counsel to Retirement Advisors of America

1. What happens when a company files Chapter 11 bankruptcy?

First, a bankruptcy case for a large company can be commenced either as a Chapter 11 reorganization case or a Chapter 7 liquidation case. In the context of a Chapter 11 case, the debtor-company's management typically remains in control of the business and its operations[1] – subject to Bankruptcy Court and creditor supervision, as further described below.

In the context of a Chapter 7 case, a third-party trustee (usually randomly selected from a panel of eligible persons maintained by the United States Trustee's Office, a division of the U.S. Justice Department) is appointed to take over the assets of the debtor-company and to shut it down and liquidate it. Sometimes companies ultimately liquidate (partially or totally) in a Chapter 11 case, rather than reorganizing, if it is determined that reorganization is not achievable and an orderly liquidation in Chapter 11 is in the best interests of creditors and other parties in interest (as opposed to having a third-party trustee come in and liquidate).

When a voluntary Chapter 11 case is filed, then the company is immediately (from the moment the bankruptcy petition is filed) considered ***under the supervision of the Bankruptcy Court and creditors***. From that moment forward, the debtor-company must ***obtain Court permission*** (with notice to parties in interest and a hearing) before engaging in such acts as:

(1) Borrowing money;
(2) Using or selling property outside of the ordinary course of business;
(3) Entering into contracts or other transactions that are considered significant or outside of the ordinary course of business;
(4) Rejecting (*i.e.,* terminating) or assuming contracts or leases (including collective bargaining agreements or other employment-related agreements);
(5) Entering into settlements or compromises;

1 Sometimes existing management is replaced in a Chapter 11 case, particularly if existing management is perceived by parties-in-interest as not being credible, honest, or capable of managing the company through the crisis.

(6) Undertaking material capital expenditures, whether for maintenance or new projects; or
(7) Paying prepetition creditors (the general rule is that a debtor-company will not be allowed to pay any prepetition creditors outside of the context of an approved plan of reorganization, although bankruptcy courts sometimes adopt an equitable "doctrine of necessity" and allow the debtor-company at the outset of the proceedings to pay employee wage claims or trade vendors who might be critical to ongoing operations).

Additionally, upon the filing of a voluntary bankruptcy petition, an "automatic stay" immediately goes into effect, which is the legal equivalent to an injunction (issued from the bankruptcy court) prohibiting anyone or any entity:

(a) From filing or going forward in any non-bankruptcy court forum with a pending lawsuit or other court or administrative proceedings (with certain exceptions)[2]; and
(b) From exercising any control over property of the debtor-company. The purpose of the automatic stay is to give the debtor-company a "breathing spell," to stop the "race to the courthouse" and seizing of assets of the various collecting creditors, and to generally "level the playing field" by requiring all parties in interest to now go through the Bankruptcy Court if they want to request some type of relief.

2. What are some of the reasons a company files Chapter 11 bankruptcy?

A company may not be "balance sheet insolvent" when it chooses to seek bankruptcy relief (although this will typically be the case). "Insolvency" is not a requirement for a company to seek bankruptcy protection. The reasons a company might seek bankruptcy relief include:

(a) A cash flow crisis (the company is not cash flowing at a level that allows it to sustain operations and pay its debts, so the company may need to restructure and/or shed some of its debt and, in the process, revise its business plan going forward. The company may have tried unsuccessfully to accomplish these things out-of court. Note that if new credit is needed by the company, a new lender may not be willing to extend the credit without a bankruptcy court order giving the new lender special high priority).

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2 The exceptions include the following: (a) the debtor-company is permitted to continue with any lawsuit or action in which it was the plaintiff or initiator; (b) a criminal action/proceeding involving the debtor may be commenced or continued; (c) an action or proceeding by a governmental unit to enforce such governmental unit's "police and regulatory power," may be commenced or may continue; (d) certain labor matters, including grievances and arbitrations under collective bargain agreements, are permitted to go forward; (e) acts by lessors to obtain property, when a lease has terminated by expiration of its term prior to the filing of the bankruptcy, are permissible; (f) an audit by a governmental unit to determine tax liability, and the issuance of a notice of tax deficiency, and the demand for tax returns are all permissible; and (g) there are a few other, more obscure exceptions to the automatic stay.

(b) The company might have burdensome contracts or leases that it wants to “reject” or be relieved from (the Bankruptcy Code has a tool—section 365—that permits a debtor-company to reject contracts and leases, although collective bargaining agreements are separately addressed in section 1113 of the Bankruptcy Code).

(c) The company may have overwhelming litigation in various forums and filing for bankruptcy “stays” such litigation and provides a way for the litigation to be streamlined into the bankruptcy court and resolved more efficiently and expeditiously in that forum.

3. If “shedding debt” and “rejecting contracts” are two things companies do (usually) in a bankruptcy case, does this mean employee and retiree benefits can be shed/modified or that collective bargaining agreements can be rejected?

The unfortunate answer is yes, although there are statutory requirements that must be followed, to ensure some protections to employees/retirees. Also, please see the specific discussion about pension plan benefits in <u>Section 4</u> below (*i.e.,* the discussion of “retiree benefits” in this section refers only to welfare benefits—medical and insurance benefits—rather than retirement benefits from an ERISA-qualified pension plan).

First, section 1113 of the Bankruptcy Code permits a company in Chapter 11 to modify provisions of a collective bargaining agreement, including provisions that provide for retirement and welfare benefits. Section 1113 even allows for rejection of a collective bargaining agreement in total. However, the company cannot simply walk in on “Day 1” of the bankruptcy case and obtain an order terminating the collective bargaining agreement.

Section 1113 requires the company to first attempt to reach ***consensual*** modifications with an authorized representative of the employees and retirees. Specifically, the company, if it wants to modify or reject a collective bargaining agreement (resulting in changes to employee or retiree benefits), must first make a proposal to the authorized representative of employees/retirees and give the representative complete, reliable, and relevant information to evaluate the proposal.

The company must meet at reasonable times with the authorized representative and confer in good faith to try to reach agreements. If the company goes through this meeting and information-exchanging process and the authorized representative does not accept the proposal, the company may then ask the bankruptcy court to approve a modification or rejection of a collective bargaining agreement.

The court may approve the company’s request if the court finds that the company attempted to reach a consensual agreement regarding the modifications, the authorized representative refused to accept the proposal without good cause, and the modifications to benefits are necessary to permit reorganization of the company and would assure that creditors, the debtor-company and all other affected parties are treated fairly and

equitably and the balance of equities clearly weighs in favor of permitting the modification/rejection.

Note that the bankruptcy court can, during the pendency of the negotiations, order interim relief in the form of temporary allowance of modifications to the collective bargaining agreement, if necessary to enable the company to continue in business and avoid irreparable damage to the bankruptcy estate.

Section 1114 of the Bankruptcy Code operates similarly to section 1113 and permits a company in Chapter 11 to modify or not pay retiree benefits (meaning payments promised to retired persons and their dependents, for medical, disability or death benefits under any plan, including through the purchase of insurance or otherwise). As with a collective bargaining agreement, the company cannot simply walk in on "Day 1" of the bankruptcy case and obtain an order relieving the company from paying retiree benefits. Section 1114 describes a required procedure, as a pre-cursor to modification of retiree benefits.

The company must first make a proposal for modification to the authorized representative of retirees and give the representative complete, reliable, and relevant information to evaluate the proposal. The company must meet at reasonable times with the authorized representative and confer in good faith to try to reach agreements. If the company goes through this meeting and information-exchanging process and the authorized representative does not accept the proposal, the company may then ask the bankruptcy court to approve a modification of retiree benefits.

The court may approve the company's request if the court finds that the company attempted to reach a consensual agreement regarding the modifications, the authorized representative refused to accept the proposal without good cause, and the modifications to benefits are necessary to permit reorganization of the company and would assure that creditors, the debtor-company and all other affected parties are treated fairly and equitably and the balance of equities clearly weighs in favor of permitting the modification/rejection.

Similar to section 1113, the bankruptcy court can, during the pendency of the negotiations, order interim relief in the form of temporary allowance of modifications to retiree benefits, if necessary to enable the company to continue in business and avoid irreparable damage to the bankruptcy estate.

4. What happens to a pension plan and the retirement benefits from an ERISA-qualified pension plan?

The good news is that the assets in an ERISA-qualified pension plan are not "property of the bankruptcy estate" that are available to the company (and are not available for distribution to general creditors). The plan assets are available only for plan participants and reasonable expenses of administering the plan. However, the not-so-good news is that a company can move in the bankruptcy case for bankruptcy court permission to

terminate a pension plan—to stop any future accrual of benefits—and this would usually be through a “distress termination” (meaning the defined benefit plan’s liabilities exceed its assets).

The bankruptcy court and the PBGC will generally permit the termination of a pension plan if either the company is liquidating in bankruptcy or if it is reorganizing and the court determines that, unless the plan is terminated, the company will not be able to pay its debts under a plan and continue on in business. In other words, if keeping the pension plan in place has simply become too onerous to the company’s future viability, then the court will probably permit terminating the pension plan.

If a plan is terminated, the assets of the plan (not part of the bankruptcy estate) will be used to pay the retirement benefits that were vested as of plan termination. However, if there are insufficient assets in the plan (underfunding), the PBGC will step in to cover the underfunding and pay the benefits to plan participants up to a certain guaranteed amount. There are certain formulas that the PBGC applies to determine whether the benefit to a participant is fully or only partially covered by the PBGC. These PBGC formulas are beyond the scope of this memorandum.

5. How much time does it take for all of these issues to be resolved in a bankruptcy?

There is no magic answer or even guess for this question. A large complex company may stay in Chapter 11 for years. If a company has reached certain agreements with certain creditors and constituencies before filing bankruptcy (or does so promptly thereafter) the bankruptcy case could be completed in a few months. It would be highly unusual—almost unprecedented—for an airline to emerge from bankruptcy in less than one year. The U.S. Airways bankruptcy case was unusually fast--but it remains to be seen whether that reorganization is a complete success.

In order to emerge from Chapter 11, a company must obtain bankruptcy court approval for a plan of reorganization (which plan is, essentially, a large contract restructuring or providing for the payout of debt—with cash, with new notes, with newly issued stock, *etc.*). Before the court will consider it, the plan must be mailed out in a solicitation process, whereby creditors (and possibly shareholders—if they are receiving or retaining anything)[3] are given the opportunity to vote for or against the plan. This solicitation process usually takes more than 60 days. After the votes are tabulated, the results are reported to the court and the court may approve the plan even without the

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3 Shareholders are not entitled to receive any property, or even retain their shareholder interests, under a chapter 11 plan, unless all creditors of the company will be paid in full under the plan or the creditors otherwise agree that shareholders can receive property or retain their equity interests. Thus, shareholders frequently walk away with nothing from a Chapter 11 case—the existing stock is usually cancelled. When this is the case, shareholders’ votes are not even solicited for the plan and they are deemed to have “rejected” it. The bankruptcy court, in this scenario, will simply need to consider and decide whether the plan of reorganization is fair and equitable to the shareholders (and it will generally be consider fair and equitable, if creditors themselves are not even being paid in full).

full support of creditors, as long as at least one impaired class of creditors voted to accept that plan (a class of creditors has accepted a plan if at least 2/3 in dollar amount and one-half in number of the creditors voting voted “for” the plan).

Note that, in addition to addressing the repayment of debt of the company, a plan will usually outline a future business plan for the company, and possibly provide for the sale of assets, downsizing, merger or acquisition, or other strategies.

6. Who should file a Proof of Claim?

Upon the filing of a bankruptcy petition, creditors of the debtor-company receive a notice of the filing of the petition. This notice contains a few important pieces of information including the proof of claim bar date (which is generally several months after the bankruptcy case is filed). The proof of claim bar date is the deadline for asserting a claim against the debtor for amounts owing by the debtor to a person. Proofs of claim are filed with the clerk of the bankruptcy court in which the debtor’s case is pending (or sometimes a third-party claims administrator is appointed by the court to receive and create a data base of claims).

If an employee is owed accrued wages or benefits by the company that go unpaid, he will have grounds to file a proof of claim. At some point during the bankruptcy case, the company will undertake a review of proofs of claim and decide which ones are legitimate and the company will object to certain disputed ones. Note that if a pension plan is terminated, it is generally the PBGC who will file the proof of claim in the bankruptcy case in respect of the underfunding and termination of the pension plan (not the individual participants). Note also, that if a collective bargaining agreement is rejected during a case, it is likely that the union/authorized representative will file a proof of claim on behalf of the affected parties, but this is not certain. An employee/retiree should first start by consulting with the union/authorized representative to see what it is proposing in this regard.

7. What if a retiree gets paid retirement benefits in a lump sum prior to the company filing bankruptcy--can this somehow be recaptured in the bankruptcy case?

There is good news and possibly-not-good news with respect to this question. First, in the context of a bankruptcy case, there is nothing in the Bankruptcy Code that provides a tool for the PBGC or any other party to try to recapture lump sum payments already paid out to retirees from an ERISA-qualified defined benefit plan.

The reason is that--assuming that the defined benefit plan was properly set up as a separate legal entity (and it is almost inconceivable that it would not have been--if we are talking about a company with sophisticated professionals and plenty of people watching over their shoulders)--this plan and its assets would not be considered "property of the bankruptcy estate." See Answer #4 above.

This means that a "fraudulent transfer" or "preference" claim could not be crafted to try to recapture payments because "fraudulent transfers" and "preferences" essentially involve recapturing funds that (a) would have been property of the estate if not transferred pre-bankruptcy; and (b) were transferred to a party without reasonably equivalent value being paid to the company in return (or, in the case of "preferences," the transfers allowed the recipient to receive more than he/she would have in the bankruptcy case if not for the transfer).

So the reason there is no Bankruptcy Code-tool to recapture lump sum payments from a qualified defined benefit plan is that the plan assets are not property of the estate. (Note that if the company itself transferred funds into the defined benefit plan pre-bankruptcy--to perhaps address an underfunding--then that particular transfer of funds from the company to the plan might be scrutinized and challenged, possibly as a preference (since it would be a payment on account of an antecedent debt owed--i.e., a debt to the plan--while other creditors were not being paid), but it certainly would not be challenged by the PBGC--maybe by some other creditors.)

Now the <u>possibly</u>-not-good news is that there is a tool under nonbankruptcy law (ERISA law) that might permit recapture <u>by the PBGC</u> of lump sum payments made prior to a bankruptcy--but <u>there are several assumptions that have to be made before recapture could become a possibility</u>. The first major "assumption" that has to be made is that the defined benefit plan is being <u>terminated</u> (which does not always happen in a bankruptcy case).[4]

In general, ERISA Section 4045(a) authorizes the PBGC, as trustee of a <u>terminated</u> pension plan, to recover certain payments (described in Section 4045(b)) made by the plan to a participant <u>within a three year period immediately preceding the date the plan terminated</u>. The maximum amount the PBGC could recapture is the excess of (i) the sum of the actual payments received by the participant during the three-year period immediately preceding the time the plan terminated, over (ii) the amount calculated under 4045 (the"4045 amount").

The 4045 amount is the sum of three amounts:

(1) The amount the participant would have received during each consecutive 12-month period within the three years prior to plan termination, if he had elected to receive his benefits in a monthly amount in the form of a single-life annuity beginning at the time of his first payment made during the three year period (the "yearly amount");

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4 It should be reiterated that in order for the recapture-possibility discussed in this Question #7 to apply, the PBGC would have to be involved in the case by taking over as trustee of a plan under the authority of ERISA Section 4042; that is, the PBGC would have to have instituted proceedings to <u>terminate</u> the defined benefit plan (i) because, among other things, of a failure to meet the plan's minimum funding standard, or the possible long-run loss to the PBGC may reasonably be expected to increase unreasonably if the plan is not terminated, or (ii) because it determines that the plan does not have sufficient assets to meet the payment of guaranteed benefits, after the bankrupt or insolvent employer initiates a voluntary termination of the plan (a distress termination).

(2) The lesser of,

(a) The excess, if any, of $10,000 over the yearly amount, or
(b) The excess of the actual payment over the yearly amount;

(3) The present value, determined at the time of termination, of the participant's future PBGC-guaranteed benefits, as if those benefits started in the form of a single life annuity beginning at the time of his first payment made during the three-year period. Unfortunately, there are no regulations or other guidance regarding the calculations under section 4045. In summary, these three amounts are added together and subtracted from the total actual payments received by the participant over the three-year period. The difference, if any is the amount potentially recoverable.

Note that these amounts are potentially recoverable in all cases, unless the participant has since died or become disabled. Also note that the PBGC is authorized to waive, in whole or in part, the recovery of any amount that is otherwise recoverable if the PBGC determines that "substantial hardship would result to the participant or his beneficiaries from whom such amount is recoverable."

It should be stressed that the three-year period from which payments may be recoverable goes backward from the date of the plan termination. So if a plan termination date does not occur until three years after an employer goes into bankruptcy, any lump sums paid before the bankruptcy would appear to be free from recovery. By the same token, if the plan termination did not happen until four years after a bankruptcy filing, any lump sums paid during the first year of the bankruptcy would seem to be free from recovery.

Finally, we should note that we are unaware that the PBGC has ever applied this section to lump sum distributions to retirees such as the Delta retirees. The PBGC is more likely to apply this provision in situations where there have been lump sum distributions to substantial owners (i.e., generally 10% or more owners of businesses).