Half-Baked: The Treatment of Pension Obligations in Bankruptcy

Lessons Learned from Hostess and Other Cases

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Bankruptcy: A Means to Reduce or Eliminate Pension Obligations

- Sophisticated debtors' lawyers have spent several decades devising strategies which use the bankruptcy process to reduce or eliminate pension liabilities. They have been very successful.

- Examples in the **Private Sector:**
  - **American Airlines** (2011): Three plans frozen, lump-sum payment option eliminated, one plan terminated.
  - **General Motors** (2009): Cuts limited to executive pensions > $100,000 per year (reduced by 2/3). "Top-up" obligation for Delphi union preserved.
  - **Delphi** (2009): Union pensions preserved, salaried pensions transferred to PBGC (reduced up to 70%).

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Bankruptcy: A Means to Reduce or Eliminate Pension Obligations (cont'd)

Examples in the **Public Sector:**

- **Pritchard, Ala.** (2009): Chapter 9 dismissed, but negotiated settlement reduced pension by two-thirds.
- **Central Falls, R.I**. (2011): Negotiated Restructuring. Pensions under $10k/year preserved; those over $10k reduced up to 55%.
- **Stockton, Cal. (2012):** City's proposed plan would preserve pensions, but bondholders argue this unfairly discriminates. Judge has suggested (July 2014) that pensions can be cut and CALPER's $1.5 billion termination charge may be unenforceable.
- **Detroit, MI (2013):** Employees and retirees voted to accept reduced benefits. Confirmations hearings to be concluded in mid-September.

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Enter: The Twinkie

- In 2004, Hostess (then Continental) filed its first chapter 11; in that case, it left the pensions intact and untouched.
- In 2012, Hostess filed its chapter 22. This time, it used bankruptcy law to eliminate more than $2 billion in withdrawal liability, and relieve itself of any future obligation to fund pension contributions.
- Twinkies are still being produced in this country -- but the people who make them no longer accrue pension benefits under the CBA in place before the bankruptcy was filed.
- So, how did Hostess do it?

Treatment of Pension Fund Claims in Bankruptcy

- In bankruptcy, general unsecured claims are subordinated to:
  - **Secured Claims** – where a creditor holds a lien on assets
  - **Administrative Claims** – arising after the bankruptcy filing
  - **Priority Claims** – certain special categories of pre-bankruptcy claims, including taxes
- After payment of secured, administrative and priority claims, there is often minimal (if any) value left to pay general unsecured claims.

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Treatment of Pension Fund Claims in Bankruptcy (cont'd)

There are many benefits to having an administrative claim:

- More **leverage** than general unsecured claim
- Must be **paid in full** on the effective date of a chapter 11 plan unless holder agrees otherwise.
- Bankruptcy Judges may be more inclined to **listen to large administrative claims holders**, rather than to individual unsecured creditors (typically, they defer to the Unsecured Creditors Committee)
- Administrative creditors gain a **seat at the bargaining table**

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Treatment of Pension Fund Claims in Bankruptcy (cont'd)

Effect of **terminating pre-petition:**

- **Withdrawal liability** claims are locked in as pre-petition, unsecured claims
- Claims for **unpaid contributions** through termination are locked in as pre-petition, general unsecured claims
- Employees can continue working for the debtor company, but will **not accrue pension credits for work performed post-petition**

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Hostess Likely Stopped Making Pension Contributions Strategically, to Provoke Termination

In this scenario, Hostess would have:

- Identified the **termination policies** in effect at largest pensions (*i.e.*, how many months of nonpayment before termination)
- Next determined the **best time to file chapter 11** (taking into account business considerations, such as cash flow, sales, etc.)
- And then worked backwards from the target filing date → picking a date to stop making pension contributions that would **ensure termination by the funds prior to filing for bankruptcy protection**

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Hostess Likely Stopped Making Pension Contributions Strategically, to Provoke Termination (cont'd)

The facts, as they actually played out in Hostess:

- Hostess stopped making pension contributions in July of 2011.
- Most of its major pension funds terminated within six months thereafter. This played right into Hostess' overall strategy for eliminating its pension obligations.
- Hostess filed for chapter 11 protection in the SDNY in January of 2012 – after Central States, the B&C Fund and several other pension funds issued letters of termination.

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The Effect of Pre-Petition Termination in Hostess

- Termination prior to the bankruptcy filing reduced the withdrawal liability claim to a general unsecured claim. **General unsecured claims in Hostess were paid $0.**
- **Pre-petition contribution claims in Hostess were also paid $0.**
- Pre-petition termination by Hostess' big pension funds also **eliminated Hostess' obligation to make pension contributions for work performed post-petition.**

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Other Key Strategy Points Used by Hostess in the Chapter 11

- Hostess used the bankruptcy process to **reject its collective bargaining agreements.**
- With its collective bargaining agreements rejected, Hostess **sold its assets free and clear** to third-party buyers.
- Twinkies, Ring Dings and Devil Dogs are now being manufactured by workers in this country **without the benefit of the collective bargaining agreements** in effect at the time Hostess filed chapter 11 – or the pension benefits that accrued thereunder.

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“To Terminate or Not to Terminate?” That is the Question. . .

- Just as was the case in Hostess, after a certain period of non-payment, a pension fund typically has the right to terminate, but is not required to do so.
- The driving question must be: Assuming a bankruptcy at some point in the company’s future, does terminating today increase or decrease your leverage?
- To arrive at the correct answer, the fund should compare the its strategic position after termination vs its strategic position if it chooses not to terminate.

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Comparing the Options:

Terminate Pre-Petition	Don't Terminate Pre-Petition
Cease accruing pension credits	Pension credits continue to accrue without any corresponding contribution from employer • Fund's exposure for pension benefits increases • Employer's debt to fund continues to grow
Remove the hurdle of complying with section 1113 vis-à-vis pension obligations	Force the debtor to comply with 1113 in order to terminate
Chapter 11 Claims: • Unsecured claim for pre-petition monthly contributions through termination • Withdrawal liability – prepetition, general unsecured claim	Chapter 11 Claims: • Unsecured claim for pre-petition monthly contributions • Post-petition pension contributions -- administrative claim • Withdrawal liability – administrative claim to the extent attributable to work performed post-petition *plus* general unsecured claim for the balance

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Terminate vs. Not: Financial Factors to Consider

- Relative **ability of the debtor to reorganize**, the viability of the business, the likely size of the workforce
- Value of **ending pension credit accruals** based on a range of possible termination dates (pre- and post-petition)
- Potential value of **administrative claim** based on a range of possible petition dates and projected administrative solvency of debtor
- Potential value of **general unsecured claim** taking into consideration debtor's capital structure and value of unencumbered assets

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Terminate vs. Not: Legal Factors to Consider

- Ability of debtor to **comply with 1113 requirements** (discussed *infra*) and likely timeframe to complete the rejection / modification process

- **The X Factor**: Given all the variables at play, would termination provide the fund with more leverage in negotiating with the company? Or would not terminating put the fund in the position of greatest bargaining strength?

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Complying With 1113 – What Is Involved?

- Outside of bankruptcy, the debtor may not voluntarily terminate a plan if termination would violate an existing CBA.

- Debtor may seek to remove the CBA's contractual bar to termination by rejection or modification of the CBA by complying with section 1113 of the Bankruptcy Code. The debtor must:

  - Make a proposal to union that:
    - Contains modifications necessary for debtor's reorganization
    - Assures fair and equitable treatment of debtor, its creditors and covered employees
    - Is based on most complete/reliable information available

  - Provide union with information necessary to evaluate the proposal.

  - Meet with union at reasonable times and negotiate in good faith toward mutually agreeable CBA modifications.

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Complying With 1113 (cont'd)

- After meeting these requirements, the debtor can unilaterally modify or terminate CBA if the court finds that
  - Authorized representative of employees refused to accept the proposal without good cause, and
  - The balance of the equities clearly favors rejection.
- If debtor prevails under section 1113, then
  - Pension fund may be entitled to an administrative claim for withdrawal liability to the extent it is attributable to post-petition employment; balance of claim will be unsecured
  - With administrative claim, fund gets a seat at the bankruptcy bargaining table.

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Chapter 11 Alternative: Keep It Out of Court

- If the company is so inclined, the fund can **attempt to achieve a consensual deal outside of bankruptcy**
- Compared to chapter 11, an out-of-court restructuring may offer several significant benefits:
  - **Cost** – bankruptcy proceedings are very expensive and reduce the size of estate available to satisfy pre-petition and administrative pension contribution claims
  - **Deterioration** of the underlying business – bankruptcy can have significant negative consequences to business as managers lose focus on operations and customers evaluate other options
  - **Lost leverage** – a bankruptcy filing results in pre-petition pension claims (if terminated prepetition) being treated as one of many in a general unsecured liabilities pool
  - **Negotiation vs Litigation –** bankruptcy **is** often a battleground, more about litigation than restructuring
  - **Timing** – bankruptcy can be long and drawn out and payment of pre-petition liabilities, if any, occur upon emergence from bankruptcy

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Out-of-Court Restructuring – Factors to Consider

- Are there **operational and financial restructuring alternatives** that the debtor has not considered?
- Are there **non-performing assets** that the debtor could monetize to reduce leverage and improve cash flow?
- Would a consensual restructuring have a different (better) **impact on the work force** and the terms of employment?
- Is **existing management** the proper steward of the debtors' assets?
- Are **other creditor constituencies contributing ratably** to the restructuring of the debtor – or is the pension being asked to bear more than its share?
- Are creditors, including pensions, better served by a **sale of the debtors' assets**?

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Out-of-Court Restructuring – Possible Deal Terms

- **Payment holiday** to provide short/medium term relief and time to fix the business
- **Reduced contributions** to assure long term viability of a “fixed” business
- **Taking a security interest (lien) on available collateral** to secure deferred payments
- **YRC** – an example of a successful out-of-court restructuring

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Lessons Learned – Concrete Countermeasures

- In any distressed situation, pension funds should be part of the solution, **not the primary underwriter of the loss.**
- **Protect and enhance rights <u>before</u>** contributing companies become financially distressed. Once a bankruptcy is filed it is too late to make improvements—parties generally are limited to the rights they have coming into a bankruptcy, which may be even further limited by the Bankruptcy Code.
    - **Evaluate documents** that govern the duty to make pension contributions and determine how they can be updated/improved.
    - Be prepared with a **bankruptcy strategy** proactively (*i.e.*, prior to contributor distress).

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Lessons Learned (cont'd)

- **Adopt techniques and tactics that are used by other creditor constituencies** to protect their positions in financially distressed situations.
  - **Actively monitor** the financial health of contributors.
  - **Determine options/strategies** available to the pension at the first signs of financial distress.
  - Be **early and proactive in understanding** the company's:
    - Cash flows
    - Business strategy
    - Restructuring plan and feasibility
    - Operational and financial restructuring alternatives
    - Willingness to "'share the pain" among ALL constituencies
    - Potential control group liability
  - Understand the **"asks" of other constituencies**

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Lessons Learned (cont'd)

- After default, **decide whether or not to terminate**, based on deep due diligence, detailed financial and legal analysis of all factors.

- Demand a **seat at the table** as soon as work-out/restructuring discussions begin
  - Other creditors are well represented
  - Senior lenders and bondholders all have sophisticated counsel and financial advisors
  - Unsecured creditors have huge competitive insights
  - Regulatory agencies have police power
  - If pensions are not at the table, they (and the unions) will be the "meal."

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Lessons Learned (cont'd)

- **Keep lines of communication open** with all constituents to the restructuring

- **Find allies** by looking for constituents with common interests to increase leverage and avoid being isolated.

Ms. Nastasi has deep experience with complex chapter 11 cases, out-of-court restructurings and distressed financial transactions. She is known within the insolvency community for devising creative and effective solutions to complex cases and transactions. Ms. Nastasi has played a prominent role in national cases spanning a broad range of industries, including financial services, manufacturing, food, hospitality, insurance, construction and real estate. Her clients include pension plans, debtors, chapter 11 trustees, secured and unsecured creditors, distressed investors and other strategic parties. The hallmark of Ms. Nastasi's practice methodology is close collaboration with her clients in formulating strategies to achieve comprehensive solutions and positive outcomes.

After graduating from Vanderbilt University with a degree in mathematics, Ms. Nastasi obtained a graduate diploma in accounting and finance from the London School of Economics and a law degree from University of Pennsylvania. She began her career as a clerk to Hon. Robert Ginsberg (Bankr., N.D. Ill.) and thereafter was associated with several prominent law firms specializing in bankruptcy and restructuring. Immediately prior to founding Nastasi Partners, Ms. Nastasi was the chair the bankruptcy group at the New York office of Norton Rose Fulbright.

ANCELA R. NASTASI
ancela@nastasipartners.com
(212) 744-5801
www.nastasipartners.com

Marshall Tracht combines his bankruptcy and real estate legal expertise with business acumen from an MBA in Finance from the Wharton School and background in management consulting. A tenured professor at New York Law School, he has more than 20 years of experience in bankruptcy law and restructuring.

Prof. Tracht began his career with economic research and management consulting at the American Enterprise Institute and the Cambridge Research Institute. Following a clerkship with The Honorable S. Martin Teel, Jr. of the D.C. Bankruptcy Court, he joined Arnold & Porter as part of their Bankruptcy and Real Estate Practice Groups.

Prof. Tracht has published and lectured widely on topics ranging from bankruptcy reorganization to guaranties and suretyship, real estate transactions and mortgage and corporate finance. He advised a "Fortune 50" company on potential bankruptcy strategies for handling mass tort litigation, served as an economic expert in the WorldCom bankruptcy, counseled multiemployer pension plans in a major Chapter 11 case, and has served as an expert witness in bankruptcy proceedings and other legal cases.

Prof. Tracht brings a broad strategic perspective encompassing both legal and financial concerns.

MARSHALL E. TRACHT
Of Counsel
(Admitted in D.C.)
marshall@nastasipartners.com
(212) 744-5802
www.nastasipartners.com

Contact Information:
200 Berkeley Street
Boston, MA 02116
D: +1.617.437.2399
F: +1.877.793.7518
C: +1.617.875.6404
Email: stgray@deloitte.com

Industries:

- Business Services
- Communications
- Distribution
- Environmental Management
- Financial Services
- Health Care
- High Technology
- Manufacturing
- Pharmaceutical and Chemical
- Real Estate
- Retail
- Transportation

Education:

B.S., George Washington University

Stephen Gray

Director, Deloitte CRG
Deloitte Transactions and Business Analytics LLP

Stephen Gray has more than 35 years of experience developing and implementing restructuring and crisis management plans for public and private companies, general creditors, secured parties, acquirers of non-performing companies, and judicial bodies. Mr. Gray is the founder of TRG and CRG Partners LLC, which was acquired by Deloitte in 2012.

Mr. Gray has led the successful operational and/or financial restructuring of hundreds of companies. He has worked as a turnaround consultant and crisis manager for a wide variety of companies. Mr. Gray is well known in the financial and legal communities throughout the U.S. for his work as a fiduciary. He has served as Chapter 11 trustee, state or federal receiver, examiner, and post-confirmation trustee in numerous situations.

Mr. Gray is highly skilled in the dynamics of the insolvency process, bankruptcy procedures, cash flow management and general areas of business, management, and finance. In addition, he has managed the sale of many companies in a variety of industries. Some of his more recent engagements include:

- Chapter 11 trustee for High Voltage Engineering, a $450 million manufacturer of industrial electrical motors and control systems
- Chief restructuring officer (CRO) of CompUSA, a $1.8 billion retailer of consumer electronics, in an out-of-court restructuring
- CRO of a $1.2 billion construction and real estate development company in an out-of-court restructuring
- Chapter 11 trustee of Molten Metals Technology, a high-tech nuclear waste company

Prior to forming TRG, Mr. Gray was president of Gray and Company, a professional services organization specializing in turnaround and workout consulting. He also served as vice president for a company specializing in consulting for distressed businesses, and as a member of the corporate development staff at an international management consulting company.

Mr. Gray was a master's level teaching fellow in mechanical engineering at Tufts University. He is a fellow of the American College of Bankruptcy, a member of both the American Bankruptcy Institute and the Turnaround Management Association, and he is a regular speaker at restructuring and insolvency conferences. Additionally, Mr. Gray was named one of Turnarounds & Workouts' 2008 People to Watch.

This biography may refer to client engagements performed prior to joining Deloitte Transactions and Business Analytics LLP ("DTBA") in the Deloitte Corporate Restructuring Group ("Deloitte CRG").

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