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MEMORANDUM TO CLIENTS

April 29, 2005

Re: Pension Provisions in the New Bankruptcy Legislation

Over the past 8 years, Congress has repeatedly attempted to pass major bankruptcy reform, but failed for various reasons (most recently, in 2001 and 2003, over abortion clinic protest activity provisions). Less than two months ago, however, the roadblocks were removed and the bill moved swiftly through the legislative process. Specifically, on March 10, the Senate passed the "Bankruptcy Abuse Prevention and Consumer Protection Act of 2005" (S. 256) by a vote of 74 to 25. The House approved an identical 500-page bill on April 14 by a vote of 306 to 126, after brief but heated debate. The President signed the legislation into law on April 20 (Pub. L. No. 109-8).

As widely reported in the press, many of the legislation's provisions would make it tougher for debtors to shed their debts in bankruptcy. However, the principal changes in the pension area are intended to expand the individual's protection from bankruptcy creditors – generally limited now to ERISA-covered plans – to more uniformly cover participant interests in non-ERISA 403(b) plans, governmental, church and 457 plans. The legislation also would shelter up to $1 million (indexed) in a regular or Roth IRA, not counting most rollover contributions (governmental 457(b) plan rollovers are not covered by the special rollover provision) and with no dollar limit for SIMPLE and SEP IRAs.

In the past, this has been a tortured area. A 1992 Supreme Court decision, Patterson v. Shumate, 504 U.S. 753 (1992), has generally protected participant interests in ERISA-covered plans subject to anti-alienation provisions (ERISA sec. 206(d)), but some courts found ways to limit the protection to trusteed arrangements – excluding, for example, ERISA-covered 403(b) annuity plans. Just earlier this month, the Supreme Court resolved a longstanding split in the circuits and ruled that IRAs may qualify for protection under a different provision of the bankruptcy law – one requiring that the right to payment must be from a "pension, annuity or similar plan or contract" and be "on account of" illness, disability, death, age or length of service. Rousey v. Jacoway, 2005 WL 742304 (April 4, 2005). Because this exception under current law is limited to amounts "reasonably necessary to support" the accountholder or his dependents, the new law again provides more complete protection. Similarly, many state laws protect governmental plan benefits, but again the protection is not universal.

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We are concerned that one of the new legislation's requirements for presumptively protecting all of these retirement accounts – i.e., that the retirement fund has received a "favorable determination" under the IRS Code that is in effect on the date of the filing of the bankruptcy petition – will cause more problems than it solves. This requirement applies not only to privately sponsored qualified plans and IRAs which typically receive IRS determination or opinion letters, but also to governmental plans, church plans, 403(b) and 457(b) plans which often do not. Where a fund does not have a favorable determination, the protection is available if (1) there is no prior contrary IRS or judicial determination and (2) either the retirement fund is in "substantial compliance" with the applicable Code requirements or the debtor is not "materially responsible" for the fund's failure to be in substantial compliance. While this ill-conceived scheme may not adversely affect the protection of private ERISA-covered plans that were the subject of the 1992 Supreme Court case (the legislative history clearly states that the law is intended to add to – and not detract from – the protection provided by the Court's ruling), it may well frustrate the apparent Congressional goal of more uniformly protecting all types of tax-favored retirement funds.

Several other provisions would have a favorable impact on debtor's interests in tax-favored retirement plans by

- preventing most plan loans from being automatically discharged in bankruptcy and allowing plan loan payments to continue during the bankruptcy process, and
- specifically providing that amounts withheld from wages or received from employees as contributions to an employee benefit plan – including plans subject to Title I of ERISA, and governmental, 457, and 403(b) plans – are excluded from the bankruptcy estate.

The legislation also includes several provisions relating to employers in bankruptcy and their executives. In particular –

- the priority claim under section 507(a)(4) of the Bankruptcy Code for contributions owed to employee benefit plans during the 180 days prior to the bankruptcy petition would be increased from $4,000 to $10,000 per employee (the principal effect being to give priority to unpaid vacation, severance and sick leave),
- the "look-back" period for determining fraudulent transfers under section 548 of the Bankruptcy Code would be extended from one year to two years, and would include certain transfers to "insiders" outside the ordinary course of business,

- retention bonuses to induce "insiders" to continue working for the debtor would be disallowed absent certain judicial findings, including that such services are "essential to the survival of the business," and

- allowable administrative expenses would not extend to special severance payments to insiders, including payments that are not made under a program generally applicable to all full-time employees, and that exceed 10 times the amount of the mean severance pay amount for non-management employees made in the same calendar year.

In general, the bankruptcy changes would become effective October 17, 2005 (180 days after enactment), and would not apply to cases commenced before that date.