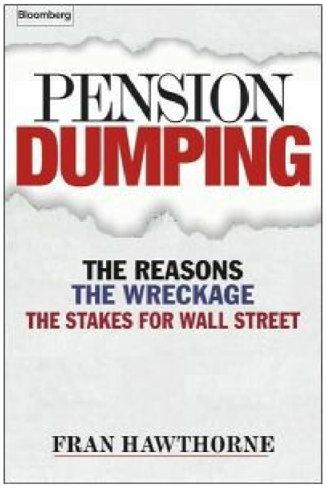

Book Pension Dumping

The Reasons, the Wreckage, the Stakes for Wall Street

Fran Hawthorne
Bloomberg Press, 2008
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Recommendation

Fran Hawthorne began writing about pension dumping in the 1980s and her expertise is evident. In this excellent book, she provides clear explanations about why pension dumping exists, why the practice will continue, and how the laws and organizations created to protect workers against pension dumping often abet it instead. You work all your life to put some retirement money together and should be able to count on the promises made to you. However, too many people are finding that those promises were written in disappearing ink. *BooksInShort* recommends reading this book to understand what you are up against, to know what distinguishes defined-benefit plans from defined-contribution plans, and to see why those differences matter. Hawthorne also teaches you why business executives, investors in distressed firms, bankruptcy judges and even union leaders are willing to throw retirees under the proverbial bus to keep companies running. Even if the book is a bit too technical in spots for the average employee who needs to grasp these matters, the subject's importance should inspire you to embrace and understand the daunting technical terminology of pension legislation and regulation.

Take-Aways

- U.S. firms may drop many of the 29,000 remaining private-sector pension plans.
- Investors in distressed firms want pensions dumped to fatten their return on investment or to help rebalance the bottom line.
- Bankruptcy courts allow some firms to drastically reorganize to try and keep the firm viable.
- Pension obligations rarely cause bankruptcy; dumping them won't save a sick firm.
- Companies created pensions in the 19th century as a mechanism for replacing older workers with younger, stronger ones.
- Traditional, defined-benefit pensions create more employee loyalty than 401(k)s.
- Congress responded to pension failures by passing the Employment Retirement Income Security Act (Erisa) in 1974.
- The Pension Benefit Guaranty Corporation (PBGC), created under Erisa, got its first notice of a pension failure two days after its formation.
- The PBGC has successfully reassigned pension obligations to some reorganized companies that emerged from bankruptcy.
- Not all reforms that strengthen the PBGC improve pension security.

Summary

Why Pensions Are Being Dumped

Until the last 20 years of the 20th century, people who worked at major American companies often had the promise of lifetime pensions after decades of loyal work. However, as the U.S. economy changed and some very large companies went through bankruptcy, Americans were shocked to learn that their pensions were not as certain as they had hoped. Major companies, such as Bethlehem Steel, LTV Steel, Polaroid, Kaiser Aluminum and others, could not afford to pay the millions and billions of dollars they had promised to their retirees, so they threw their pension plans overboard. The public outcry about this during the early 1970s spurred Congress to pass the Employment Retirement Income Security Act (Erisa) and to create the Pension Benefit Guaranty Corporation (PBGC). The intention, of course, was to protect workers. But a heavy volume of plan terminations in the 1980s, 1990s and the early 21st century burdened the PGBC. Little relief is in sight: The PBGC created a pension watch list and discovered that the potential future volume of pension dumping could dwarf anything that has already happened.

> "With nearly 29,000 private-sector defined-benefit plans still in operation as of 2007, logic and history alone dictate that some percentage will fail in coming years."

Wrenching change has come to the automobile industry. Decades ago, the Big Three carmakers were synonymous with U.S. manufacturing might, union power, lavish executive perks and gold-plated retirement programs. Relentless competition, rising regulatory-compliance costs, skyrocketing health costs and longer retiree life spans have combined to necessitate a drastic restructuring of the auto industry. The United Auto Workers (UAW) has renegotiated worker pay and retiree benefits with General Motors and Ford, and more concessions may be coming. As painful as these changes were, workers and retirees in other industries have experienced worse. Defined-benefit pension plans became a business burden. While these pensions were neither the source of the problem nor the biggest financial problem these companies faced, they became an obligation that could be jettisoned in bankruptcy. Companies increasingly made the cold business decision that their pension promises were too costly to keep.

> "The bankruptcy process holds no special protections for the pension plan."

After a company enters bankruptcy, creditors with secured claims against its assets may get court-ordered payments. Retirees claiming pension benefits may not be so lucky. They hold a promise, not a legal claim secured by the company's assets. The PBGC usually steps in, commonly granting requests for it to take over the pension obligations of companies in bankruptcy. A collective belief that keeping a viable company alive is better than letting too many obligations kill it drives this process. Unions often go along with pension dumping because they get their dues from active workers and, so, give them higher priority than retirees. Considering the concessions active workers have made, many of them believe retirees who get a PBGC pension and Medicare are getting enough. Everyone has to take a hit when the company is fighting for survival.

> "If things are so shaky that they have to file for bankruptcy, the pension plan is probably a dead man walking."

When trying to emerge from bankruptcy, a company usually seeks exit financing. So-called "vulture investors" specialize in such high-risk funding. They commonly reduce their risks and maximize their returns by requiring a wholesale transformation of the bankrupt company and its liabilities. Pensions are among the vulture investors' first targets. The main question the bankruptcy judge and potential new investors must face is whether the debtor firm can compete profitably after reorganization. Some companies are doomed no matter how many cuts they make. A convincing business reorganization plan is critical to any company's effort to emerge from bankruptcy.

> "Bankruptcy has simply gotten a lot cheaper, easier, and more socially acceptable than it used to be."

Competition can change a retirement plan, too. If all your competitors have defined-benefit plans, and you switch to a lower cost 401(k) or some other type of defined-contribution plan, you have an advantage until they all match what you have done. If your firm is the last in its industry with a traditional pension plan, it almost certainly will have to switch to a defined-contribution plan. However, companies must carefully calculate any potential costs in shifting from defined-benefit to defined-contribution plans.

How the Laws Enable Pension Dumping

Pension plans are not a product of corporate charity. Industrial companies created them in the late 19th century to encourage aging, less efficient workers to retire and to create job openings for younger, stronger workers. The promise of a pensioned retirement also encouraged employee loyalty and discouraged requests for pay raises. However, in the 1920s, some pension funds failed to meet their obligations, a problem that would persist for decades. As late as 1974, the typical pension fund had only half of the funding it needed to meet its obligations.

> "Unloading a pension commitment was often easier than trying to wriggle out of a trade debt or an unsecured loan."

On September 2, 1974, President Gerald Ford signed the Employee Retirement Income Security Act (Erisa) into law to protect pensions. It created the Pension Benefit Guaranty Corporation (PBGC) to monitor pension funds and to relieve troubled companies of their pension obligations. Just two days after Erisa was enacted, the PBGC got its first notice of a company terminating its pension plan. Erisa was designed to make it hard for companies to transfer their pension obligations to the PGBC. For a while, such bailouts carried a social stigma. However, as entire industries collapsed, the process was streamlined, inviting bigger bailouts and softening the stigma.

> "If a financially weak company hopes to have a second chance at survival, it will require new capital. Most likely, that capital will have to come from large investors. And those investors usually expect to see the pension plan dumped."

LTV Steel made one of the largest transfers of pension obligations to the PBGC. The company's bankruptcy filing in 1986 involved two dozen bankers and attorneys, created several new legal precedents and even spawned a couple of new laws. It carved a clear legal path wide enough for many other companies to follow. Congress based Erisa on the idea that business vagaries can prevent firms from predicting their futures accurately, so workers need the government to protect pensions. However, the legislators who crafted Erisa also had trouble predicting the future.

> "The ultimate test of whether a company is a good investment is whether it survives and makes money. Shedding the pension plan, in itself, doesn't guarantee a passing grade."

Today, if a company wants to end its pension plan and rescind its obligations, the tools are available. Consider how a company works through Chapter 11 bankruptcy.

The process permits the debtor company to file a petition to transfer its pension obligations to PBGC. The company must convince the PBGC that it cannot survive under the burden of its pension commitments. The bankruptcy judge also must weigh the purported merits of dumping a pension plan. This complex and expensive process is a well-choreographed dance that usually involves creditors, investors and management, and generally excludes retirees with pension claims. Their claims usually sit at the bottom of the stack; only equity stockholders are lower in priority as bankruptcy judges decide how to divvy up corporate remains. In some cases, bankruptcy judges who want to keep a troubled company alive will approve changes in its union contracts.

Why Investors Want Pensions Dumped

Companies in the throes of bankruptcy are not attractive investments to most institutions or people with money. Successfully investing in distressed companies is hard. The investor must understand the company's position in its industry, know how to make the company more competitive and pick the best time to invest. If the company is likely to remain uncompetitive despite restructuring, even a vulture can't justify the investment. Poorly considered investments can leave a company inefficient or inert. For example, a restructuring plan that drains talent from a company by encouraging employee turnover is likely to fail. To minimize such risks, successful investors in distressed businesses carefully study possible targets and their industries, and drive hard bargains, paying not one dollar more for any company than they must.

> "Whenever a company says it will go out of business if it can't terminate the pension plan, most unions will settle."

Dumping a pension plan will not save a sick company. The key is the size of the pension fund deficit relative to corporate assets or market capitalization. A company's debt load and credit rating may point to an increased risk of pension underfunding. An aging work force and limited young hires are signs that a company feels pension pressures. Key factors to evaluate include a pension plan's investment strategy, the plan's return on investment, and its benefit payment obligations now and in the future.

> "Skeptics say that the reason unions often sign on to this sort of bargain with the devil is that unions generally represent active employees, not retirees."

Many troubled companies recover in Chapter 11 and return to profitability. Academic studies of companies entering Chapter 11 for the first time show that about 65% emerge, but then face another challenge. Studies indicate that between 33% and 60% of these companies will file for bankruptcy a second time. Dumping its pension plan did not guarantee a re-emerging company's success or failure, but the choice had implications for employee satisfaction. The managers of companies that filed Chapter 11 petitions and yet maintained their pension plans clearly had decided that keeping employee morale high would be part of their reorganizations. Switching to a new 401(k) plan, on the other hand, can hurt morale. Indeed, some companies have dumped defined-contribution plans and reinstated traditional defined-benefit plans to demonstrate their commitment to their workers and, perhaps, garner some positive publicity.

> "Better to have a job and a shrunken pension than no job at all."

Retirement plan risk is especially high in destructively competitive industries, such as the airline business. Consider the unfortunate legacy of US Airways. When the airline was headed for its second bankruptcy in the spring of 2005, its pension plan needed a $2.5 billion injection to become fully funded. The PBGC took over the pension plan but was legally prevented from paying full pension benefits to its highly compensated retirees, including former pilots. Later, when US Airways demonstrated renewed financial health by bidding to acquire a rival carrier, Delta Air Lines, the PBGC tried to transfer pension obligations back to US Airways but it failed to do so after the Delta bid fizzled.

What Does the Future Hold for Pensions?

Is the crisis of pension dumping ending? It probably is not, given the 29,000 defined-benefit plans in place in the private sector. Some are short millions of dollars, so you can safely predict that several will fail. Venture capitalists and hedge funds are also becoming more aggressive in going after distressed firms. You will see more vulture capitalists circling over these firms looking for the right targets. Some of these companies are barely hanging on and the least dip in the economy will push them into the vultures' talons. Congress has put up a shield. It passed the Pension Protection Act (PPA) in August 2006 to improve pension safety at distressed firms. But while some analysts believe the law will limit pension dumping, others fear it will encourage more.

> "Which other industries might be candidates for bankruptcy and pension dumping? Some interesting speculation swirls around electric utilities."

Which industry will spawn the next round of failures? Some say the auto industry. General Motors and Ford face terrible pressures, though they also have shareholders, such as the Ford family, who want to avoid the loss of control that bankruptcy entails. The auto parts industry is squeezed by high-cost overhead, including pension and healthcare benefits, and foreign competition. Not all auto parts companies are struggling, but the industry's pension liabilities deserve careful attention. The PBGC has electric utilities on its watch list, and while no utility declared bankruptcy from 1930 to 1988, several have done so in the past two decades. Increased deregulation of utilities will heighten competition among them and reduce pension safety.

> "Pension terminations don't happen out of the clear blue sky. They are part of a much bigger set of trends – some of them contradictory."

Pensions are a hot topic among working people who are thinking about and worrying about the future. Elected leaders have joined the pension debate, not only to protect workers but also to serve their own political needs. Greedy executives who gain from dumping pension plans have offended public sensibilities. The issue extends to other fronts as well. Even healthy companies are finding ways to gradually kill their defined-benefit plans. They cover new hires with cheaper 401(k) plans, for example, and as retirees die, old defined-benefit plans expire with them.

> "Companies could avoid a lot of these problems by putting more into the pension trust than they needed in flush times, as a kind of rainy day fund."

Carefully distinguish steps to "save" pensions from actions taken to support the PBGC. They are not necessarily the same thing. The federal government, for example, could encourage companies to keep their pension plans fully funded by rewarding them with lower PBGC premiums. But because these premiums are immaterial expenses for many companies, lowering them probably would enrich the PBGC without reducing the incidence of pension dumping. Still, economic volatility can make pension promises hard to keep, and government must play a supportive role. What the government and the governed cannot do is merely ignore the problem and hope it will go away. It won't.

About the Author

Fran Hawthorne is the author of three previous books and writes on financial issues for *The New York Times*, *Crain's New York Business* and other publications. She first wrote on pension dumping for the publication *Institutional Investor* in 1983.