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The Impact of Underfunded OPEB Obligations on Business Valuation

BY JAMES C. MCCARROLL, PARTNER, REED SMITH LLP, AND JUDITH A. THORP, PARTNER, & CARL R. MOWERY, DIRECTOR, KPMG LLP

The impact of defined benefit (DB) pension plans and contractual retiree medical and welfare obligations — often referred to as other post-employment benefit (OPEB) obligations — on a business enterprise's value and creditworthiness has been an ongoing source of consternation for investors, lenders, and suppliers for many years. These difficulties have created substantial roadblocks to valuation efforts throughout the course of steel and airline industry bankruptcies in recent years. There is little sign of the problem abating as restructurings in the automotive sector and other old and heavy industry sectors loom. The following two articles examine these issues.

Retiree medical and welfare obligations — often referred to as other post-employment benefits (OPEB) — differ substantially from defined benefit (DB) pension plans. They are not insured by Pension Benefit Guaranty Corporation (PBGC) or any other entity, nor is pre-funding of future OPEB benefits mandated by any statute. OPEB is a contractual obligation between an employer and employee and generally is governed by terms of a contract signed by the employer and provided to the employee.

The Employee Retirement Income Security Act of 1974 (ERISA) plays a role in the enforcement of OPEB contracts, but only in limiting beneficiaries' legal rights to actions to compel specific performance. Suits for compensatory and punitive damages are prohibited.[1] Therefore, an employer's liability for failure to satisfy OPEB obligations is somewhat limited, at least unless or until the company files for bankruptcy.[2]

Upon an employer's bankruptcy filing, OPEB contracts become subject to U.S. Bankruptcy Code Section 1114, which requires that benefit obligations, including OPEB, continue unaffected through a bankruptcy case, unless specific procedures are followed to permit their modification or rejection.[3] This includes a requirement that OPEB obligations be paid currently during pendency of a bankruptcy case. If an OPEB contract is modified or rejected under Bankruptcy Code Section 1114, the resulting claim that arises is deemed a pre-bankruptcy general unsecured claim. However, to the extent an OPEB contract is not fully rejected pursuant to Section 1114, no plan of reorganization can be confirmed unless a satisfactory showing is made that the reorganized entity can make required funding payments on the OPEB contract going forward.[4]

There are compelling reasons for many old-industry companies to attempt to reduce OPEB liabilities. This was the case in the steel industry throughout the early years of this decade, but for those companies, the path was fairly well defined. As they were compelled to file for bankruptcy protection by other considerations, steel industry companies that were subject to OPEB contracts simply followed the map provided by Bankruptcy Code Section 1114, negotiating with union representatives of hourly employees and appointed representatives of salaried employees, and ultimately obtaining Bankruptcy Court approval for the needed modifications. Companies in other industries, including automotive, may not have the same extrinsic motivations to seek bankruptcy protection, but their need to reduce OPEB obligations is at least as strong.[5]

As life expectancy in the U.S. population has increased over the past 20 years and the industrial workforce has aged, the ratio of retired to active employees has grown concurrently. In the automotive industry, for example, the ratio of retired to active employees hovers around 2.53:1 for General Motors Corporation (GM), 2.3:1 for Ford Motor Company, and 0.98:1 for Daimler Chrysler.[6] These ratios encompass union-represented and non-union-represented beneficiaries. It is notable that union-represented retirees constitute 73 percent of the aggregate retiree population. The percentage of benefit costs attributable to union-represented retirees is a critical factor to consider when analyzing a company's prospects for reducing OPEB expenses outside of bankruptcy. Such legacy costs total about $1,500 per automobile sold.[7]

Because no statutory or regulatory funding requirements apply to OPEB contracts outside of bankruptcy, modifying them to limit a sponsoring employer's liability *should* be easy. But the problem — and the hidden liability — is not in the contracts with current employees today. It lies in contracts entered into under collective bargaining agreements that have since expired, but under

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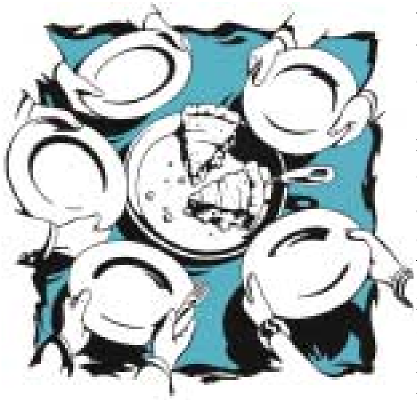

As demonstrated by the recent public struggles of GM and the United Auto Workers (UAW), as well as other parties, apart from the legal issues that overlay this debate, there is an inevitable dilemma over balancing the long-term needs of the enterprise against the shorter-term needs of many of its most vulnerable constituents.

which a substantial volume of employees retired. Similarly, individual contracts entered into with salaried employees over the last five or 10 years generally do not present substantial legal obstacles to reduction of OPEB obligations. However, individual promises made to employees who retired in the last 20, 30, or 40 years may create a morass of obligations that a company cannot escape.

In addition to the legal obstacles that companies encounter in seeking to reduce their OPEB obligations, they also face a terribly difficult balancing equation. In many instances, survival of a company — and therefore the future economic stability of all employees and retirees — depends on its ability to effectuate cost savings by reducing OPEB obligations. But these obligations are not insured by a federal agency, as are basic benefits payable under DB plans. As demonstrated by the recent public struggles of GM and the United Auto Workers (UAW), as well as other parties, apart from the legal issues that overlay this debate, there is an inevitable dilemma over balancing the long-term needs of the enterprise against the shorter-term needs of many of its most vulnerable constituents. And there inevitably will be strong resistance by constituents whose arguments will be punctuated with sympathetic stories of the consequences of medical benefits lost by vulnerable senior citizens.

Analyzing the legal issues pertaining to DB plans and OPEB obligations is, of course, critical. However, particularly with respect to OPEB, it is important to bear in mind the extrinsic human factors that may affect a union's willingness to negotiate modifications and may influence a company's decision whether to exercise its available legal options.

Modifying OPEB Obligations Outside of Bankruptcy

Unlike its obligations with DB plans, a company does not have to satisfy any statutory criteria to modify or terminate OPEB contracts. However, this does not give the company carte blanche to impose changes to these contracts unilaterally in all circumstances. To most easily understand the constraints placed on companies considering modifications to OPEB contracts outside of bankruptcy, the beneficiaries of the contracts should be considered in four separate categories:

- Current non-union employees (typically salaried workers)
- Non-union retirees
- Current union employees (typically hourly workers)
- Union retirees

Current Non-Union Employees. In terms of legal impediments, current non-union employees belong to the easiest group on which to impose OPEB reductions. Promises made in summary plan descriptions (SPDs)[8] provided to current non-union employees almost universally include qualifying language to the effect that the benefits promised may be modified or terminated at any time, with or without reason, at the employer's sole discretion.

By definition, current employees have not begun to receive OPEB payments. Many current non-union employees no doubt are looking forward to the future security that the company's OPEB contract will provide, but modifying or terminating the OPEB contract will have no immediate effect on them. While modifying or terminating all OPEB contracts with current non-union employees may create a certain amount of angst and displeasure within the current non-union ranks — and in some instances, even resignations — assuming that the contracts are drafted with the now standard qualifying language, there is no legal impediment to reducing or nullifying a company's OPEB liability to these employees. However, in many companies, this only resolves a very small piece of the problem of crushing OPEB costs.[9]

Non-Union Retirees. Non-union retirees are in a position similar to current non-union employees in that the flexible language in modern SPDs allows employers to modify or terminate OPEB benefits at will. However, there may be notable – and in many cases, unpredictable – exceptions to this rule.

Over the past 20 years, as healthcare costs have risen and employers have begun to consider the possibility of reducing or terminating OPEB benefits, SPDs have been modified progressively to turn what in many cases used to be an unconditional promise of lifetime medical benefits into a noncommittal suggestion that a company will provide retirees with healthcare benefits in such amounts and for such durations as it sees fit.[10]

However, this change did not occur overnight, and the last SPD that was given to each individual employee before he retired is the document that fixes a company's responsibility to that person. Therefore, if a retired non-union employee's SPD effectively says, "We guarantee you healthcare benefits at X level until you die," then that is what the company is obligated to provide to that employee under the contractual terms of the SPD. That obligation can be modified or rejected through a bankruptcy case. However, unless a company files for bankruptcy protection and satisfies the requirements of Bankruptcy Code Section 1114, it cannot escape this liability if it has not specifically included language that allows it to change, remove, or reduce benefits.

Nor is the SPD always the end point of a company's obligations. For example, even with an SPD that says "in such amount and for such duration

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as we see fit," an employee's manager or the then-president of the company may have written a sentimental letter to him upon his retirement, thanking him for his years of service and assuring him that the company will, of course, take care of him in his golden years, including by providing lifetime medical care. This sort of informal promise can undo a company's careful efforts to leave itself with flexibility. In fact, it is possible that even a verbal promise that conflicts with the terms of a carefully crafted SPD can leave a company liable for providing lifetime benefits.[10]

When companies attempt to reduce or terminate non-union retirees' OPEB *en masse*, there is no basis for most of these retirees whose SPDs contained the modern SPD language at the time of their retirement to challenge those efforts. However, as noted earlier, for many companies there will be exceptions. After all, the trend toward modern SPD language only began in roughly the last 20 years. A non-union employee who retired in 1980 at age 51, after 30 years of service, would be only 76 years old today. Furthermore, a non-union employee who retired in 1990, in the earlier days of the modern SPD language, might well produce a letter from the company's then-president or another executive countermanding the flexibility reserved in the modern SPD language.

While companies should face no legal impediments to modifying OPEB benefits of recent non-union retirees, the further back an employee's retirement date is, the greater the risk that the company will face an unpleasant surprise in its efforts to modify these parties' OPEB *en masse.* Therefore, the cost and uncertainty attendant to any efforts to modify non-union retirees' OPEB may somewhat reduce the benefits a company could realize through this undertaking.

For companies that do not have a unionized workforce, this is the end of the analysis. For companies with union workers, it is merely the end of the *easy* part of the analysis.

Current Union Employees. Assuming that a union and company agree on modifications to OPEB benefits promised to current union employees, this group is easily manageable. But of course, negotiations regarding retirement benefits have provided some of the more acrimonious clashes between unions and management in recent years.[12]

In a company with a unionized workforce, a collective bargaining agreement (CBA) governs the relationship between members of the union and the company.[13] Except in unusual circumstances, a CBA cannot be modified unilaterally by a union or employer, and it must apply uniformly to all employee members. A union is the sole bargaining representative of its employee members and, subject to approval by a requisite majority of the members, it can agree to increase, decrease, or terminate any benefit previously agreed to with the company.[14] While unions are typically very reticent to compromise these important benefits, they likely will weigh the value of the benefits to their members and retirees against the prospects for the business to continue operating—and therefore employing its members—if modifications are not made going forward.

> The *Yard-Man* case and its progeny make clear that no matter which CBA is in effect at the time a union employee retires, that agreement will forever define the relationship between the company and the union retiree.

Interestingly, Congress and the president recently took an unprecedented step to interpose the Bankruptcy Code into this private, but government-regulated, relationship. The Bankruptcy Abuse Prevention & Consumer Protection Act of 2005, which was signed into law on April 20, amends Bankruptcy Code Section 1114 to make the standards applied to review of OPEB modifications and terminations proposed during a bankruptcy case apply retroactively to any OPEB modification made within 180 days before a company files for bankruptcy protection. Effectively, this means a company and union agreeing to an OPEB modification must consider (a) the possibility of the company seeking bankruptcy protection within the next 180 days, and (b) if that is a realistic possibility, whether the modification will pass muster as necessary, fair, and equitable under Section 1114.[15]

Notwithstanding this new concern for companies considering OPEB modifications, modification or termination of current union employees' OPEB, if agreed to by the company and the union, remains relatively uncomplicated. This is particularly true when considered in relation to efforts to modify OPEB obligations owed to retired union employees outside of a bankruptcy case.

Union Retirees. For many major companies, union retirees make up the largest number of benefit plan participants. As discussed earlier, in certain instances the ratio of union retirees to all other classes is staggering. While companies generally can modify OPEB benefits payable to each of the other classes of recipients with more or less ease and reliability, this largest category of benefit recipients presents a much greater challenge, in many instances making meaningful across-the-board modifications to OPEB obligations outside a bankruptcy case impossible.

As noted earlier, the document that generally governs a company's relationship with and obligations to a retired employee is the one that was in effect on the day the employee retired. With regard to non-union retirees, those documents over the past 20 or more years generally have been drafted with some circumspection. Companies realized that they would be bound forever by the language contained in such a document and therefore drafted it to grant the company the flexibility necessary to make changes down the road.

Many companies, however, have not been able to accomplish the same levels of flexibility in negotiating the terms of their collective bargaining agreements. Unions frequently can exert more leverage on a company than can individual non-union employees.

It may seem reasonable that benefit promises made in a CBA would be more stringently binding on a company, because such an agreement governs the relationship between an employer and union-member employees only for a fixed period of time — typically on the order of five years. At the end of that period, the terms of employment and the promises made are all up for renegotiation. These factors, combined with the additional leverage that may be exerted by a union, have resulted in more broad-ranging promises in CBAs than those found in many non-union employee SPDs in recent years. For example, in promising OPEB payments upon retirement:

- GM promised in 1999: "[T]he Corporation shall make contributions…for health care coverages…for: (1) a retired employee…." (*See* GM 1999 CBA, Exh. C, p. 32)
- Delphi Corporation, a major supplier to GM and other automobile manufacturers, that same year merely adopted the benefits language from the 1999 GM CBA (*See* Delphi 1999 CBA, p. 645)
- Ford promised in 2003: "The Company will make monthly contributions [for medical benefits] for the following month's coverage

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on behalf of [eligible] retired employees…." (Ford's 2003 CBA, p. 317)

Each of these promises is subject to revision or revocation during the next round of collective bargaining negotiations, and the companies and unions will be free to do as they please with respect to employees who will be subject to that new CBA. But what about those who retire while the 2003 CBA or an earlier legacy CBA is in effect?

The question of whether retirement promises made in a legacy CBA — and then changed or revoked through negotiation of a new agreement later — are forever binding on an employer for employees who retired during the term of the legacy CBA is a difficult one. A CBA, by definition, governs the employer/ employee relationship for a fixed period of time. It is not uncommon for many terms of employment and benefit promises to change from one CBA to the next. It would be nonsensical for a company to have to continue paying an employee the same wages payable under a 1997 CBA once downward revisions were negotiated in connection with a 2002 CBA merely because that employee was working for the company during the period of the 1997 agreement. The employee's union, as his sole bargaining representative, is authorized to speak on his behalf, and the employee, subject to his and all others' vote on any issue, is bound by the agreements made by his union.

After these agreements, several questions remain: What about employees who retired in 2001 and presently are receiving OPEB benefits? Can the union act on their behalf to modify OPEB benefits to which they are entitled?

These questions have not been resolved fully. The concept of benefits vesting under ERISA, while arguably not directly relevant to contractual OPEB obligations, may provide some statutory basis for the argument advanced in favor of union retirees' continuing entitlement to OPEB benefits promised under a CBA that has expired and been replaced by a new CBA that does not promise these same benefits. However, the primary argument for the continuation of benefit obligations after the term of the CBA under which the union employee retired is a simple contractual one.

The 6th U.S. Circuit Court of Appeals addressed this issue head-on in a 1983 case, *Int'l Union, United Automobile, Aerospace, and Agricultural Implement Workers of America (UAW), and Local 134, UAW v. Yard-Man, Inc.*, (716 F.2d 1476 (6th Cir. 1983)). In *Yard-Man*, the 6th Circuit found that OPEB benefits of employees who retired during the life of a CBA could not be terminated by the employer upon expiration of the agreement, notwithstanding the fact that the company was lawfully terminating the OPEB benefit entitlements of all active employees. While finding that material issues of fact needed to be resolved on remand to the U.S. District Court for the Eastern District of Michigan, the appellate court held that, absent an express statement to the contrary, there is an inference that a promise of retiree benefits is intended to survive expiration of the CBA under which the promise was made. *Id*. at 1482. The 6th Circuit reached this conclusion while noting that the express terms of a CBA must be examined to determine the intent of the parties.

Courts of Appeals for the 2nd, 3rd, 5th, 7th, and 8th Circuits have cited *Yard-Man*, in each instance echoing the need for close examination of the CBA under which a union member retired.[16] In *Linville v. Teamsters Mic. and Industrial Workers Union Local 284*, the 6th Circuit cited *Yard-Man* in 2000 with approval, affirming the inference of lifetime OPEB benefits for union retirees, absent an express agreement as to the company's ability to terminate or modify its OPEB obligations, or a provision for the automatic termination of benefits upon a certain event occurring. 206 F.3d 648, 650-51 (6th Cir. 2000). The 6th Circuit confirmed that the *Linville* CBA clearly called for OPEB benefits to terminate upon a retiree reaching age 65, and therefore, under the express terms of the contract, the claim for lifetime benefits by retirees over 65 failed. *Id*.[17]

The *Yard-Man* case and its progeny make clear that no matter which CBA is in effect at the time a union employee retires, that agreement will forever define the relationship between the company and the union retiree. This means that GM and Ford, two of America's largest automobile manufacturers, and one of their largest suppliers, Delphi, likely will have little or no ability to modify their OPEB liabilities with respect to union members who have retired to this point. In essence, absent a bankruptcy filing, this limits these companies' ability to modify or terminate their OPEB liabilities to, on average, roughly three-quarters of the parties to whom they have promised benefits. No doubt, many other companies face the same issues.

Modifying OPEB Obligations in Bankruptcy

With the prospects for meaningful modification of OPEB obligations outside a bankruptcy case limited by several factors, some companies may consider seeking bankruptcy protection to avail themselves of the benefits of Bankruptcy Code Section 1114 and, if necessary, Section 1113. The daunting challenges of a bankruptcy filing, however, no doubt will make this a difficult decision for many.

Companies that have no union employees and seek bankruptcy protection can avail themselves of the benefits of Bankruptcy Code Section 1114, which permits a company to modify or terminate all OPEB benefit obligations, whether owed to active employees or retirees, if it can establish that such action is necessary, fair, and equitable. Importantly, as noted previously, representatives of both active and retired employees will be appointed in a Section 1114 proceeding, allowing for modification or rejection of all OPEB obligations, regardless of the promises made in individual SPDs. In this way, bankruptcy protection may provide a workable solution to companies that otherwise could not modify or terminate substantial portions of their OPEB obligations.

The same comparatively low standards will apply to companies with union employees to the extent the bargaining unit agrees to the proposed modifications. Similar to the court-appointed group of non-union retirees, a court-appointed group of union retirees will satisfy the standards of Section 1114 for modification or termination of all OPEB obligations, notwithstanding the presence of a union, if the bargaining unit agrees with the proposal on behalf of all current union employees.

Bankruptcy Code Section 1114 is unavailable to companies with CBAs that provide for OPEB benefits, unless the union consents to a proposed modification on behalf of all current union employees. If the union opposes a proposed modification, the company will be required to satisfy the somewhat more stringent standards for modification or termination of a CBA under Bankruptcy Code Section 1113.[18] That section clearly presents substantial hurdles for a company seeking to modify or terminate OPEB benefits over the objection of its labor union. Thus, even seeking bankruptcy protection may be of little help to a company with substantial OPEB obligations and an uncooperative labor union. CR

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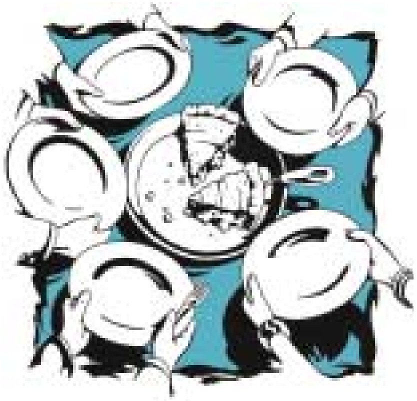

[1] See 29 U.S.C. Section 1132.

[2] Recent amendments effectively have stretched the requirements of Bankruptcy Code Section 1114(I) to apply retroactively for 180 days prior to a bankruptcy filing. Notably, unlike most provisions of the recent Bankruptcy Code amendments, this change went into effect immediately upon the amendments being signed into law by President Bush on April 20.

[3] In sum, Bankruptcy Code Section 1114 requires a company seeking to modify its OPEB obligations during a bankruptcy case to demonstrate that it has made substantial efforts to negotiate the terms of the modification, that an authorized representative of retirees has refused to accept the proposal without good cause, that the requested modifications are necessary to permit the reorganization of the company, and that the proposed modifications provide for the fair and equitable treatment of all retirees.

[4] See Bankruptcy Code Section 1129(a)(13).

[5] For example, GM's U.S. DB plans are reported as fully funded, but its OPEB obligations are substantially underfunded, requiring contributions of about $5.2 billion for 2004.

[6] See *Reporting on the Economic Crisis and Technology Changes of the Auto Industry,* Sean McAlinden, January 8, 2004, available at: www.facsnet.org/tools/biz_econ/detroit_auto.php. Also, OPEB costs per car produced are staggering. In 1999, GM had healthcare-related legacy costs per vehicle of $527; Ford's legacy costs were $304. In 2003, those costs had risen to $928 and $619, respectively.

[7] Will Smarts, "Is the Worst Over for Detroit?" *Smart Money,* July 18, 2005, available at: www.smartmoney.com/stockwatch/index.cfm?story=20050718.

[8] The plan document and SPD are collectively referred to in this article as the SPD. There is a difference between the documents, and employee benefits attorneys certainly will take the position that collapsing them as such is an improper oversimplification. This convention is used here only for convenience of reference.

[9] See, *e.g.*, General Motors, Ford & DaimlerChrysler, above.

[10] See *Sprague, et al., v. General Motors Corp.*, 133 F.3d 388 (6th Cir. 1998) (GM was sued on, among others, the theory that OPEB benefits vested upon retirement. The court held that there is no provision for vesting of non-pension benefits under 29 U.S.C. Section 1001 and that GM had included sufficiently clear modern SPD language in *most* of the SPDs at issue to permit it to modify OPEB obligations in its discretion).

[11] See, *e.g., In re: Unisys Corp. Retiree Medical Benefit "ERISA" Litigation*, 242 F.3d 497, 503-504 (3d Cir. 2001) (holding that a company may be liable for lifetime medical benefits if verbal representations were made to employees that contradicted terms in an SPD).

[12] It is worth noting that OPEB is not a mandatory subject of collective bargaining and therefore cannot by itself be grounds for a labor interruption. However, if a union negotiator follows the normal pattern of leaving at least one mandatory subject of collective bargaining open and unresolved until all non-mandatory subjects have been resolved, there is always an unresolved issue available on which a strike can be based.

[13] See 29 U.S.C. Section 159.

[14] *Id.*

[15] See n. 28, *supra.*

[16] See, *e.g., Int'l Multifoods Corp. v. Commercial Union Ins. Co.,* 309 F.3d 76 (2d Cir. 2002); *Int'l Union, United Auto., Aero. & Agric. Implement Workers of America v. Skinner Engine Co.,* 188 F.3d 130 (3d Cir. 1999); *United Paperworkers Int'l Union v. Champion Int'l Corp.,* 908 F.2d 1252 (5th Cir., 1990); *Vallone v. CNA Financial Corp., et al.,* 375 F.3d 623 (7th Cir. 2004); *Anderson v. Alpha Portland Indus., Inc.,* 836 F.2d 1512 (8th Cir., 1988).

[17] But see *In re: Unisys Corp. Retiree Medical Benefit "ERISA" Litigation* (242 F.3d 497 (3d Cir. 2001)), for potential complications arising out of follow-on verbal promises made to employees. (n. 36, *supra*).

[18] While the requirements for modification or rejection of a CBA under Bankruptcy Code Section 1113 on their face appear similar to those applicable to modification of OPEB obligations under Section 1114, the reality of such a proceeding often proves substantially more complex.

The views and opinions are those of the authors and do not necessarily represent the views and opinions of Reed Smith LLP and KPMG LLP. The information contained herein is general in nature and based on authorities that are subject to change. Applicability to specific situations is to be determined through consultation with your legal or tax advisors.

James C. McCarroll (top) is a partner with Reed Smith LLP's Commercial Restructuring and Bankruptcy Practice. He joined Reed Smith in 2005 after being employed as an associate with Kramer Levin Naftalis & Frankel LLP from 2000 to 2005. After graduating from law school in 1998, McCarroll began his legal career as an Honors Attorney with PBGC. He is based in New York, and can be reached at (212) 549-0209 or jmccarroll@reedsmith.com.

Judith A. Thorp (center) is the national partner in charge of the compensation and benefits practice, and Carl R. Mowery (bottom) is a director in the compensation and benefits practice at KPMG LLP. Both are based in Chicago. Thorp can be reached at (312) 665-5632 or jthorp@kpmg.com, and Mowery can be reached at (312) 665-2336 or cmowery@kpmg.com.