

May 27, 2009

WEATHERING THE STORM Retiree Benefits and Section 1114

Retiree benefits are often a central issue in bankruptcy cases. For many employers the high cost of retiree medical benefits has been a significant contributing factor to the Chapter 11 filing and a matter of ongoing concern if the debtor is to be able to successfully reorganize. Understandably, employees, retirees and unions are equally concerned about the status of retiree benefits. Their obvious interest is to attempt to prevent the erosion of benefits that had been expected to be available during retirement. The accommodation and resolution of questions concerning these conflicting interests, and what to do about retiree benefits are governed by § 1114 of the Bankruptcy Code. That Section dictates that a debtor is to continue to pay benefits while in Chapter 11, while prohibiting the debtor from unilaterally modifying or terminating retiree benefits except in accordance with the procedural and substantive requirements of § 1114.

Section 1114 requires that the debtor employer first attempt to negotiate or secure agreement regarding a modification of retiree benefits with a labor organization or a court appointed committee representing the retirees. The debtor must make a proposal providing for only those modifications “that are necessary to permit [its] reorganization” and assures that all affected parties are treated “fairly and equitably.” 11 U.S.C. § 1114(f). The debtor must then provide relevant information to, and bargain in good faith with, the appropriate representative of the retirees in an attempt “to reach mutually satisfactory modifications” to the benefits. *Id.* If the parties are unable to reach an agreement, then the debtor must seek authority from the bankruptcy court to modify the benefits. The court may enter an order permitting the proposed modifications only if it finds that 1) the retirees’ representative has “refused to accept [the debtor’s] proposal without good cause;” 2) the proposed modification “is necessary to permit the reorganization of the debtor;” 3) the proposal treats all affected parties “fairly and equitably;” 4) and permitting the proposed modification is “clearly favored by the balance of the equities.” 11 U.S.C. § 1114(g).

On its face the statute mandates that the requirements of § 1114 be satisfied before a debtor may either unilaterally modify or terminate retiree benefits. Despite this seeming clarity, several courts have determined that § 1114 is not applicable where the retiree benefit plan specifically allows the debtor to make unilateral changes or to modify or terminate the plan (a common feature of many plans.) This is a matter of significant, practical consequence. If § 1114 is not applicable, a debtor is allowed to modify or terminate retiree benefits if it is able to satisfy the less stringent “business judgment” standard of § 363 of the Code. While the majority of courts addressing the issue have held that § 1114 does not apply when the retiree benefits plan in question permits unilateral modification or termination, others have held that Congress enacted § 1114 for the express purpose of protecting retiree benefits against unilateral modification in such circumstances.

Bankruptcy Judge Robert Drain of the Bankruptcy Court for the Southern District of New York recently became the latest judge to wrestle with this significant issue. In a decision arising out of the Delphi Corporation bankruptcy, Judge Drain joined the majority and issued a ruling on March 10, 2009 that § 1114 was not applicable where the pre-petition plan documents governing the benefit granted the debtor the right to modify those benefits at-will. See *In re Delphi Corp.*, Case No. 05-44481 (Bankr. S.D.N.Y. March 10, 2009).

After Delphi filed a motion under § 363(b) seeking authority from the court to modify its salaried retirees’ benefits – a move that would impact 15,000 current and former employees – over 1500 of those impacted filed objections to the motion. Delphi argued that § 1114 did not apply because the benefit plans in question permitted it to unilaterally

modify the benefits and § 1114 was not intended to alter parties' pre-petition rights and agreements. The objectors countered that the plain language of Section 1114 evinced Congress' intent to override debtors' pre-petition rights to modify retiree benefits and that, in any event, the benefit plans did not give Delphi the right to unilaterally modify those benefits.

The Court ruled first that accepting the objectors' contention would mean that § 1114 "creates a federal law overriding pre-petition contractual rights of the debtors" to modify or terminate retiree benefits, even though no other Code provision creates such a right. Reading § 1114 to do so "would violate a fundamental tenet of the Bankruptcy Code in that it would enhance the substantive non-bankruptcy rights of one set of creditors at the inevitable expense of other creditors simply because a bankruptcy petition has been filed." The court concluded that § 1114 was not clear enough to overcome these fundamental bankruptcy principles, particularly since Congress was presumably aware of these principles when it enacted § 1114 but did not clearly state an intent to override them in either the statute itself or its legislative history.

The Court also ruled that the provisions of another section of the Code (§ 1114(1) which permits the court to reinstate benefits modified within 180 days of the filing of the bankruptcy) may not apply to benefit plans that could be unilaterally modified and did not imply that § 1114 was applicable to post-petition unilateral modification if permitted by the benefit plan. The Court also drew an inference from previous failed legislative attempts to specifically make § 1114 applicable to retiree benefit plans containing unilateral modification language, observing that such legislation would have been adopted had Congress intended § 1114 to cover such plans.

Even though Delphi was not subject to § 1114, the Court ruled that it was still required to "make a significant showing that it, in fact, has such a unilateral right and that the benefits [to be modified] are not vested" under the plans. Delphi satisfied the burden by showing that the express language of the plan documents and the summary plan descriptions granted it the right to unilaterally modify the benefits at will. Further, there was an absence of any evidence that Delphi had made promises to its current former employees to the contrary. Finally, the court concluded that Delphi had satisfied the § 363(b) good business judgment standard as it had established the apparent necessity of cutting the \$1.1 billion in projected liability for retiree benefits in order to allow a successful reorganization.

Although the question of whether § 1114 applies to the modification or termination of retiree benefits that would otherwise be modifiable at will remains an open one, Judge Drain's recent decision is significant for several reasons. First, it adds further support to the seemingly growing consensus that § 1114 does not apply in such circumstances. Second, it gives debtor-employers a well-reasoned treatment of the issue to follow in fighting off objections to their attempts to escape or lessen the crushing burden of retiree benefits costs, the success of which may be the difference between a successful reorganization or a failed effort. Finally, it may spur further attempts by Congress and President Obama's administration to amend the Bankruptcy Code to strengthen the protections for retiree benefits, particularly since this issue is one that will likely take center stage in future automotive and other cases.

For more information, please contact:

[Arthur Carter](#)

214.651.5683

arthur.carter@haynesboone.com

[Samuel Brett Glass](#)

214.651.5991

brett.glass@haynesboone.com

[Scott Night](#)

214.651.5523

scott.night@haynesboone.com

[Kenric Kattner](#)

713.547.2518

kenric.kattner@haynesboone.com

[Lenard Parkins](#)

212.659.4966

lenard.parkins@haynesboone.com

[Stephen Pezanosky](#)

817.347.6601

stephen.pezanosky@haynesboone.com

[Sarah Foster](#)

512.867.8412

sarah.foster@haynesboone.com

[Eric Terry](#)

210.978.7424

eric.terry@haynesboone.com

In order to comply with certain U.S. Treasury regulations, we are informing you that any U.S. federal tax advice that may be contained in this document is not intended or written to be used, and cannot be used, by any person for the purpose of (i) avoiding any tax penalties that may be imposed by the Internal Revenue Service or any other U.S. federal taxing authority or agency or (ii) promoting, marketing, or recommending to another party any transaction or matter addressed herein.