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Third-party Liability in Pension Plan Terminations Under the Bankruptcy Code

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Recent corporate bankruptcies have highlighted the impact of a company's financial insolvency (or near-insolvency) on fiduciary liabilities resulting from termination of its pension plans. In addition, the president's proposed overhaul of the pension system will likely tighten disclosure regulations for companies with poor credit ratings.[1]

While business managers and legal practitioners should be aware of the opportunity the Bankruptcy Code provides to reduce a company's financial liabilities through termination of its pension plans, they must also consider the potential liabilities for such terminations. Such liability may accrue to members of a bankrupt company's "control group" and to its affiliate corporations, directors and officers who act as fiduciaries.

Standard for Distress Terminations

A plan sponsor that intends to terminate a defined benefit plan covered by Title IV of ERISA may seek a "distress termination." One circumstance of distress involves a bankruptcy reorganization.[2] The following four criteria must be met to warrant a "distress termination:" (1) the company must have filed a chapter 11 petition, (2) the bankruptcy case must not have been dismissed, (3) the company timely seeks approval of the termination from the bankruptcy court and (4) the bankruptcy court determines that unless the pension plan is terminated, the debtor will be unable to pay its debts pursuant to a reorganization plan and will be unable to continue in business outside of the chapter 11 process.[3] A bankruptcy court's function in approving a termination is narrow in scope, limited to making a factual determination that unless the pension plan is terminated, the debtor will be unable to pay its debts pursuant to a reorganization plan and will be able to continue in business outside of the chapter 11 process.[4]

Control Group Liability

Generally, when a plan sponsor terminates a pension plan in a distress termination, the Pension Benefit Guaranty Corp. (PBGC) has two claims against the sponsor and the sponsor's control group: a claim for the difference between the value of the plan assets at the time of termination and the amount of the plan's obligation to its participants, and a claim for unpaid minimum funding contributions required by ERISA.[5]

PBGC may collect on its claims not only from a plan sponsor but also from members of its "control group." Under ERISA's definitions, a parent-subsidiary control group exists when a parent directly or indirectly owns at least an 80 percent equity interest in its subsidiary. A brother/sister control group exists where the same five or fewer individuals own at least 8 percent of two or more businesses.[6] The sponsor and each member of its control group are jointly and severally liable on the claims.[7]

If PBGC does not receive full satisfaction of its deficiency claims against the debtor, it will pursue non-debtor members of the plan sponsor's control group that do not have the protections of the automatic stay afforded by the Code to debtors.[8] Thus, as a practical matter, a distress termination may occur only if all members of a control group are in bankruptcy.

In the spinoff context, control groups include present as well as former companies that may be liable for benefits accrued but not paid during its affiliation with the control group. While individual shareholders are generally not liable under the control group rules, a control group includes any trade or business whether or not incorporated. Thus, any unincorporated trade or business an individual operates (such as a sole proprietorship or a partnership) could be liable for deficiencies upon plan termination.[9] Accordingly, directors of a company evaluating whether to terminate an ERISA-qualified plan should take into account potential liabilities to members of such company's control group.

Parent Corporation's Fiduciary Liability for Actions with Respect to Subsidiary's Pension Plans

In addition to control-group liability, a parent or an affiliate corporation may also be sued for breaches of its fiduciary duties. ERISA requires every employee benefit plan to be established and maintained pursuant to a written instrument that provides for one or more "named fiduciary[ies]" who have authority to control and manage the operation and administration of the plan.[10] These named fiduciaries may face liability when a plan is terminated. In addition, under ERISA, persons or entities that are not named as fiduciaries in plan documents but exercise discretionary authority and control over the plan or its assets may be held to be *de facto* fiduciaries. Courts construe fiduciary status under ERISA liberally to promote ERISA's policies and objectives and define it in functional terms of control and authority over the plan, thus expanding the universe of persons subject to fiduciary duties—and to damages—under §409(a).[11] "Fiduciary obligations can apply to managing, advising and administering an ERISA plan."[12]

1 Walsh, Mary W., "Overhaul Plan for Pensions is Outlined," *New York Times,* Jan. 11, 2005, at C1.
2 29 U.S.C. §1341(c)(2)(B)(ii).
3 *Id.*
4 *See, e.g., In re US Airways Group Inc.,* 296 B.R. 734 (Bankr. E.D. Va. 2003); *In re Wire Rope Corp. of Am. Inc.,* 287 B.R. 771 (Bankr. W.D. Mo. 2002); *In re Sewell Manufacturing Co. Inc.,* 195 B.R. 180, 185 (N.D. Ga. 1996).
5 29 U.S.C. §§1362(b) and (c).
6 Treas. Reg. §1.414(c)-2(c).
7 *Teamsters Joint Council No. 83 v. Centra Inc.,* 947 F.2d 115, 121-22 (4th Cir. 1991).
8 *Id.* (holding that solvent members of a control group must bear the responsibility for a bankrupt employer's pension plan liability).
9 *See, e.g., Central States, Southeast and Southwest Pension Fund v. Personnel Inc.,* 974 F.2d 789 (7th Cir. 1992) (imposing withdrawal liability on sole shareholder's real estate investments since they constitute a trade or business).
10 29 U.S.C. §1102(a)(2).
11 *Musmeci v. Schwegmann Giant Supermarkets,* 332 F.3d 339, 351 (5th Cir. 2003); *Arizona State Carpenters Pension Trust Fund v. Citibank (Arizona),* 125 F.3d 715, 720 (9th Cir.1997), *citing John Hancock Mut. Life Ins. v. Harris Trust and Sav. Bank,* 510 U.S. 86, 96, 114 S.Ct. 517, 126 L.Ed.2d 524 (1993).
12 *Pegram v. Herdrich,* 530 U.S. 211, 223, 120 S.Ct. 2143, 147 L.Ed.2d 164 (2000).

Varity Corp. is the leading case imposing such *de facto* fiduciary liability on a parent corporation. Former employees of Varity's subsidiary, Massey-Ferguson Inc., sued Varity, alleging that "Varity had affirmatively represented to them that their benefits would remain secure if they transferred to a new subsidiary, Massey Combines."[13] Varity held a special meeting with the employees promising that the benefits would remain secure, even though it knew the result would be quite different. The Supreme Court concluded that when Varity convened the meeting to represent that the transfer would not threaten benefits, it was acting in its fiduciary capacity as a plan administrator with respect to its subsidiary's plan.[14] The Supreme Court opined that "Varity was exercising 'discretionary authority' respecting the plan's 'management' or 'administration' when it made these misrepresentations" and that "[c]onveying information about the likely future of plan benefits, thereby permitting beneficiaries to make an informed choice about continued participation, would seem to be an exercise of a power 'appropriate' to carrying out an important plan purpose."[15] The Court emphasized the ERISA fiduciary's duty of loyalty and concluded that Varity had breached that duty in "participating knowingly and significantly in deceiving a plan's beneficiaries in order to save the employer money at the beneficiaries' expense" and lying to the employee participants.[16] Thus, parent companies contemplating termination of their subsidiaries' pension plans due to financial distress must consider whether their past or present conduct with respect to the plans could result in fiduciary liability.

Fiduciary Liability of Directors and Officers

The recent wave of bankruptcies has also fueled lawsuits against corporate directors or officers with respect to termination of a company's pension plans. Recent lawsuits have sought to impose a liability on directors and officers for failure to monitor individuals having control of plan assets or for other conduct that directly or indirectly harms plan participants. Among the types of conduct that may give rise to a breach of fiduciary duty claim, particularly in insolvency situations, are statements that misrepresent present financial conditions of a company. To state a claim, plaintiffs must show that such misrepresentations are material and could induce reliance by a reasonable person.[17]

In addition, concern for uninformed and vulnerable plan participants has increasingly led some courts to conclude that circumstances known to the plan fiduciary can give rise to an expanded affirmative duty to disclose information necessary to protect a participant or beneficiary because that participant or beneficiary "may have no reason to suspect that it should make inquiry into what may appear to be a routine matter."[18] In a similar vein, the First, Fourth and Sixth Circuit Courts of Appeal have held that after an ERISA participant or beneficiary requests information from his plan's fiduciary, who is informed of that participant/ beneficiary's circumstances, the fiduciary has a duty to provide full and accurate information material to the participant/ beneficiary's situation, including information about which the participant/ beneficiary did not specifically ask.[19] The Third Circuit has concluded that there is an additional affirmative duty, beyond a full and accurate response triggered by a participant/ beneficiary's specific question, to disclose material information to plan participants and beneficiaries.[20]

Taking an additional step, in two recent mega bankruptcies, *Dynegy* and *WorldCom,* the courts have held that the prohibition against making false statements extends to disseminating financial information that a fiduciary knows or has reason to know is false.[21] In *Dynegy,* the district court refused to dismiss the complaint against ERISA fiduciaries based on allegations that they described the company's financial statements as reliable sources of information regarding investment in the company stock with the knowledge that the financial information contained material misrepresentations.[22] Similarly, in *WorldCom,* the district court held that ERISA fiduciaries cannot, in violation of their fiduciary obligations, disseminate false information to plan participants, including false information contained in SEC filings.[23]

Enron represents another recent example of a case where ERISA fiduciaries have faced personal liability. In *Enron,* plan participants sued the company itself, the stock ownership plan committee as well as individual directors and officers for fiduciary duty breaches.[24] Relying on recently developed case law laying out the expansive duties of plan fiduciaries, the court refused to dismiss the complaint.[25] Among its other rulings, the court concluded that plan fiduciaries had stated claims for inducement of plan participants to direct the plan trustee to invest plan assets in Enron stock, failure to provide material information to plan participants regarding Enron's financial condition and intentional concealment of Enron's financial condition.[26]

Accordingly, directors and officers of financially troubled companies who may be actual or *de facto* fiduciaries must bear in mind their fiduciary responsibilities in disclosing information to or withholding information from participants of ERISA-covered plans.

Injunctions to Prevent Actions Against Non-debtor Subsidiaries

The Code provides certain protections to ERISA fiduciaries who may be sued for fiduciary duty breaches while the company is in chapter 11. For instance, recently an Illinois bankruptcy judge granted the request of United Air Lines (UAL), which has been in bankruptcy since December 2002, and issued an injunction preventing a labor union from proceeding with a breach-of-fiduciary-duty suit against three company officers. The plaintiffs sued when UAL announced that it would no longer make contributions to its employee pension plans while in chapter 11. The lawsuits alleged that the company's CEO, CFO and executive vice president breached their fiduciary duties to the company by entering into negotiations to obtain financing for the company on the condition that the pension obligation would not be paid. In response, United sought an injunction against prosecution of the suit. UAL maintained that continued prosecution of the suit would circumvent protections of the Code, since any judgment against the officers would be a judgment against the corporation, impairing its assets and ability to reorganize. Judge **Eugene Wedoff** issued the injunction on Aug. 23, 2004.[27] During reorganization, such injunctions may be

13 *Varity Corp. v. Howe,* 516 U.S. at 489, 493-94, 116 S.Ct. 1065, 134 L.Ed.2d 130.
14 *Id.* at 498.
15 *Id.* at 502.
16 *Id.* at 415-16; *see, also, Musmeci v. Schwegmann Giant Supermarket Inc.,* 332 F.3d 339 (majority stockholder could be held liable as a fiduciary based on management of a subsidiary); *Bannistor v. Ullman,* 287 F.3d 394 (5th Cir. 2002) (upholding imposition of fiduciary liability on a majority stockholder).

17 *Ballone v. Eastman Kodak Co.,* 109 F.3d 117, 122-23 (2nd Cir. 1997).
18 *Glaziers and Glassworkers Union Local No. 252 Annuity Fund v. Newbridge Securities Inc.,* 93 F.3d 1171, 1181 (3rd Cir.1996); *see, also, Griggs v. E.I. DuPont de Nemours & Co.,* 237 F.3d 371, 380 (4th Cir. 2001) ("ERISA administrators have a fiduciary obligation 'not to misinform employees through material misrepresentations and incomplete, inconsistent or contradictory disclosures....' Moreover, a fiduciary is at times obligated to affirmatively provide information to the beneficiary...[including] 'facts affecting the interest of the beneficiary which he knows the beneficiary does not know and which the beneficiary needs to know for his protection....'").
19 *See, e.g., Watson v. Deaconess Waltham Hosp.,* 298 F.3d 102, 114 (1st Cir. 2002); *Griggs v. E.I. Dupont de Nemours & Co.,* 237 F.3d 371, 380-81 (4th Cir. 2001); *Krohn v. Huron Memorial Hosp.,* 173 F.3d 542, 547-48 (6th Cir. 1999) ("[A] plan administrator has 'an affirmative duty to inform when [it] knows that silence might be harmful...' including a duty to disclose full information about short-and long-term disability benefits when asked about disability benefits generally").
20 *Adams v. Freedom Forge Corp.,* 204 F.3d 475, 480 (3d Cir. 2000). "This 'duty to inform is a constant thread in the relationship between beneficiary and trustee; it entails not only a negative duty not to misinform, but also an affirmative duty to inform when the trustee knows that silence might be harmful.'" *Bixler v. Central Pa. Teamsters Health & Welfare Fund,* 12 F.3d 1292, 1300 (3rd Cir. 1993).
21 *In re Dynegy Inc. ERISA Litigation,* 309 F.Supp.2d 861, 879 (S.D. Tex. 2004); *Worldcom Inc. ERISA Litigation,* 263 F.Supp.2d 745 (S.D.N.Y. 2003).
22 *Dynegy,* at 879-881.

23 *Worldcom* at 766.
24 284 F.Supp.2d 511 (S.D. Tex. 2003).
25 *Id.* at 653-59.
26 *Id.* at 656-658.

available to debtors to forestall fiduciary duty lawsuits that threaten reorganizations.

Conclusion

Bankruptcy enables companies to terminate pensions plans, shedding millions of dollars of liabilities. However, in preparing for and executing such terminations, companies and their executives should be aware of the potential for liability to their control groups and individuals who act in fiduciary capacity. ■

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[27] *Id. See, also, In re Chateaugay Corp.*, 109 B.R. 613 (S.D.N.Y. 1990) (upholding a bankruptcy court's injunction preventing lawsuits by former employees of the debtor's subsidiaries against the subsidiaries and related entities because they threatened the integrity of the reorganization process).