

# How Would Bankruptcy Affect the Flight Attendant's Pension Plan?

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The business news this month has been full of stories about American Airlines' financial problems, including its \$3.5 billion loss in 2002, its \$5 million in daily expenses and its depressed stock price, despite a reported \$2 billion in cash on hand. These articles coupled with the status of other major airlines, provoke major concerns on the part of employees about the future of the Company, and in particular, the safety of our pensions in the event the situation does not improve. Following is a series of questions that we suspect are on everyone's mind and their answers. While times are troubling, we want you to have the facts about the status of the retirement plan in the event the Company does end up in bankruptcy.

## **WHAT IS BANKRUPTCY?**

Bankruptcy is a judicial process, which an employer may undertake pursuant to the United States Bankruptcy Code to liquidate or reorganize its debts. There are two forms of bankruptcy proceedings for corporate entities.

## **WHAT ARE THE TWO TYPES OF PROCEEDINGS?**

In a Chapter 7 proceeding, a Trustee is appointed by the Bankruptcy Court to oversee the liquidation of the Company's assets and the payment of the Company's creditors. In a liquidation, the Company ceases to exist.

In a Chapter 11, the Company intends to stay in business and needs the protection of the bankruptcy laws to reorganize and restructure its debts. Generally, in a Chapter 11 proceeding, the Company remains in control of its business and is known as the Debtor in Possession. The Company is subject to the supervision of the Bankruptcy Court while in bankruptcy. Creditors must cease collection efforts, and, subject to court approval, the Company is permitted to reject certain contracts, including collective bargaining agreements, and discharge certain pre-bankruptcy debt in order to obtain a "fresh start". Creditors also participate, along with the debtor/Company in the reorganization.

## **WHAT DOES IT MEAN TO REJECT A COLLECTIVE BARGAINING AGREEMENT?**

Section 1113 of the Bankruptcy Code permits an employer who is in Chapter 11 to seek modifications of a collective bargaining agreement pursuant to expedited negotiations with the union or, if the union does not agree, with the approval of the Bankruptcy Court.

Section 1113 requires the employer to make a proposal to the union and to provide certain information to the union supporting its proposed changes in the contract. The Company's proposal must provide for "necessary" modifications that are "necessary" to permit the Company's reorganization and must assure "fair" and "equitable" treatment of all parties. If the parties do not agree on the changes, the employer can move the court to approve its rejection of the contract and its modifications to the contract. In order to approve the Company's rejection of the contract, the Bankruptcy Court must find that the union refused the proposed modifications without good cause, and that the balance of the equities clearly favor the employer's position. If the court issues a rejection order, the Company is still obligated to negotiate with the union on the terms of the new contract.

## **DO ALL COMPANIES EMERGE FROM CHAPTER 11?**

No. Sometimes, a company is unable to reorganize itself successfully and is liquidated in the Chapter 11 or the case may be converted to a Chapter 7, either by the debtor itself or upon a motion of one or more creditors.

## **IF AMERICAN FILES A CHAPTER 11 CASE, WHAT HAPPENS TO OUR RETIREMENT PLAN AND BENEFITS?**

Filing of a Chapter 11 Case does not automatically terminate or have any other immediate impact on a pension plan. However, in a Chapter 11 proceeding, all aspects of the Company's financial obligations are scrutinized, and the Company may seek changes in the retirement plan or other benefits, in negotiations with the Union, including termination of the pension plan. However, depending on the funded status of the plan, termination may not be in the debtor's interest in a Chapter 11 proceeding due to the liabilities imposed by federal law on the employer sponsor of a plan.

**ISN'T THERE A FEDERAL AGENCY THAT HAS TO APPROVE A PLAN TERMINATION EVEN IF THE COMPANY IS IN BANKRUPTCY?**

Yes. The Pension Benefit Guaranty Corporation ("PBGC") oversees the terminations of tax-qualified defined benefit pension plans, even if the employer is in bankruptcy.

**WHAT IS THE PBGC?**

The PBGC is a government agency that was created in 1974 by Congress as part of the Employee Retirement Income Security Act ("ERISA"). It is a quasi insurance agency established to protect the retirement benefits of American workers and retirees covered by defined benefit pension plans. The PBGC's revenue is derived from insurance premiums paid by insured pension plans, plus investment income, and the assets in underfunded terminated pension plans which it takes over.

Information about the PBGC can be found by visiting its web site at: **[www.pbgc.gov](http://www.pbgc.gov)**.

**DOES THE PBGC INSURE OUR RETIREMENT PLAN?**

Yes. The PBGC insures the Retirement Benefit Plan for Flight Attendants, because it is a tax-qualified defined benefit pension plan. The PBGC does not insure defined contribution plans, including 401(k) plans, such as the \$uper \$aver Plan.

**WHAT IS THE DIFFERENCE BETWEEN A DEFINED BENEFIT AND A DEFINED CONTRIBUTION PLAN?**

A defined benefit ("DB") plan promises a stated pension benefit for life, generally payable annually, that is usually based on a formula using some combination of compensation and years of service. By contrast, in a defined contribution ("DC") plan, each employee has an individual account and the benefit payable upon retirement or termination is simply the amount in the individual account plus (or minus) investments over the course of the employee's employment while covered under that plan. In a DB plan, the employer bears the entire risk of the investments because the plan promises a particular benefit amount. In the DC plan, by contrast, the employer's only obligation is to make the contribution (and in many 401(k) plans, there is no employer contribution (other than the employee's salary deferral)).

## **HOW DOES THE EMPLOYER BEAR THE RISK IN A DB PLAN?**

An employer that sponsors a DB plan is legally responsible for the funding of the benefits promised by the plan. DB pension obligations are long-term obligations that are calculated by actuaries using employees' ages, actual and expected service and compensation with the employer and assumed mortality. Funding requirements are established by federal law, which establishes ranges of permissible contributions. When the plan's investments do well, the Company's contribution obligations are minimized. But if, as has been the case over the last few years, the plan's investments do not do as well as they are projected to do, the Company's contribution requirements rise. Ultimately, the Company must fund the plan according to a schedule which is designed to guarantee that there is enough money in the plan to pay all the benefits promised under the plan for all covered employees' lifetimes. Ideally, employers do not want to overfund the plan because once money is contributed to a pension plan, an employer cannot take that money out of the plan for its general uses unless the plan is terminated and all of the plan's liabilities are satisfied. Even in that case, the employer can take the money only if the plan document permits the employer to receive the residual assets. On the other hand, an employer who falls behind in its funding obligations will face excise taxes and possibly other penalties for failure to meet the strict funding requirements of federal law.

## **WHAT IS THE FUNDED STATUS OF OUR RETIREMENT PLAN?**

American has announced that it has over \$5 billion in assets in all its DB plans, not just the Flight Attendant Plan. As of December 31, 2001, it reported that the combined assets in all plans covered approximately 92% of its accumulated benefit liabilities based on service earned as of December 31, 2001 and salaries as of that date. We do not yet have the precise statistics for the year that just ended, because the government filing is not required to be made until October, 2003, or even later if the Company gets an extension. Presumably, the Plan's funded status worsened by the end of 2002, as the stock market returns were so bad. American has announced that its pension plans earned zero in investment in 2002, an investment return which was higher than many other airline pension plans, which were negative for the year. American also announced that as of the end of 2002, all of its DB plans were underfunded by between \$2 billion and \$3.5 billion depending on the different measures used. Its minimum contribution obligation to fund the plans in 2003 is at least

\$200 million. We don't know precisely yet how much of that amount relates to the Flight Attendant Plan, because as stated above, the information has not yet been released.

### **SHOULD WE BE ALARMED BY THE MULTI-BILLION DOLLAR UNDERFUNDING?**

While obviously we would be less concerned if American's flight attendant retirement plan were fully funded, we need to remember that the funded status of a pension plan reflects a long-term obligation, like a mortgage. Underfunding does not necessarily threaten the security of benefits already accrued under the plan. Like a mortgage, the pension underfunding means that the Company owes lots of money to meet its total obligation over the next forty years (or more) to all current employees for their lifetimes. But as long as the Company meets its annual funding requirements, and remains financially solvent, the underfunding should not give immediate cause for concern. The Company has asserted that it has met its funding obligations and is, in fact, required to notify participants as well as the Union if it fails to do so.

### **IS MY CURRENT BENEFIT PROTECTED, EVEN IF THE COMPANY FALLS BEHIND IN ITS FUNDING OBLIGATIONS?**

Under the tax law and ERISA, pension benefits are protected once they are accrued. That means that for service already rendered, the Company generally cannot reduce the benefits you have already earned. However, under certain circumstances, if the Plan were terminated in a distress termination and there were insufficient assets to pay all benefits accrued to the date of termination, benefits could be reduced to the amount covered by the assets, but not below the levels guaranteed by the PBGC. If the PBGC were to recover additional money from the employer, the additional money could be used to increase benefits that had been reduced under certain circumstances.

### **HOW CAN A PLAN BE TERMINATED?**

There are two types of voluntary terminations for a tax-qualified DB pension plan, each of which is initiated by the employer/plan sponsor. One is known as a standard termination; the other is a distress termination. In each case, the law requires that the termination not violate the terms of any applicable collective bargaining agreement. In our case, Article 36(L)(1) of our contract prohibits the Company from amending the Retirement Plan without the Union's consent "in any way that materially affects the benefits provided to or the cost imposed on Flight Attendants" (with three limited exceptions that are not relevant here).

## **WHAT IS A STANDARD TERMINATION?**

In a standard termination, the plan has sufficient assets (or the employer contributes sufficient assets) to cover all benefit liabilities accrued to the date of the termination. The plan assets are used to purchase a group annuity contract from a licensed insurance company to guarantee all the benefits promised under the Plan. As employees retire, they apply for and receive their benefits from the insurance company. In a standard termination, there is a required notice of intent to terminate the plan sent to all plan participants and their bargaining representatives at least 60 days but no more than 90 days in advance of the plan termination date. Participants are also required to receive benefit notices detailing the amounts of their accrued benefits as of the proposed termination date, as well as information relating to the insurance company that was selected to guarantee the benefits.

## **WHAT IS A DISTRESS TERMINATION?**

In a distress termination, there are not enough assets in the plan (and the employer does not have the cash to contribute the difference required to fully fund the plan) to cover all benefit liabilities accrued to the date of termination. In order to qualify for a distress termination, the employer and every member of its controlled group must, at a minimum, meet one of the four criteria described below. An employer's controlled group consists of related companies that have common control based, generally, on 80% stock ownership, such as a parent and its subsidiaries. AMR Corp. and American Eagle, to name two, are members of the American Airlines' controlled group.

- **Liquidation and Reorganization:**

The first two distress criteria require the employer (or members of its controlled group) to have filed a petition in either chapter 7 or chapter 11 of the Bankruptcy Code or under a similar state law. In the case of Chapter 11 reorganization, the bankruptcy court must determine that the employer (or members of its controlled group) will individually be unable to pay all debts pursuant to a plan or reorganization and will be unable to continue in business outside the reorganization process if the plan is not terminated.

- **Inability to Pay Debts or Unreasonably Burdensome Pension Cost**

If the employer (or members of its controlled group) are not in bankruptcy, in order to terminate a plan in a distress termination, the

employer (or members of its controlled group) must demonstrate to the PBGC that it will be unable to pay its debts when due and will be unable to continue in business without the distress termination; or that the costs of providing pension coverage are unreasonably burdensome because of a decline in the workforce covered by DB plans which the employer (or members of its controlled group) sponsor.

If the distress termination is approved, the PBGC takes over the plan. Benefits are payable to the levels funded by the plan assets, or the PBGC statutory guaranteed levels, which ever is higher.

In a distress termination, there is also a notice of intent to terminate the plan sent to participants and the union at least 60 days but no more than 90 days before the proposed termination date. Participants will also be notified eventually of the amount of benefits they will receive under the terminated plan.

#### **IS THERE ANY OTHER WAY A DB PLAN CAN TERMINATE?**

Yes. The PBGC may initiate an involuntary termination when the plan fails to satisfy minimum funding obligations, or the plan will be unable to pay benefits when they become due, a certain reportable event occurs, or the possible "long-run loss" to the the PBGC "may reasonably be expected to increase unreasonably" if the plan is not terminated.

In addition to the foregoing discretionary terminations, the PBGC must terminate a plan if it determines that the plan cannot pay current benefits when due under the plan.

#### **WHAT IS THE SIGNIFICANCE OF A PLAN TERMINATION?**

The major significance of a plan termination to a participant is the cessation of benefit accruals under the plan as of the termination date. The amount of benefits payable will depend principally on the funded status of the plan at plan termination.

#### **DO WE CONTINUE TO EARN BENEFITS UNLESS THERE IS A PLAN TERMINATION OR UNTIL THE PLAN TERMINATION DATE IF THERE IS A TERMINATION?**

Not necessarily. Subject to collective bargaining, if applicable, an employer is permitted to freeze pension accruals as of a prospective date, usually not less than 45 days after it adopts a freeze amendment. In our case, since the plan is collectively bargained, the Company may

not freeze the benefits without bargaining with the Union. However, a freeze could be part of the Section 1113 negotiations and contract rejection if the Company is in bankruptcy. An employer must notify plan participants in advance of a freeze.

**IF THERE IS A DISTRESS TERMINATION AND THE PBGC TAKES OVER OUR PLAN, WILL I GET THE SAME BENEFIT I AM NOW ENTITLED TO?**

Whether your benefits will be the same depends on the amount of assets in the plan as well as the amount of your benefits when the plan is terminated. There is a maximum amount payable by the PBGC, depending upon your age, if the assets in the Plan are less than the guaranteed benefits. You may view the maximum amounts guaranteed by the PBGC at the PBGC Web site, [www.pbgc.gov](http://www.pbgc.gov), or you can write to Consumer Information Center Dept. YGP, Pueblo, Colorado 81009. The actual amount of the guarantee will depend on the year in which the plan is terminated. The amount of your guaranteed benefit will depend on your age at plan termination if you had already retired when the PBGC takes over or your age when you retire if you had not retired on the termination date. It is therefore impossible to predict at this time the amount of your benefit in the event of a distress termination. Also, if there are more assets in the plan than the amount necessary to pay the guaranteed benefits, you may receive amounts in excess of the guarantee.

**ARE ALL PENSION BENEFITS UNDER THE PLAN GUARANTEED BY THE PBGC?**

No. There are certain benefits that the PBGC does not guarantee, including benefits that are not vested (for instance, for employees with less than five years of service) and improvements that have been in effect for less than five years. Guarantees for benefit improvements are phased in at 20% a year (or \$20 per month, whichever is greater) until they have been in effect for five years before the plan termination date. Thus, for instance, the improvements to the pensionable compensation that we negotiated effective September 12, 2001 will not be fully guaranteed until September 12, 2006. For example, if our plan were terminated in a distress termination on January 1, 2004, the benefit improvements would be guaranteed at 40% because they would have been in effect for two 12-month periods prior to the January 1, 2004 plan termination date.

You should also know that the PBGC guarantees only the actuarial value of the normal retirement benefit in the form of a straight life annuity. The PBGC guaranteed benefits are reduced for benefit forms other than the



straight life annuity, for instance the joint and survivor benefit, as well as for early retirement.

Disability benefits are guaranteed only if the disability occurred prior to the date of termination.

### **WHAT IS THE MAXIMUM PENSION GUARANTEED BY THE PBGC IF THE PLAN TERMINATES IN 2003?**

The maximum monthly benefit guaranteed by the PBGC for a single-life annuity (with no survivor benefit) for an employee retiring at 65 under a plan that terminates in 2003 will be \$3,664.77. If the employee retires at 62, the monthly guaranteed benefit will be \$2895.17. For retirement at 60 and 55, respectively, under the same conditions, the guaranteed monthly amounts are \$2,382.10 and \$1,649.15, respectively. The PBGC website, **[www.pbgc.gov](http://www.pbgc.gov)** shows the guaranteed amounts at different ages. Benefits will be reduced for other forms of payment, for instance joint and survivor and guaranteed survivor benefits.

### **SHOULD I RETIRE NOW?**

Only you can decide whether you are ready to retire based on your personal financial circumstances and your life plans. This decision should be made in concert with financial advisors and family members.

### **IF THERE WILL BE A DISTRESS TERMINATION IN THE FUTURE, SHOULD I RETIRE BEFORE THE TERMINATION IN ORDER TO PROTECT MY CURRENT BENEFIT?**

In general, retirement before a distress termination, as opposed to after the termination, would not affect the amount you will receive after the termination. In either event, your benefit may be subject to recalculation and reduction by the PBGC, as described below, and the test is whether you were eligible for retirement under the plan three years before the plan termination, not whether you actually retired.

The safety of your pension depends on whether the benefit amount is above or below the level of guaranteed benefits provided by the PBGC.

If the amount of your pension under the plan is less than the guaranteed amount (taking into account all adjustments for age, form of benefit, etc.), you will receive the amount of your pension regardless of when you retire.

To the extent the benefit under the Plan exceeds the PBGC guarantee,

you may receive such amounts above the guarantee, if there are enough assets in the Plan at the time of termination to cover the priority category of your benefit, as described below.

Upon plan termination, the plan's assets are allocated to the benefits of participants and beneficiaries of the plan in a specified order, known as the priority categories of Section 4044 of ERISA. If the assets are insufficient to provide for all benefits in a particular priority category, the assets are distributed proportionately within the category so all benefits within that category are paid equally.

- Categories 1 and 2

The first two priority categories involve benefits accrued from voluntary and mandatory participant contributions.

- Category 3

Category 3 benefits are either annuity benefits that were in pay status as of the beginning of the 3-year period ending on the plan termination date based on the provisions of the plan in effect for at least five years before the termination date, or those that would have been in pay status as of such time had the participant retired prior to the beginning of the 3-year period and his or her benefits commenced at such time. The AA flight attendant plan requires a minimum age of 55 with 15 years of credited service, or age 60 with 10 years. Thus, the benefits of anyone who meets these requirements at least three years before the plan terminates will be in Category 3, whether or not the person retires before the plan's termination.

- Category 4

Category 4 benefits are the PBGC-guaranteed benefits.

- Category 5

Category 5 are all other vested benefits under the plan.

- Category 6

Category 6 are all other benefits provided under the plan whether or not vested.

### **WHAT IF THE RETIREMENT PLAN ISN'T TERMINATED BUT MY COMPENSATION IS REDUCED? WON'T MY ACCRUED PENSION AMOUNT BE REDUCED?**

It is possible if your compensation is reduced for long enough to affect the calculation of your average pay over your highest consecutive 48 months in your last 120 months before retirement. In that case, your current pension amount could be reduced. (The law protects accrued benefits from reduction by amendment, not by changes in compensation). But because your pension is based on your high 48 months out of 120 months of pay, you have some time before any reduction in compensation would affect the pension calculation.

### **WHAT IS A CASH BALANCE PLAN?**

A cash balance plan is a defined benefit pension plan under which benefits are determined by reference to a hypothetical cash balance account and hypothetical interest credits through normal retirement age. In the last five years, many companies have converted their traditional DB plans into cash balance plans. While cash balance plans are DB plans, they look more like DC plans because they have an individual account component. Typically, the employer contributes a percentage of employee pay to the plan which is held in a hypothetical account, and credited with a hypothetical interest rate. Benefits are typically provided in a lump sum, although because they are technically defined benefit plans, cash balance plans must offer a lifetime annuity payable at normal retirement age as the normal form of benefit under the plan. The conversion of the hypothetical account balance to the normal form annuity and back again to a lump sum in order to satisfy certain IRS technical requirements has engendered much litigation. In addition, the manner in which the plans have been converted has given rise to litigation over whether the conversion has appropriately protected all employees' accrued benefits under the existing plan. In addition, cash balance plans have been attacked as inherently discriminatory against older workers.

### **WHY DO COMPANIES LIKE CASH BALANCE PLANS?**

Companies like cash balance plans because they can be cheaper than traditional pension plans. They are also said to have more stable contribution requirements over time. Also, companies have said that they like these plans because they are more attractive to employees due to the individual account component of the plan. Similarly, it is said that cash balance plans are more attractive to younger employees who can

see the hypothetical account balance growing through their early years of employment as contrasted with smaller accruals for younger employees in traditional DB plans where benefits are not payable until an employee reaches his or her 50s or 60's. Cash balance plan benefits are generally more portable and payable upon termination regardless of age.

### **WHAT DID THE IRS DO RECENTLY TO PROMOTE CASH BALANCE PLANS?**

The IRS recently published proposed regulations which provide rules to assure that cash balance plans do not discriminate against older employees. The new proposed rules were widely viewed as favoring employers and facilitating conversions. Because of the proposed regulations, there has been a lot of speculation that more companies will now convert their traditional DB plans (like ours) to cash balance plans. This can cause concern among more senior employees because typically the cash balance plan is less generous to more senior employees than the traditional DB plan it replaces.

### **CAN THE COMPANY REPLACE OUR DB PLAN WITH A CASH BALANCE PLAN?**

Like any other amendments to the Retirement Plan, a conversion to a cash balance plan would require negotiation and agreement of the Union. Like other amendments, however, it could be part of a Section 1113 modification if the Company files for bankruptcy.

### **WHAT HAPPENS TO RETIREE HEALTH BENEFITS IF THE COMPANY FILES FOR BANKRUPTCY?**

The PBGC does not guarantee payment of benefits other than pensions. Nor is there any other guarantee for post-retirement benefits, even for retirees. Presumably, the Company would have to negotiate with the Union to reduce or eliminate retiree benefits. There is also a special section of the Bankruptcy Code, Section 1114 which like Section 1113, permits employers to obtain modifications in collectively bargained (and other) post-retirement packages on a consensual basis or with the approval of the Court following unsuccessful negotiations.