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NEW TAX RULES FOR AMERICAN AIRLINES CASE TO BENEFIT DEBTORS

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Pension issues in the American Airlines (AMR) bankruptcy[1] have resulted in the Internal Revenue Service (IRS) issuing new final regulations, effective November 8, 2012 (Final Regulations), which broadly impact all debtors facing underfunded pension plan obligations. The Final Regulations provide chapter 11 bankruptcy debtors facing distress terminations of their tax-qualified defined benefit pension plans with the additional option of amending the plans to eliminate accelerated payment options. Such eliminations can significantly reduce potentially crushing pension liability for the companies during their chapter 11 reorganization and recovery.

The proposed June 20, 2012 regulations that preceded the Final Regulations were in direct response to a dispute between AMR, its three largest unions and the Pension Benefit Guaranty Corporation (PBGC). Internal Revenue Code (IRC) anti-cutback rules prevented AMR from reducing or otherwise eliminating pension plan obligations. As such, AMR faced massive up-front liability under its pilots' pension plan because the pension plan allowed pilots to elect payment of benefits in one lump-sum payment as opposed to monthly annuity payments, creating potentially massive cash flow and liquidity issues for AMR. AMR attempted to terminate its pilots' pension plan early in its bankruptcy case; however, those efforts failed due to fierce opposition from AMR's unions and AMR's inability to obtain PBGC and bankruptcy court approval.

Under pressure from PBGC, AMR later determined to freeze its pilots' pension plan rather than eliminate it entirely, meaning that AMR's current pension obligations under the plan would continue, but that it would not enroll any new plan participants. Because of the IRC anti-cutback rules, even a freeze of the pilots' pension plan could lead to potentially crushing liability for AMR since it would still be required to honor the plan's lump-sum and other similar accelerated payment options.

Similar dilemmas are commonly faced by chapter 11 debtors with tax-qualified defined benefit pension plans (Pension Plans). Debtors are somewhat limited in their treatment of Pension Plans. For example, since termination of Pension Plans is governed by the Employee Retirement Income Security Act of 1974, as amended (ERISA), chapter 11 debtors cannot simply reject such plans under Bankruptcy Code Section 365. Additionally, chapter 11 debtors are only entitled to terminate a Pension Plan in one of two ways: by standard termination or distress termination. A chapter 11 debtor may effectuate a standard termination if the chapter 11 debtor has the cash available to fund the Pension Plan so that all plan benefits can be paid in full at the time of termination. Not surprisingly, that does not happen too often. If, conversely, the chapter 11 debtor lacks the revenue to fund the Pension Plan for a standard termination, the chapter 11 debtor must seek a distress termination[2] of the Pension Plan. A distress termination requires approval of both the PBGC and the bankruptcy court under a stringent standard of review. If the chapter 11 debtor obtains a distress termination of the Pension Plan, PBGC funds the remaining benefit obligations under the plan and is entitled to an unsecured – usually non-priority – termination claim against the debtor in that amount.

Restrictions under the IRC have further limited companies in bankruptcy in their treatment of Pension Plans. IRC Section 411(d)(6), for example, includes certain so-called "anti-cutback rules." The anti-cutback rules generally prohibit the sponsor of a Pension Plan from amending the plan to eliminate or reduce accrued plan benefits including early retirement benefits, retirement-type subsidies, and certain optional forms of benefit.

In the Final Regulations, the IRS responded to the AMR dilemma by softening the anti-cutback rules applicable to Pension Plans. Specifically, the Final Regulations create a limited exception to the IRC's anti-cutback rules which apply to chapter 11 debtors that sponsor Pension Plans. These debtors are now authorized to amend such plans to eliminate lump-sum distribution options and other optional accelerated benefit payments so long as certain conditions are met including certifications that the plans in question are underfunded, and determinations by the bankruptcy court and the PBGC that the plans would otherwise be subject to distress or involuntary terminations under ERISA.

As a result of the Final Regulations, AMR will now be able to amend the pilots' pension plan to eliminate optional lump-sum and other accelerated payments to retirees, thereby alleviating a potentially material cash flow drain. If AMR is able to satisfy the requirements of the Final Regulations, AMR will also avoid the otherwise likely result of a distress termination by successfully freezing the pilots' pension plan without being forced to continue paying onerous accelerated pilots' pension benefits. On November 23, 2012, AMR took an important step toward amending the pilots' pension plan by filing a motion with the bankruptcy court seeking approval of such an amendment consistent with the Final Regulations. To date, the bankruptcy court has not ruled on the motion.

[1] In re *AMR Corp. et al.*, Case No. 1:11-bk-15463-SHL

[2] Additionally, the PBGC may bring an action against the debtor for involuntary termination of a benefit plan.

The restructuring and tax professionals at Squire Sanders play a central role in bankruptcy and other regulatory proceedings throughout the United States, and are well-situated to address evolving issues in these arenas. For more information on the effect the new treasury regulation may have on your company's bankruptcy or restructuring needs, or for other bankruptcy, restructuring or tax advice, contact your principal Squire Sanders lawyer or one of the lawyers listed in this alert.

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