RESTRUCTURING ALERT

KIRKLAND & ELLIS LLP

August 2006

Recent Developments in Pension Restructuring

This Restructuring Alert focuses on recent developments in restructuring and pension law that may interest clients and friends of the Kirkland & Ellis LLP Restructuring Group. The Alert focuses primarily on the recent overhaul of federal pension law, and also summarizes several recent Circuit-level opinions of note addressing pension restructuring. We invite you to contact us with any questions about the matters addressed in this Alert, or for copies of any materials discussed in this Alert.

PENSION PROTECTION ACT OF 2006

The Pension Protection Act of 2006 ("PPA"), signed into law on August 17, 2006, contains sweeping changes to pension plan funding and maintenance rules that will dramatically alter the pension restructuring landscape. This Alert highlights certain PPA provisions that are most relevant to distressed (or potentially distressed) pension plan sponsors who are considering restructuring their pension plans, but is not a comprehensive discussion of the PPA and should not be relied upon for that purpose.

Minimum Funding Requirements. The PPA changes the "minimum funding standards" (i.e., pension funding targets) for single-employer pension plans, which will eventually increase the employer's minimum funding requirements. The PPA increases plan funding targets from 90% to 100% over a transition period from the 2008 to 2011 plan years, provided that employers keep pace with the annual incremental funding increases. Certain employers who have entered into special agreements with the PBGC, however, may be excused from compliance with the new minimum funding requirements until 2014. Even with the three-year transition period, the increased minimum funding requirements likely will have a material impact on the liquidity position of distressed companies that sponsor single-employer pension plans.

PBGC Premiums and Benefit Guarantees. Under the PPA, a pension sponsor now must pay to the Pension Benefit Guaranty Corporation ("PBGC") a "termination premium" when the plan is terminated either by the PBGC or by the sponsor through a distress termination during a Chapter 11 reorganization. Generally, the termination premium is $1,250 per plan participant per year for three years (i.e., the year of the termination plus the following two years). The former plan sponsor must pay the premium upon its emergence from Chapter 11. Depending on the number of participants in a terminated plan, this termination premium could significantly affect a sponsor's ability to emerge from Chapter 11 with sufficient liquidity to reorganize successfully. The premium does not apply to plans terminated during Chapter 11 cases commenced before October 18, 2005.

The PPA also changes the relevant date for determining PBGC-guaranteed benefits under plans terminated during a Chapter 11 case. For Chapter 11 cases filed thirty or more days after the PPA's enactment, guaranteed benefits will be determined based upon the Chapter 11 petition date instead of the "plan termination" date. Given this new rule, the plan administrator must notify plan participants soon after the sponsor files for Chapter 11 and inform them of the limitations on guaranteed benefits if the plan is terminated during the case.

Additionally, the PPA also imposes new limits on PBGC guaranteed benefits for contingent benefits, such as plant shutdown benefits. These limits include the phase-in of PBGC guarantees over five years after the occurrence of the contingent event.

Executive Compensation Penalties. Immediately upon enactment of the PPA, senior executives may be subject to significant taxes and penalties during specified restricted periods if the employer funds non-qualified deferred compensation programs (for example, rabbi trusts) while the employer is in Chapter 11 or maintains or terminates an underfunded pension plan. These penalties include immediate taxation on deferred compensation that is set aside during the restricted periods, plus an additional 20% excise tax, plus potential additional taxes and penalties on similar compensation programs. During these restricted periods, there is an additional 20% penalty on any payments to "gross-up" employees for taxes and penalties, and the employer will not be allowed to take a tax deduction on such gross-up payments.

Airline Relief. The PPA includes special funding rules for commercial passenger airlines and airline catering companies that sponsor defined benefit plans. Generally, these companies may elect to amortize any pension funding shortfalls over a ten-year period beginning in 2008. Alternatively, these companies can elect to freeze future benefit accruals and increases, while also electing a seventeen-year amortization period with a specified interest rate for minimum funding contributions. However, if the plan sponsor later terminates the plan with the seventeen-year amortization period, the new termination premium increases from $1,250 to $2,500 per participant, and PBGC guaranteed benefits may be restricted.

Interest Rate. The PPA also changes the interest rate used to value pension liabilities, starting in 2008. The interest rate continues to be based upon corporate bond rates, but will be supplemented with a segmented yield curve to value pension liabilities more accurately based upon when plan benefits are payable to retirees.

At-Risk Plans. The PPA includes provisions to bring large underfunded "at-risk" plans up to specified funding targets by imposing more stringent minimum funding requirements. Plans with more than 500 participants are at-risk if their funded percentage for the prior plan year is less than 80% (excluding the at-risk funding rules) and 70% (including the at-risk rules). The 80% test is phased in at 65% beginning in 2008 and then increases five percentage points per year.

Benefit Limits. Beginning in 2008, the PPA imposes new benefit plan limits. Sponsors of plans that are less than 80% funded cannot increase benefits and are restricted from paying certain types of accelerated benefits (including lump sum benefits). If the plan is less than 60% funded, then, generally, benefit accruals must be frozen, and the plan sponsor cannot make accelerated benefit payments (including lump sum payments) or pay shutdown and other contingent benefits. Moreover, generally a plan sponsor in Chapter 11 cannot increase plan benefits or pay accelerated benefits (including lump sum distributions) if the plan is not fully funded.

Other Provisions. The PPA includes many other provisions governing multi-employer plans, defined contribution plans, and prohibited transaction exemptions. Sponsors should consult with their actuarial and legal advisors on the plan amendments required to comply with the changes implemented by the PPA.

SEVENTH CIRCUIT UPHOLDS PENSION-RELATED LABOR SETTLEMENT

The United States Court of Appeals for the Seventh Circuit recently affirmed an order approving a 2005 labor settlement agreement between United Air Lines, Inc. and the Air Line Pilots Association ("ALPA")—the union representing United's active pilots. A group of retired pilots objected to the ALPA's waiver, under certain circumstances, of the right to argue that United's distress termination of the pilots' defined benefit pension plan violated the collective bargaining agreement between United and ALPA. In its opinion affirming the Bankruptcy Court's order approving the settlement, the Seventh Circuit indicated that United had no obligation to include retired pilots in its negotiations with ALPA over a new collective bargaining agreement, notwithstanding the fact that those negotiations might impact upon the rights and benefits of the retired pilots. The Seventh Circuit ultimately held that given the termination of the pension plan and United's emergence from Chapter 11, there no longer was any feasible remedy that the Court could order even if it were to rule in the retired pilots' favor. The

Seventh Circuit's opinion is published at 443 F.3d 565 (7th Cir. 2006). The retired pilots have petitioned the United States Supreme Court for a writ of certiorari.

THIRD CIRCUIT ARTICULATES STANDARD FOR TERMINATION OF MULTIPLE PENSION PLANS

The United States Court of Appeals for the Third Circuit recently interpreted the standard applicable to a Chapter 11 debtor's distress termination of multiple pension plans under federal pension law. Generally, an employer in Chapter 11 may terminate a pension plan if the bankruptcy court finds that the "reorganization test" is satisfied, i.e., that the employer will be unable to successfully reorganize unless the pension plan is terminated. Kaiser Aluminum Corporation, a Chapter 11 debtor, sought the distress termination of several of its pension plans, some of which had large funding requirements, and some of which had relatively small funding requirements. The PBGC objected to the termination of all the pension plans, arguing that each plan must independently satisfy the "reorganization" test, and that several of Kaiser's smaller plans were affordable and therefore did not satisfy this test. The Third Circuit noted the difficulty in having to select one pension plan over another plan for termination, and ultimately held that bankruptcy courts may properly consider the collective impact of a Chapter 11 debtor's pension plans on the debtor's reorganization prospects, such that a court need not apply the reorganization test to each individual pension plan. The Third Circuit's opinion is published at WL 2061337 (3rd Cir. 2006).

Should you have any questions about the matters addressed in this Alert, or should you wish to add parties to our distribution list, please contact the following Kirkland & Ellis author or the Kirkland & Ellis attorney you normally contact

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