Treatment of Pension Plans When an Employer Is in Bankruptcy

By Jonathan Lewis and Vivek Melwani

The Employee Retirement and Income Security Act, enacted in 1974 and commonly referred to as “ERISA,” seeks to protect and promote employee retirement benefit plans. Chapter 11 of the Bankruptcy Code, on the other hand, seeks to encourage the reorganization of financially distressed companies by allowing them to, among other things, reject burdensome contracts and obtain a discharge of pre-petition obligations. Recent bankruptcy reorganizations of some of the nation’s largest companies, especially airline companies, have highlighted some of the tensions between the goals and provisions of ERISA and the Bankruptcy Code. This article discusses certain of the key issues regarding pension plans when an employer is in bankruptcy and focuses on some of the areas of controversy with respect to pension plans and treatment of the employees’, and the Pension Benefit Guaranty Corporation’s (the “PBGC”), claims in bankruptcy.¹

I. Overview of the Bankruptcy Code

While a discussion of the entire bankruptcy process is not within the scope of this article, below is a summary of certain bankruptcy concepts that are necessary to understand how pension plans may be dealt with when an employer is in bankruptcy.

Companies generally file for bankruptcy protection under chapter 7 or chapter 11 of the Bankruptcy Code. Chapter 7 cases are liquidations while chapter 11 cases are generally reorganizations (although a company can file a liquidating chapter 11 plan). This article focuses primarily on pension plans in the context of chapter 11 cases. A chapter 11 case is commenced upon the filing of a chapter 11 petition for relief. Upon the commencement of the case, the “automatic stay” under section 362 of the Bankruptcy Code takes effect. The automatic stay is designed to give the debtor “breathing room” as it attempts to restructure, and generally prohibits the creditors of the debtor from taking actions against the debtor in respect of a claim that arose before the commencement of the case.² A company emerges from a chapter 11 bankruptcy by confirming and consummating a chapter 11 plan that either reorganizes or liquidates the debtor.³

The type of claim a party has against a chapter 11 debtor can significantly affect the recovery such creditor will ultimately receive. Claims that arise prior to the date the case was filed are often referred to as “pre-petition” claims and claims that arise subsequent to the filing date are often referred to as “post-petition” claims. Claims that arise post-petition, and that are for actual and necessary costs and expenses incurred during the chapter 11 case, are generally deemed “administrative expenses” of the debtor’s estate.⁴ Administrative expenses are typically paid during the case in the ordinary course and must be paid in full in cash no later than the effective date of a plan. Claims that arise pre-petition are either secured or unsecured. To the extent that claims are secured by collateral, they will be considered “secured” claims in an amount not exceeding the value of such collateral. Secured creditors are entitled to retain their security interests and receive deferred cash payments with a present value, as of the effective date of the plan, of at least the value of their collateral. Depending on the nature of the claim, unsecured claims may be entitled to priority status. Priority claims are entitled to be paid in full and in cash on the effective date of the plan, unless, with respect to certain types of priority claims, the holders of such claims, as a class, vote to accept deferred cash payments of a value, as of the effective date of the plan, equal to the allowed amounts of their claims.⁵ The various levels of priority include, among others, a fourth level priority under section 507(a)(4) of the Bankruptcy Code for claims for wages, salaries and commissions of up to $10,000 per employee that were earned within 180 days of the bankruptcy filing or the cessation of the

¹ The treatment of pension plans when an employer is in bankruptcy is extremely complex and there are numerous nuances as well as diverse case law on various issues. This article is not meant to be a comprehensive survey of the law or the issues but rather a general overview of the treatment of pension plans in bankruptcy.
³ In order to be confirmed, a chapter 11 plan must be supported by the requisite votes and satisfy various confirmation standards set forth in section 1129 of the Bankruptcy Code.
⁴ 11 U.S.C. §§ 503(b) and 507(a)(2).
⁵ Generally, priority tax claims may be paid in cash through regular installments, over a period not exceeding five years after the date of the order for relief, equal to the allowed amount of such claim, and in a manner not less favorable than the treatment of the most favored nonpriority unsecured claim. 11 U.S.C. §1129(a)(9).
debtor’s business\(^6\) and a fifth level priority under section 507(a)(5) of the Bankruptcy Code for claims for contributions to employee benefit plans arising from services rendered within 180 days of the bankruptcy filing or the cessation of the debtor’s business, minus the total amount paid to such employees in accordance with the fourth level priority for wages or paid to other benefit plans on behalf of such employees. The majority of unsecured claims are not entitled to a priority and are often referred to as “general unsecured claims”. General unsecured claims are entitled to distribution based on the value of the debtor’s estate and the distribution on such claims can be in the form of cash, debt instruments, equity or other securities and recoveries can range from 0% to 100% of the claim amount.

In addition, as discussed in greater detail in section IV.B. below, “executory contracts” can be rejected or assumed by the debtor pursuant to section 365 of the Bankruptcy Code. Executory contracts are contracts under which the obligations of both the debtor and the other party to the contract are so far unperformed that the failure to complete performance would constitute a material breach excusing the other party’s performance. The ability to reject an executory contract often allows a debtor to free itself from burdensome contracts in exchange for a pre-petition rejection damage claim.

II. Pension Plans under ERISA

ERISA defines a pension plan as a “plan, fund, or program … established or maintained by an employer or an employee organization, or by both,”\(^7\) that provides employees with retirement income or defers employee compensation for a period beyond employment. There are two types of pension plans under ERISA: defined benefit pension plans and defined contribution pension plans. Defined contribution plans generally do not come into play in bankruptcy cases, for two related reasons. First, defined contribution plans can never have an unfunded liability because, under these plans, the assets in a participant’s account are always equal to the liabilities in the account. Second, because there can never be a mismatch in assets and liabilities, defined contribution plans are not insured by the PBGC.

Defined benefit plans, on the other hand, typically specify benefit levels in advance through a formula that takes into account years of service and salary. As a result, defined benefit plans are frequently overfunded or underfunded because their funded status depends on (among other things) the performance of assets held in the plan, as well as assumptions as to future salary increases and participant mortality. Poor performance of a plan’s assets and the inability of an insolvent employer to continue to contribute to a plan historically resulted in participants receiving lower benefits to which they would otherwise be entitled under the plan’s provisions. For this reason, Congress established the PBGC as a public agency that insures the payment of pension benefits under defined benefit plans at statutorily specified benefit levels. Defined benefit plans are very common with a unionized workforce and are frequently required in collective bargaining agreements (“CBAs”).

III. The PBGC

Defined benefit pension plans generally must participate in the PBGC’s insurance program under sections 4002 and 4021 of ERISA.\(^8\) The PBGC is a wholly owned United States government corporation established under 29 U.S.C. §1302(a). The PBGC administers the pension plan termination insurance program established under Title IV of ERISA. Thus, when a defined benefit pension plan terminates and has insufficient funds to pay pension benefits, the PBGC becomes the trustee of the plan and provides pension benefits to the participants of the plan pursuant to sections 4022, 4042, and 4061 of ERISA.\(^9\) The PBGC’s insurance program is funded by insurance premiums paid by the covered plans and their sponsors and by recoveries from plan sponsors upon pension plan termination.

In many bankruptcy cases, particularly those involving large or industrialized employers, the PBGC is one of the largest unsecured creditors. Due to the magnitude of the PBGC’s claims, it will often play an important role in such cases and will often serve on the creditors committee. Moreover, because the PBGC’s claims will often dwarf the claims of other creditors, they are also often challenged by the debtors and other creditors with respect to priority and amount.

IV. Termination of Pension Plans

A bankruptcy case does not automatically terminate a pension plan. Rather, as described below, the PBGC or debtor must seek to terminate the pension plan. It is possible for a pension plan to be unaffected by a bankruptcy case. If neither party seeks to terminate the pension plan (which could occur for example, if the pension plan was fully funded on an ongoing basis

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\(^6\) 11 U.S.C. §507(a)(4) (for cases commenced prior to April 1, 2004, the dollar amount is $4,925).


\(^8\) ERISA §§ 4002, 4021, codified at 29 U.S.C. §§ 1302, 1321.

and its continuation did not impair the estate of the debtor, the plan could, in effect, “ride through” the bankruptcy process without any disruption.

A. Methods of termination

As noted above, one of the rights a debtor has under the Bankruptcy Code is to reject executory contracts which are burdensome or unnecessary. Courts have held, however, that a pension plan cannot be rejected by a debtor in bankruptcy as an executory contract but rather may only be terminated through the methods provided by ERISA. Under ERISA, underfunded pension plans can be terminated only through an involuntary termination by the PBGC or a distress termination by the plan sponsor.

An involuntary termination may be initiated by the PBGC if the PBGC determines that one of the following grounds exists: (1) the plan sponsor has not made its required minimum funding contributions to the plan; (2) the plan does not have sufficient funds to pay benefits when due; (3) there has been a distribution to a substantial owner under section 4043(b)(7) of ERISA, or (4) possible long-term loss to the PBGC can reasonably be expected to increase unreasonably if the pension plan is not terminated. The PBGC typically relies on ground “(4)” above to terminate an underfunded pension plan in connection with a bankruptcy case.

To terminate a pension plan under the distress termination provisions, a debtor must satisfy the following requirements set forth in section 4041(c) of ERISA: (a) the plan administrator must provide 60-days advance notice of its intent to terminate to the affected parties (i.e., to plan participants and union representatives); (b) the plan administrator must provide the necessary data and information required by section 4041(c) of ERISA to the PBGC; and (c) the PBGC must determine that the “necessary distress criteria” exist. There are four different types of “necessary distress criteria” under which a party may qualify in order to terminate a pension plan: (i) a liquidation in bankruptcy or insolvency proceedings; (ii) a reorganization in bankruptcy wherein the bankruptcy court has determined that the plan termination is essential to the confirmation of a successful plan of reorganization; (iii) the debtor cannot pay debts when due and cannot continue in business unless the pension plan is terminated, or (iv) costs of maintaining the plan have become unreasonably burdensome due solely to a declining workforce. The date of the pension plan termination in a distress termination is established by the plan administrator in agreement with the PBGC.

In determining whether the “necessary distress criteria” for the termination of the pension plan are present, the courts consider primarily whether the debtor would be unable to pay its debts when due and continue in business unless the pension plan is terminated. In In re Resol Manufacturing Company, Inc., the debtor argued that the appropriate standard for purposes of section 4041(c)(2)(B)(II) of ERISA was whether it would be unable to comply with the provisions of its confirmed plan of reorganization. The court disagreed and ruled that the correct standard was whether “but for the termination of the pension plan, the debtor will not be able to pay its debts when due and will not be able to continue in business.” In a later case, In re Sewell Manufacturing Co., PBGC argued that the submission of a plan of reorganization and the qualification of various controlled group entities was a prerequisite to debtor’s entitlement to a distress termination of its pension plan. However, the court held that a plan of reorganization does not need to be submitted prior to the court undertaking to determine the financial necessity of a pension plan’s distress termination. The court also found that all members of the debtor’s controlled group did not have


11 The PBGC and debtors have often sought authority to terminate a plan from the Bankruptcy Court. In a recent opinion, however, by the U.S. District Court for the Northern District of Illinois in the United Air Lines case, it was held that involuntary termination proceedings filed by the PBGC under Title IV of ERISA was a non-core proceeding and could not be decided by the Bankruptcy Court. The court held that the mere fact that the proceeding may affect the size of the debtor’s estate does not mandate that the proceeding is a core proceeding. In re United Air Lines, Inc, 2006 U.S. Dist. LEXIS 4382 (N.D. Ill. February 2, 2006).

12 ERISA § 4043(c)(7), codified at 29 U.S.C. § 1343(c)(7).

13 In Ass’n of Flight Attendants-CWA, AFL-CIO v. PBGC, 2006 WL 89829 (D. D.C. 2006) the union challenged PBGC’s decision to terminate one of the United Air Lines’ pension benefits plans. The court held that the PBGC could terminate the pension plan because the plan was unable to pay benefits when due and the possible long-run loss to the PBGC with respect to the plan could reasonably be expected to increase unreasonably if the plan was not terminated. The court further noted that the settlement agreement worked out between the PBGC and United did not taint the termination process. 2006 WL 89829 at *12-16.

14 ERISA § 4041(c), codified at 29 U.S.C. § 1341(c).


to be isolated and found to qualify under some recognized circumstance of distress in order for the court to undertake to determine the financial necessity of a plan’s termination under ERISA. The court held that such criteria will, however, form a key element in the debtor’s final application for termination and its success in terminating its pension plan.

B. Collective Bargaining Agreements and Section 1113 of the Bankruptcy Code

Pension plans are often required to be maintained under the terms of a debtor’s CBA. In general, ERISA does not prevent the PBGC from terminating a pension plan if the standards for an involuntary termination discussed above have been satisfied. ERISA does, however, prohibit the voluntary termination by a plan sponsor of a pension plan if it would violate the terms of a CBA. As a result, a debtor cannot obtain a distress termination of a pension plan if such plan is required by a CBA.

In bankruptcy, CBA’s are generally viewed as “executory contracts”. As noted in section IV-A above, executory contracts can generally be rejected by the debtor based on a debtor’s business judgment pursuant to section 365 of the Bankruptcy Code. If section 365 were applicable, a debtor would theoretically be able to reject the CBA and then be free to seek to terminate the pension plan. Section 1113 was added, however, to the Bankruptcy Code in 1984 and it provides the exclusive method by which a debtor may seek to reject the CBA.

The purpose of section 1113 is to reconcile the Bankruptcy Code’s policy of fostering the rehabilitation of companies with labor law’s policy of protecting employee rights through the collective bargaining process.

Sections 1113 of the Bankruptcy Code added significant hurdles that a debtor must satisfy before a Bankruptcy Court will allow rejection of a CBA. While a full discussion of 1113 is outside of the scope of this article, in general terms, before seeking to reject a CBA, the debtor must first make a proposal to the authorized representative of the employees covered by the CBA. Such proposal by the debtor must specify the proposed modifications to the CBA that are necessary for the debtor’s successful reorganization. Prior to a hearing to consider the rejection of a CBA, section 1113 obligates the debtor to meet with the authorized representative of the union and to attempt, in good faith, to reach an agreement regarding the proposed CBA modification.

If the debtor and the authorized representative cannot reach an agreement, the court can only allow rejection of the CBA if it finds that: (1) the debtor has made an appropriate proposal to the union; (2) the union has refused to accept the proposal without good cause; and (3) the balance of the equities clearly favors rejection of the CBA.

Therefore, if a debtor wants to terminate a pension benefit plan that is required to be maintained by a CBA, the debtor must first obtain the authorized representative’s agreement to eliminate the CBA provisions that require the maintenance of a pension plan or it must satisfy the requirements of section 1113 and reject the CBA. The debtor must then seek to satisfy ERISA’s requirements for distressed termination of such plan under the relevant ERISA provisions (as discussed more fully above).

V. The PBGC’s Claims in Bankruptcy

The PBGC generally may have three types of claims in a bankruptcy case. If the pension plan is terminated, the PBGC has a claim for the difference between the present value of its liabilities and the value of the plan’s assets (the “unfunded benefit liabilities” claim). This claim is contingent upon termination of the pension plan. The PBGC also may have a claim for any unpaid minimum funding contributions owed to the pension plan by its sponsor; this claim is often a subset of the unfunded benefit liabilities claim. Finally, the PBGC may have a claim for any unpaid pension plan termination insurance premiums.

17 195 B.R. 180.
20 Prior to the enactment of section 1113, in the case of NLRB v. Bildisco & Bildisco, 465 U.S 513, 1984 U.S. LEXIS 6 (1984), the Supreme Court held that a debtor could reject a burdensome CBA under section 365 of the Bankruptcy Code. That decision resulted in intense lobbying of Congress by unions to modify the Bankruptcy Code. That decision resulted in intense lobbying of Congress by unions to modify the Bankruptcy Code. As a result of these lobbying efforts, the Bankruptcy Code was modified in 1984 to add section 1113 which effectively overruled Bildisco and imposed the requirements set forth in section 1113 before a debtor could reject a CBA.
As described above, claims in bankruptcy have various priorities and rights depending on the type and nature of the claim. The classification of the PBGC’s claims and their priority status in bankruptcy have a significant impact on the PBGC’s recovery and, potentially, the recovery of a debtor’s other creditors.

A. Controlled Group Liability for PBGC Claims
Pursuant to ERISA, not only is the sponsor of the pension plan liable for the PBGC’s claims, but all members of the sponsor’s “controlled group” are jointly and severally liable for the liabilities to the PBGC. The controlled group is generally defined to include a parent corporation and all of its 80 percent owned subsidiaries. In addition, brother-sister corporations of a common parent are typically members of the same controlled group.24 As a result of controlled group liability, the PBGC’s claim may be better positioned than the claims of other creditors because the PBGC may be structurally senior to the claims of such other unsecured creditors as a result of the controlled group liability.25 For a very simplified illustration of structurally seniority, assume that (i) Company is a holding company with three operating subsidiaries (subsidiary 1, 2 and 3), (ii) Company owes Creditor X $100 as a result of prepetition obligations (which is not guaranteed by the subsidiaries) and (iii) Company has terminated its pension plan during its chapter 11 case and as a result the PBGC has a $50 non-priority unsecured claim. Further assume each operating subsidiary has net asset value of $25 (for an aggregate $75) and that there are no obligations other than those of the PBGC and Creditor X. While Creditor X and the PBGC each have a non-priority unsecured claims, the PBGC has a direct claim against subsidiary 1, 2 and 3. Creditor X only has a claim against Company and only benefits from the value of subsidiary 1, 2 and 3 to the extent such subsidiaries have equity value (i.e. value in excess of their liabilities). In this simplified example, the PBGC could recover 100% of its claims from the value of subsidiaries, while Creditor X would only recover 25% of its claim due to its structural subordination (Creditor X would only be entitled to the $25 in equity value which remains in respect of its subsidiaries after the PBGC recovered on its direct claims against such subsidiaries).

B. PBGC Lien
Prior to the termination of a pension plan, if an employer misses its minimum funding contributions, by operation of ERISA and the Internal Revenue Code, an automatic lien is created in favor of the PBGC against the assets of the entities in the controlled group provided that the aggregate amount of such unpaid contributions exceeds $1 million.26 This lien automatically arises 60 days after a missed contribution. Under ERISA, upon termination of a pension plan, the PBGC will also have an automatic lien on all of the assets of the entities in the controlled group, for the total amount of the unfunded benefits liabilities.27

In bankruptcy, the automatic stay prevents any lien from arising and prevents any creditor, including the PBGC, from perfecting a lien against the debtor’s assets. As a result, if a minimum funding contribution is missed or if a pension plan is terminated after the petition date (as is typically the case), the automatic stay will prevent a lien from arising against the assets of any of the debtors notwithstanding the provisions of ERISA which contemplate such lien. In addition, if a lien is perfected within 90 days prior to the bankruptcy filing, the debtor may have the ability to avoid such a lien as a preferential transfer under section 547 of the Bankruptcy Code. It should be noted that the automatic stay would generally not prevent the lien from arising against members of the controlled group that have not filed for bankruptcy protection. The PBGC would be a secured creditor to the extent it has obtained an unavoidable lien prior to the bankruptcy filing.

C. The PBGC’s Unfunded Benefit Liabilities Claim
Prior to a 1991 decision in In re Chateaugay Corp.,28 the PBGC asserted that if a pension plan was terminated post-petition, the PBGC’s entire unfunded benefit liabilities claim was entitled to administrative expense priority. The PBGC claimed that its unfunded benefit liabilities claim was an administrative expense under the Bankruptcy Code because it was an “actual, 

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24 In many contexts (for example, a public company with 80% owned subsidiaries), the determination of controlled group liability is straightforward. In other contexts, including those involving private corporations, these rules can require a significant amount of analysis.

25 Under ERISA, controlled group liability also runs to foreign subsidiaries of a plan sponsor. There are, however, numerous issues related to the PBGC ability to enforce its claims against such foreign controlled group subsidiaries. A discussion of this issue is outside the scope of this article.


necessary costs of preserving the estate. However, in Chateaugay, the bankruptcy and district courts ruled that the PBGC’s claim arose from the service of the debtor’s employees prepetition, and there was no resulting post-petition benefit to the estate. The courts further held that the PBGC’s claim was not entitled to priority status. While the Chateaugay decision was vacated at the parties’ request, other courts continue to cite the case as precedent. As a result of Chateaugay, the PBGC no longer claims that the entire amount of its unfunded benefit liabilities claim is entitled to administrative priority.

Recently, the PBGC has asserted in its proofs of claim that a portion of its unfunded benefit liabilities claims are entitled to priority as a tax under section 503(b)(1)(B) of the Bankruptcy Code. Under section 4068 of ERISA, if an employer fails to pay its liability under section 4062 of ERISA, the PBGC has a lien on all of the employer’s assets, up to 30% of the controlled group’s collective net worth. Section 4068 of ERISA also provides that in a bankruptcy case, this lien is to be treated in the same manner as a tax due to the United States. Based on this provision, the PBGC argues that the portion of its claim that is subject to section 4068 lien is entitled to tax priority.

While a few earlier cases supported the PBGC’s argument, most recent case law rejects the PBGC’s position on this issue. Generally, the later decisions hold that a section 4068 lien is necessary to warrant tax treatment and, as discussed above, in a bankruptcy case, the automatic stay prevents the PBGC from obtaining such a lien post-petition.

The PBGC also asserts occasionally that its unfunded benefit liabilities claim is entitled to tax priority even if section 4068 of ERISA had never been enacted. The Bankruptcy Code does not define the term “tax”, but the PBGC argues that its unfunded benefit liabilities claim meets the definition of taxes stated by the Supreme Court as “pecuniary burdens laid upon individuals or their property, regardless of their consent, for the purpose of defraying the expenses of government or of undertakings authorized by it.” However, courts have not supported the PBGC’s position, pointing out that under section 4062 of ERISA the money collected as unfunded benefit liability from the employers goes not to the government, but to the PBGC who then pays the employees.

The PBGC can also seek to obtain priority status under section 507(a) of the Bankruptcy Code which, as discussed above, provides a priority for up to $10,000 per employee for claims for contributions to benefit plans arising from services rendered within 180 days prior to the petition date. As noted above, however, section 507(a)(4) of the Bankruptcy Code provides a similar priority for wages earned in the 180 days paid to the petition date. Debtors typically file pleadings on their first day of the case which seek authority to pay employees for immediate prepetition wages up to the amount of the 507(a)(4) cap. The payment of such wages can often offset a substantial portion of the priority that the PBGC may have been entitled to under section 507(a)(5).

In general, the PBGC’s unfunded benefit liability claim will be treated as a nonpriority general unsecured claim except to the extent that the PBGC can establish that a portion of the claim is attributed to services rendered post-petition or within the 180 days prior to bankruptcy up to the section 507(a)(5) cap (in which case, such portion may be entitled to administrative expense priority or priority unsecured claim status).

D. The PBGC’s Minimum Funding Contribution Claim

Some debtors in bankruptcy continue to make minimum funding contributions under pension plans before such plans are terminated and will seek the bankruptcy court’s authority to make these payments. Where the debtor stops making the

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30 130 B.R. at 697-98; 115 B.R. at 779-82.
32 ERISA § 4062, codified at 29 U.S.C. § 1362 (Section 4062 of ERISA deals with calculation of unfunded benefit liabilities).
33 In some cases, however, where the net worth of the debtor and its controlled group is zero, the PBGC’s cannot claim priority status.
34 In re Bayly Corp., 163 F.3d 1205, 1998 U.S. App. LEXIS 32235 (10th Cir. 1998) (the PBGC’s claim was not entitled to administrative priority because its claim was not incurred by the estate post-petition); In re Kent Plastics Corp., 183 B.R. 841, 1995 Bankr. LEXIS 1087 (Bankr. S.D. Ind. 1995) (the PBGC’s claims do not constitute taxes entitled to priority).
37 In a recent case, where secured creditors of a debtor argued that minimum funding contributions were voidable post-petition preferences, the court ruled that such contributions are required by section 1113(f) of the Bankruptcy Code and were not voidable under section 549 of the Bankruptcy Code. See Wilmington Trust v. WCI Steel (In re WCI Steel), 313 B.R. 414, 2004 Bankr. LEXIS 1075 (Bankr. N.D. Ohio 2004).
minimum funding contributions, the PBGC may assert a claim for these payments. As with the unfunded benefit liabilities claim, the PBGC typically advances a number of rationales in arguing that the post-petition minimum funding contribution claim should be entitled to priority as a tax claim or as an administrative expense.

Where the missed post-petition contributions are in the amount of more than $1 million, the PBGC argues that it is entitled to a tax priority in bankruptcy based on Internal Revenue Code section 412(n). This section provides that a pension plan has a lien on all of the employer’s assets for the amount of missed contributions, provided that the aggregate amount of unpaid contributions exceeds $1 million. Further, section 412(n) of the Internal Revenue Code provides that any amount with respect to which a lien is imposed under section 412(n) shall be treated as a tax due and owing the United States. The few cases that have addressed this issue decided against the PBGC by holding that the PBGC lien does not arise due to the automatic stay or that Congress did not intend for the PBGC to have administrative priority to claims under tort and regulatory law even if the estate did not derive a benefit.

The PBGC also asserts that even if its claims are not entitled to tax priority, the portion of the minimum funding contributions that is attributable to the post-petition period should be given administrative priority under sections 507(a)(2) and 503(b) of the Bankruptcy Code. The PBGC argues that, similar to wages, costs of maintaining pension plans constitute ordinary and necessary expenses of running a business and should be treated as administrative expenses in bankruptcy. Further, the PBGC claims that even if pension plan contributions do not benefit the debtor’s estate, they are entitled to administrative priority because such contributions are an ongoing cost of complying with a regulatory scheme. Courts, however, have rejected the PBGC’s arguments in cases where the benefits had ceased to accrue on a pension plan pre-petition. Courts have held in such cases that the liability on which the pension plan contributions are based arises pre-petition. With respect to a pension plan where benefits continue to accrue post-petition, the PBGC may, however, be entitled to administrative expense priority with respect to the post-petition minimum funding claims that are attributed to the post-petition services of employees.

In addition, similar to the unfunded benefit liability claim, the PBGC argues that the minimum funding contributions claim is entitled to priority under section 507(a)(5)(A) of the Bankruptcy Code to the extent it is attributable to the 180 days prior to the filing of the bankruptcy petition and does not exceed the statutory monetary cap for such priority claims.

E. Priority of the PBGC’s Premium Claims
The PBGC’s regulatory scheme contemplates that the pension plan sponsor will continue paying insurance premiums each year until the PBGC becomes trustee of the pension plan or all of the pension plan’s assets are distributed to the employees. Typically, the PBGC asserts an administrative priority claim for unpaid premiums in years since the bankruptcy filing and a general unsecured claim for the years prior to the bankruptcy filing. Generally, however, the PBGC’s claims for unfunded benefit liabilities and minimum funding contributions are much larger than the premium claims.

F. Amount and Calculation of the PBGC’s Claims in Bankruptcy

I. Amount of Unfunded Benefit Liabilities Claim
Under section 4001(a)(18) of ERISA, the PBGC’s claim for unfunded benefit liabilities is the difference between the value of plan’s assets and the value of benefit liabilities as of the plan termination date. The PBGC looks at the market value of the pension plan assets, and determines the actuarial present value of the plan benefit liabilities as provided under certain regulatory guidelines. The interest rate used by the PBGC in calculating its claim has a significant effect on the amount of the claim. Thus, the PBGC’s interest rate assumption is frequently challenged by the debtors and other creditors as discussed below.

40 The PBGC typically cites a number of cases in which courts have given administrative priority to claims under tort and regulatory law even if the estate did not derive a benefit from the claimant. See, e.g., Reading Co. v. Brown, 391 U.S. 471, 1968 U.S. LEXIS 2986 (1968); In re N.P. Mining Co., 963 F.2d 1449, 1456, 1992 U.S. App. LEXIS 14276 (11th Cir. 1992); United States v. LTV Corp., 944 F.2d 997, 1009-10, 1991 U.S. App. LEXIS 20949 (2nd Cir. 1991).
2. **Amount of Minimum Funding Contributions Claim**

As discussed above, the PBGC’s minimum funding contribution claim is usually a subset of the unfunded benefit liabilities claim. The PBGC maintains that minimum funding contributions are an asset of the pension plan and should be valued like any other asset by taking into account the risk of nonpayment, time value, and the actual expected recovery, if known. The PBGC argues that minimum funding contributions should be included as part of the total assets subtracted from the plan’s liabilities in calculating unfunded benefit liabilities claim. This position of the PBGC often leads debtors to argue that the PBGC’s minimum funding contributions claim duplicates the PBGC’s unfunded benefit liabilities claim. The majority of the courts agree and hold that unfunded benefit liabilities claim is to be reduced dollar-for-dollar by the face amount of its minimum funding contribution claim. Otherwise, as one court stated, “accepting the PBGC’s position would effectively give it $2.00 of claim for each $1.00 of loss on its [minimum funding contributions] claim. The first dollar is for the [contributions] claim itself, a portion of which would be paid with other general unsecured creditors. The second dollar results from the fact that a portion of the [unfunded benefit liabilities] claim arises because the debtor failed to make its minimum funding contributions…. Reducing the [unfunded benefit liabilities] claim by the face amount of the [contributions] claim avoids recognition of this second dollar of claims.”

3. **Interest Rate Calculation**

The interest rate used in calculating the PBGC’s claim has an inverse effect on the claim’s amount. A higher discount rate results in a lower claim and a lower rate results in a higher claim amount. The PBGC argues that under section 4001(a)(18) of ERISA the amount of unfunded benefit liabilities is to be calculated by using assumptions provided by the PBGC. The PBGC further states that, under administrative law principles, its assumptions and calculations can be set aside only if arbitrary or capricious. Most courts, however, rule that the discount rate should be set by the bankruptcy court and not the PBGC.

In determining what interest rate should be used to calculate the PBGC’s claims, a majority of courts with reported decisions turn to the prudent investor rate. The court in *Chateaugay* wrote that “the proper methodology for valuing a claim based on an obligation of the Debtors to make cash payments subsequent to the Filing Date requires an examination of the rate of return available to a reasonable, prudent private pension fund investor who invests in a “prudent” portfolio. That investor’s guiding objective is to earn the highest return on the invested capital consistent with preservation of the capital and minimization of risk. This projected rate of return should then be used to discount the Debtors’ obligations to make cash payments subsequent to the Filing Date to determine the present value of the claim.”

On the other hand, in the more recent US Airways bankruptcy case, the Bankruptcy Court for the Eastern District of Virginia held that the discount rate calculated by the PBGC should apply. The PBGC determined the value of its claims based on the cost of a single-premium annuity that could be bought in the insurance marketplace to cover all plan benefits. The court pointed out that a creditor’s claim is a function of nonbankruptcy law creating the debtor’s obligation and subject to any qualifying or contrary provisions of the Bankruptcy Code. The court reasoned that the debtor’s liability to the PBGC and the amount of the PBGC’s claim come from the same set of statutes and, therefore, the PBGC’s calculation of the amount of the claim and the discount rate should be given deference. The court pointed out that even though

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47 See, e.g., *CF&I*, 150 F.3d at 1300-01 (court holding that section 4001(a)(18) of ERISA conflicts with the Bankruptcy Code and that prudent investor discount rate should be used to calculate the PBGC’s claim); *CSI Indus.*, 232 F.3d at 509.
51 303 B.R. 784, 793.
the PBGC’s calculations may not be ideal, they were not unreasonable and the debtors did not present sufficient evidence for the court to find such calculation irrational or arbitrary.52

VI. The Future of the PBGC – The Call for Reform

In recent years, commentators have pointed out that the structure of the PBGC and the treatment of its claims in bankruptcy are due for substantial reforms. Most importantly, the PBGC is having significant financial problems due to the recent collapse of a number of large corporations and the distressed status of entire industries such as the airline industry. At the end of 2003, the PBGC had a deficit of $11.2 billion and in 2005,53 the deficit was more than $23.2 billion.54 In addition, the Congressional Budget Office states that the PBGC had an operating deficit of $30 billion in 2005 which is projected to grow to more than $100 billion within 20 years.55 Recently, when United Airlines terminated its four benefit plans, the PBGC assumed a more than $5 billion liability for those plans.56 While the PBGC may not be in an immediate risk of running out of funds, potential large liabilities such as the liabilities from United Airlines’ plans may pose a significant threat to the PBGC’s existence.57 Moreover, in most cases, there is no solvent entity for the PBGC to proceed against to collect its liabilities.58

Some critics advocate reform of the PBGC through an increase in the premiums that the employers are required to pay to the PBGC.59 Others argue that large companies, such as the airline companies, can be discouraged from shifting their unfunded benefit liabilities to the PBGC if the Bankruptcy Code is amended so as to preclude the discharge of unfunded pension liabilities by the debtors in bankruptcy60 or allow the PBGC to have an administrative or tax priority with respect to its claims.61

VII. Conclusion

As noted above, the treatment of pension plans in an employer’s bankruptcy is a complex topic with numerous issues. Financially troubled employers and their creditors should focus on these issues because their resolution can have a significant effect on the outcome of the bankruptcy and the recoveries received by the company’s various constituencies.

52 303 B.R. at 797.
53 Christine Stinson Matott, *Airlines in Distress: Can the Pension Benefit Guaranty Corporation Weather This Crisis?* 55 DePaul L. Rev. 169, 176 (Fall 2005).
56 See Matott, * supra* note 53 at 179-180. On December 9, 2002, United filed its Chapter 11 petition. In 2004, while in Chapter 11, United was to pay $500 million in pension contributions and would owe another four billion by 2008. In July 2004, United announced that it would no longer contribute to its four pension plans during bankruptcy. On May 11, 2005, the Bankruptcy Court for the Northern District of Illinois approved an agreement between the debtors and the PBGC. Pursuant to this agreement, the PBGC terminated four of the debtors’ benefit plans under section 4042 of ERISA, 29 U.S.C. § 1342, involuntary termination provisions. Under the agreement, the PBGC will receive $500 million of Senior Subordinated Notes of the reorganized debtors, $500 million 8% Contingent Senior Subordinated Notes and $500 million 2% Convertible Preferred Stock. The PBGC will have a general unsecured unfunded liability claim and will be deemed to have settled its minimum funding claim and its insurance premiums claim. The agreement also prohibited United from establishing a defined benefit pension plan within 5 years after the reorganization. *In re UAL Corp.*, Case No. 02-B-48191 (Bankr. E.D.Ill. May 11, 2005).
60 See Collins, * supra* note 54 at 311.
61 See Matott, * supra* note 53 at 176.
Vivek Melwani is a partner in the bankruptcy and restructuring department of Fried, Frank, Harris, Shriver & Jacobson LLP. He has been involved in all aspects of in- and out-of-court restructurings of financially distressed businesses and has been active in the representation of corporate debtors, official and unofficial creditors’ committees, lenders and purchasers of distressed businesses. Mr. Melwani received his JD, with distinction, in 1995 and his BBA in 1992 from Hofstra University.

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