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Reducing Costs by Terminating Retiree Benefits in Chapter 11

Debtors and retirees must actively engage in the §1114 process; it is not a statute that welcomes tepid actions

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The Employee Retirement Income Security Act does not vest in retirees any rights to their nonpension retiree benefits and, since companies treat such benefits as current expenses, they are often targeted for reductions when companies enter Chapter 11.

Chapter 11 debtors often look to terminate or modify retiree benefits to cut expenses. As Dan Keating notes in “Bankruptcy Code §1114: Congress’ Empty Response To The Retiree Plight,” 67 Am. Bankr. L.J. 17, 20 (1993), retiree benefits are subject to attack because ERISA provides disparate treatment for these benefits, on the one hand, and pension benefits, on the other. Nonpension benefit plans are covered by ERISA. However, most crucially, they are not

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covered by ERISA’s prefunding and vesting requirements — two of ERISA’s most important provisions. See 29 U.S.C. 1051, 1081.

Accordingly, while employers must fund pension plans in advance, they may treat nonpension retiree benefits as annual expenses. Moreover, ERISA vesting rules that give employees certain rights to their pensions are not applicable to nonpension retiree benefits.

In recent years, the onslaught of large Chapter 11 bankruptcies, such as *Bethlehem Steel* and *UAL Corp.*, and many small bankruptcies, such as *Horsehead Industries, Inc.*, have brought the issue of retiree health and other benefits to the fore.

In each of these cases, the debtor has sought to terminate or modify retiree benefits to reduce costs and promote their reorganization. Section 1114 of the Bankruptcy Code permits Chapter 11 debtors to modify or terminate retiree benefits if strict compliance with the statute is demonstrated.

In re Horsehead Industries, Inc., 300 B.R. 573 (Bankr. S.D.N.Y. 2003), is the most recent published opinion discussing a Chapter 11 debtor’s power to terminate retiree benefits. In *Horsehead*, the court granted in part and denied in part the debtors’ motion to terminate retiree health benefits for retirees under three separate collective bargaining agreements (CBAs).

Beyond being the most recent pub-

lished decision in this area, *Horsehead* offers a glimpse into the practical application of §1114 through three different filters — one for each of the unions involved — with vastly different results.

Horsehead

Horsehead Industries was engaged in the business of producing zinc and operating zinc manufacturing facilities at several locations throughout the United States. Approximately 75 percent of *Horsehead*’s work force were members of one of three unions: (1) the United Steel Workers of America (USWA), which through three separate locals represented employees at three different locations; (2) the Paper, Allied-Industrial, Chemical and Energy Workers’ Union (PACE); and (3) the Security, Police & Fire Professionals of America (SPFPA).

Horsehead lost significant amounts of money every month since filing Chapter 11 in August 2002. Its financial problems were caused by the low price of zinc, which is cyclical and fluctuates. The price of zinc must rise to \$0.45 per pound for *Horsehead* to break even, but the price of zinc fell to a 10-year low of \$0.33 per pound in 2001.

Nevertheless, *Horsehead* had cause for optimism because zinc prices were projected to rise to between \$0.40 and \$0.41 per pound in the near term and \$0.45 per pound shortly thereafter. *Horsehead*’s operations since entering Chapter 11 have been funded through a debtor-in-possession (DIP) loan facility, which is characterized by a \$1.7 million line of credit. The DIP lender was unwilling to increase the line of credit.

Horsehead attempted to reduce its

costs prior to seeking relief under §1114, however, it alleged that additional cuts were not possible except through a reduction in wages and benefits, including retiree benefits. Therefore, Horsehead filed a motion to reject their CBAs pursuant to §1113 and terminate retiree and nonretiree health benefits pursuant to §1114.

The company sought to save a total of \$9 million per year: \$6.5 million from its three unions and \$2.5 million from terminating retiree benefits (the discounted present value of Horsehead's retiree benefit obligations was \$34 million). The court acknowledged that "the relief now sought will provide, at most, a short term solution. ... Horsehead's business is in dire straights as its plans to sell its businesses as going concerns have failed twice, and they were, at the time of the decision, in negotiations with a third group interested in buying substantially all of its assets."

Overview of §1114

Section 1114 was enacted in 1988 in response to a decision by LTV Steel Company, then the second largest steel operation in the United States, to discontinue paying health benefits for approximately 70,000 retired employees immediately upon filing for bankruptcy in 1986. *See In re Chateaugay Corp.*, 64 B.R. 990 (S.D.N.Y. 1986). LTV's management reasoned that their obligation to pay approximately \$70 million in retiree benefits arose from the retiree's work for LTV performed prior to the bankruptcy, meaning that the retirees had prepetition unsecured claims against LTV that could only be paid under a confirmed plan of reorganization.

For the LTV retirees, the crisis was short-lived since their benefits were subsequently reinstated by the court in *Chateaugay*. LTV's action nevertheless underscored that retiree benefits are subject to attack by distressed companies.

Section 1114 (11 U.S.C. §1114(a)) addresses the payment of retiree benefits, which are defined as:

payments to any entity or person for the purpose of providing or reimbursing payments for retired employees and their spouses and dependents, for

medical, surgical, or hospital care benefits, or benefits in the event of sickness, accident, disability, or death under any plan, fund, or program (through the purchase of insurance or otherwise) maintained or established in whole or in part by the debtor prior to filing a petition commencing a case under [Chapter 11].

Section 1114 grants priority status to benefits payable to a debtor's retirees, and requires their payment in full at confirmation of a plan. The section also requires that debtors "timely pay and shall not modify any retiree benefits unless the debtor and retirees agree to terminate or modify the retiree benefits or the court, after notice and a hearing, orders the termination or modification." The process for a debtor to obtain court-ordered modifications of retiree benefits is similar to the requirements under §1113 for obtaining modifications to or rejection of collective bargaining agreements.

One distinction between these two sections is that §1113 sets forth what debtors must do prior to obtaining a court order authorizing the rejection of CBAs, while §1114 provides only for modifications of retiree benefits. Another distinction, owing probably to the retired status of the employees, is that §1114 expressly provides for the appointment of an authorized retiree representative, usually the union representing the retired employees. The expenses of the authorized representative must be paid by the estate as expenses of administration. *See In re Federated Dep't Stores, Inc.*, 121 B.R. 332 (Bankr. S.D. Ohio 1990).

Despite these distinctions, §1113 and §1114 contain virtually identical requirements for obtaining relief. Section 1114 requires debtors, prior to moving the court for modification of retiree benefits, to make a proposal to the authorized retiree representative "which provides for those necessary modifications in the retiree benefits that are necessary to permit the reorganization of the debtor and assures that all creditors, the debtor and all of the affected parties are treated fairly and equitably."

On the other hand, courts have refused to terminate retiree benefits under §1114 when benefits for one group of retirees are terminated while benefits of another group of retirees are not. In *In re Express Freight Lines, Inc.*, 119 Bankr. 1006 (Bankr. E.D. Wis. 1990), the court held that the burdens must be shared by workers, management and creditors with no group favored over the other.

Additionally, debtors must provide sufficient information to enable the authorized retiree representative to evaluate the proposal and must meet at reasonable times with the representative and attempt in good faith to resolve the matter consensually.

Section 1114(f), like its §1113 cousin, requires debtors' proposals to be limited to the modifications necessary to permit reorganization. The legislative history of §1113 is spartan, and the meaning of what constitutes necessary modifications to CBAs has been the subject of litigation. In contrast, the legislative history of §1114 expressly provides that "it is intended that the words 'necessary for the reorganization of the debtor' ... should be interpreted as the Third Circuit interpreted them in *In re Wheeling Pittsburgh Corporation* [791 F.2d 1074 (3d Cir. 1986)]. ... There the court held that a proposal to modify a labor contract is 'necessary to permit reorganization' when essential to the 'goal of preventing the debtor's liquidation.'" S. Rep. No. S6825 (Daily ed. May 26, 1988).

It is therefore reasonably certain under §1114 that only those modifications necessary to avoid a debtor's immediate liquidation are permissible.

Once a debtor has made a proposal to the authorized retiree representative, it still must obtain court approval of the modifications unless the authorized retiree representative consents. Section 1114's requirements for obtaining court approval mirrors those contained in §1113 — but not precisely.

Modifications to retiree benefits can be granted only if: (1) the debtor has made a proposal pursuant to §1114(f); (2) the authorized retiree representative has refused the proposal without good cause; and (3) the "modification is necessary to permit the reorganization of the

debtor and assures that all creditors, the debtor and all the affected parties are treated fairly and equitably, and is clearly favored by the balance of the equities." See 11 U.S.C. 1114(g) and 11 U.S.C. 1113(c).

To show that it acted with good cause, as required by §1114(g)(2), the authorized representative must articulate and discuss in detail with the debtor prior to the hearing on the debtor's application to terminate retiree benefits, the retirees representative's reasons for declining to accept a proposal. Courts have found that a representative rejected a debtors' proposal without good cause when the debtor provided evidence of the unfeasibility of continuing operations under collective bargaining agreements, but the representatives failed to provide evidence for their reasons for declining such proposals. See *In re Valley Steel Prod.*, 142 B.R. 337, 341-42 (Bankr. E.D. Mo. 1992).

As the court noted in *In re Maxwell Newspapers, Inc.*, 981 F.2d 85, 91 (2d Cir. 1992), the failure to respond to a debtor's proposal within a reasonable time period may constitute a refusal without good cause. The court further noted that the authorized representative may be shown to have refused to accept the debtor's proposal without good cause where the representative adheres to demands that the debtor cannot meet and fails to offer alternatives that focus on the needs of the debtor's reorganization.

The first two criteria of §1114(g) are identical to the corresponding paragraph of §1113. The third criteria, however, also requires debtors to be on the brink of financial meltdown as characterized in the Third U.S. Circuit Court of Appeals' decision in *In re Wheeling*. Generally, courts will find that the balance of the equities favors terminating retiree benefits when the debtor can show that the only alternative is liquidation.

As additional safety, §1114(g) also provides that "in no case shall the court enter an order providing for such modification which provides for a modification to a level lower than that proposed by the trustee in the proposal." Consequently, even if additional modifications to the debtors' retiree benefits are warranted to prevent the debtor's liqui-

dation, it will not be allowed. Such additional modifications are not precluded by §1113; however, §1114 expressly does not foreclose the filing of more than one modification proposal and motion.

Once modified or terminated, any claims to future retiree benefits are treated as unsecured claims. Section 1114 prohibits the offset of retiree benefits paid prior to the confirmation of the debtor's plan against unsecured claims arising from the modification. It is clear from the legislative history of §1114 that the unsecured claim is in addition to any court ordered or agreed upon modifications. See 1988 U.S. Code Cong. & Admin. News 683, 686. Retirees with incomes over \$250,000 are not covered by §1114, so presumably, their entire claim is unsecured.

Finally, §1114(h) authorizes bankruptcy courts to enter orders allowing for interim modifications in retiree benefits if they determine that doing so is essential to the continuation of the debtor's business, or to avoid irreparable damage to the debtor or its estate. See 11 U.S.C. 1114(h).

The Process Matters

Approximately one year after filing bankruptcy, Horsehead sent identical letters to each union explaining its need to reduce current wages and modify retiree benefits. These letters were followed up with proposals calling for wage concessions and the termination of retiree medical benefits. Horsehead and the USWA consensually resolved all issues except for the proposed elimination of retiree medical benefits. Two of the three USWA locals and PACE rejected the proposal, while the remaining USWA local and the SPFPA were still negotiating with Horsehead at the time of the hearing on Horsehead's §1114 motion.

Each of the three unions approached the §1114 process differently. The USWA took an active approach, choosing to negotiate vigorously with Horsehead. As discussed below, the USWA's active approach paid enormous dividends: the court denied Horsehead's motion to reject the USWA's retirees' benefits.

The three USWA locals submitted counterproposals to Horsehead's propos-

al to terminate retiree medical benefits. Horsehead then informed the USWA that it had decided not to treat the retiree benefits as collective bargaining issues and, instead, to seek relief under §1114, whereupon the parties stopped talking about retiree benefits. Horsehead's decision to stop negotiating with the USWA proved fatal to its efforts to terminate the retiree health benefits.

The USWA objected to Horsehead's motion to modify its CBAs and terminate retiree benefits. The court denied the motion to terminate the retiree benefits, holding that Horsehead had "failed to demonstrate that ... attempted to confer in good faith in attempting to reach a mutually satisfactory modifications."

In contrast to the USWA's aggressive approach to the negotiations, PACE refused to negotiate with Horsehead unless the proposed buyer of Horsehead's assets also participated in the negotiations. PACE also adhered to the letter, but not the spirit, of §1114 by refusing to submit counterproposals, "despite the fact that the union representatives knew there was room for negotiation."

Counterproposals are not required, however, as the outcome here demonstrates, retirees' mechanical participation in the §1114 process — a process designed to curb a debtor's power to take unilateral adverse action against retirees — can place retirees at risk of a finding by the bankruptcy court that its actions were not taken in good faith. That the court noted PACE's failure to make a counterproposal when Horsehead's proposal was clearly open to discussion gives color to §1114's requirement that the parties attempt to reach a consensual resolution of the matter prior to seeking court-ordered termination or modification of retiree benefits.

Moreover, PACE submitted Horsehead's initial proposal to its membership for a vote without endorsement or support. This further incensed the court, which viewed the move as unusual and was therefore not surprised that the proposal was overwhelmingly rejected.

Unsurprisingly, the court held that PACE's conduct, including its refusal to negotiate unless Horsehead's suitor also participated, led to a rejection of

Horsehead's proposal without good cause. Horsehead's motion to terminate retiree benefits was accordingly granted.

The SPFPA took the least active position vis-à-vis negotiating with Horsehead: it just didn't. Other than rejecting Horsehead's proposal, the

SPFPA did not participate in the bankruptcy proceedings. Thus, the court found that Horsehead complied with the procedural requirements of §1114 and granted the motion as to SPFPA.

One lesson to take away from *Horsehead* is that process matters when seeking or opposing relief under §1114.

Strict compliance with the processes, requirements and, as PACE and SPFPA learned in *Horsehead*, the spirit of §1114, are essential. Another lesson is that debtors and retirees must commit to actively engage in the §1114 process; it is not a statute that welcomes tepid actions by debtors or retirees. ■