

Northwest Bankruptcy Underscores Larger Pension Issues

Wednesday, March 15, 2006 --- As the U.S. Department of Labor begins its investigation into Northwest Airlines' pension plans, the controversy surrounding the bankrupt carrier's alleged "systematic shortchanging" highlights a deeper problem: how to insure pension plans remain adequately funded in the face of financial difficulties.

On Wednesday, Northwest Airlines announced that it had turned over documents, including some sensitive material, to government investigators, two months after being subpoenaed by the Labor Department.

The struggling carrier drew suspicion after filing for bankruptcy last September, only one day before a \$65 million payment to the pension fund was due.

Northwest's pension fund, comprised of three individual plans, represented 8,000 pilots, 9,000 salaried employees and 52,000 unionized employees.

By the end of 2004, the plans collectively owed \$9.2 billion to the participants but only had assets of \$5.4 billion.

The nearly \$4 billion shortfall has led some to wonder if the nation's number-two carrier breached its fiduciary duty and violated the pension law.

Stuart Lewis, head of the tax section at Buchanan Ingersoll PC, does not necessarily believe this is the case.

"The system has a bunch of mechanical rules about how you fund these plans," says Lewis. "You can obviously significantly underfund those plans without violating the rules."

While Lewis does not believe such underfunding is a widespread, he does believe that certain industries, particularly the airlines, struggle with it.

"In order to get rid of your pension obligation altogether, there are rigid rules about what you can do," says Lewis.

Bankruptcy becomes an attractive option since it releases a business from having to pay its debts, including debts to pension funds, he says.

"It's a common problem," says Craig Rasile, a partner at Hunton and Williams LLP, who heads the firm's bankruptcy practice.

In the wake of Sept. 11, airlines have been “clobbered” by numerous factors, including skyrocketing jet fuel prices, rising gate leases and landing fees, and price wars.

If the business is running short on cash, then it will likely use the money to cover ongoing operations rather than pay the fund, leading to the shortfall.

“It’s robbing from Peter to pay Paul,” says Rasile. “The pensions are underfunded and the Pension Benefit Guarantee Corporation ends up taking it on the chin.”

The government-backed PBGC, functioning as an insurance agent, assumes the collapsed large plans and pays out the benefits, according to Louis.

But there are several problems connected to such a bailout.

“The danger with the PBGC is that benefits are insured only up to a certain level,” says Lewis. “Higher income people will lose a significant part of their pension benefit.”

Depending on the PBGC for help could also be problematic down the road, as the institution is rumored to have potential long-term funding issues of its own.

A report released in early November by Rochdale Research in New York concluded that a taxpayer bailout of the PBGC is inevitable.

The corporate bankruptcies of four major airlines, United, U.S. Airways, Delta and Northwest, along with auto parts manufacturer Delphi Corp. have compounded an already rocky financial position for the PBGC, according to the report.

In mid-November, the PBGC, intended to be self-funded by businesses’ premiums, reported to Congress that it faces a deficit of \$22.8 billion, down \$530 million from the previous year.

The agency faces an uphill battle, with its exposure to losses from pension plans sponsored by financially troubled businesses rising from \$96 billion to \$108 billion last year, according to the agency’s executive director Bradley Belt.

Even so, PBGC probably will not be in trouble at least for a few years, contends Lewis.

“At the moment, the agency is not [facing] any kind of cash shortage,” he says. “It has the guarantees of the federal government.”

The real danger is that the federal government might end up with a huge liability, according to Lewis.

In the Northwest case, as soon as the airline filed for bankruptcy, the government became an unsecured creditor for the \$65 million that was due the following day.

But the question of who should bear ultimate responsibility for the plans and how to ensure their survival in the wake of a company's bankruptcy is still subject for debate.

"The financial challenges facing the airline industry are significant, but nothing in the bankruptcy code requires companies to skip their pension funding payments," said PBGC executive director Bradley Belt, in the wake of Northwest and Delta filing for Chapter 11 protection.

A lack of regulation, however, may be partly to blame for the pension plans' gross underfunding.

The Labor Department, charged with enforcing fiduciary duty, has stressed voluntary compliance in recent years, hoping to help wayward pension officials straighten out their plans.

After United Airlines' \$10 billion pension fund collapsed last fall, the Labor Department and the Internal Revenue Service pledged to join forces and enforce the pension law's minimum funding requirements.

But the IRS has found itself overwhelmed by requests from companies seeking to waive or delay their annual contributions.

In 2003, Northwest received a waiver from the IRS enabling the airline to spread out that year's annual contribution over five years.

"This [latest instance with Northwest] is no different than what's been going on," says Lewis, noting that the steel industry has been plagued by this issue as well.

"It points out the problems with current rules for defined benefit plans," he says.

Congress is presently contemplating how to address this issue, with bills pending in both the House and the Senate.

The legislation is attempting to revise the rules so that companies will not be able to leave pension funds so woefully underfunded.

"The concept is that once you have one of these plans, you have to adequately fund it," says Lewis.

The pension reform legislation would also raise the employer-paid annual PBGC fees from \$19 to \$30 per plan participant, marking the first such increase in a decade.

But the Senate bill currently contains a controversial provision, which would grant the airlines 20 years to catch up on their pension contributions, nearly three times the amount of time other businesses will receive.

The White House opposes the proposed special treatment and has threatened to veto the bill if it appears in the final version.

While Congress continues to wrestle with pension reform, not everyone thinks the problems surrounding Northwest are emblematic of a flawed system.

Ken Yager, a managing consultant with Morris-Anderson, believes that the unions are actually the reason for the Labor Department's sudden interest in Northwest.

In an attempt to "raise the bar" the unions have become more aggressive, trying to negotiate for the most money possible.

Yager speculates that the unions may be whispering about pension underfunding impropriety as part of a bigger bankruptcy strategy.

"Unions are ready for the fight," says Yager, explaining that legacy costs are the biggest issues facing bankrupt companies today.

He doubts that Northwest shirked its personal fiduciary responsibility and knowingly ran afoul of several laws to get away with "systematic shortchanging."

"I hope for Northwest's sake that this was not the dominant measurement of how to manage their bankruptcy," says Yager. "There may be an incentive but there is definitely a disincentive too."

Calling the pension system "already solid," Yager believes that the real problem revolves around an age-old accounting question.

"It's all about my future value versus your future value," he says. "That's forever the argument."

Yager does acknowledge that more and more corporations are finding themselves having to ask the PBGC for help, which could be a significant problem in the future.

"The last four years, the PBGC got to a point of being virtually catastrophic," says Yager, noting that the deficit gap is narrowing thanks to companies' increased profitability and higher interest rates.

"Without sustained economic recovery, though, there will be a permanent gap," says Yager, noting that a taxpayer bailout may eventually be necessary.

“Either that, or the government will be forced to renege on people’s pensions.”

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