Is Chapter 11 Bankruptcy A Possibility? Have You Remembered Your Employee Benefit Plans?

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In recent years bankruptcy has become a necessity for many companies. Some companies are liquidated under chapter 7 of the Bankruptcy Code,[2] but many other companies reorganize under chapter 11 of the Bankruptcy Code and emerge as viable ongoing concerns.

As bankruptcy looms, financial pressures may cause a company to overlook employee benefits issues, even though the company faces substantial liabilities for its employee benefit programs. However, by planning ahead for employee benefits issues in chapter 11 bankruptcy, a company may be able to maximize the benefits to its creditors and current employees.

Although some issues, such as collectively bargained obligations, are common to all types of employee benefit plans, a company facing a chapter 11 bankruptcy filing should individually consider the impact of bankruptcy with respect to each of its defined contribution plans, defined benefit plans, executive plans, and welfare benefit plans.

Collectively Bargained Obligations. Many company-provided employee benefits are provided pursuant to collective bargaining agreements between a company and its unions. Most collective bargaining agreements contain restrictions on the ability of a company to amend or modify these benefits. Upon entering bankruptcy, Sec. 1113 of the Bankruptcy Code provides special protections for collective bargaining agreements. Under Sec. 1113, collective bargaining agreements may only be modified or rejected by a company if the union agrees, or if an agreement is not reached, upon receipt of court approval. Because of these limitations, a company facing bankruptcy may be limited in the steps it may take with respect to its collectively bargained employee benefits.

Defined Contribution Plans. In light of the Enron collapse, a greater focus has been placed on defined contribution plans and the bankruptcy risks related to them. Accordingly, a company should review the following issues on an ongoing basis:

- **Diversification of Investment in Employer Stock**. Code Sec. 401(a)(28) imposes diversification requirements on ESOPs. No parallel diversification

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[2] For purposes of this article, "Bankruptcy Code" refers to Title 11 of the United States Code.

requirements apply to employer stock matching funds. As a company's stock begins to lose value, plan fiduciaries may have a duty to determine whether the company's stock remains a prudent plan investment under ERISA Sec. 404. *Moench v. Robertson*, 62 F.3d 553 (3d Cir. 1995); *Kuper v. Iovenko*, 66 F.3d 1447 (6th Cir. 1995).

Even if a plan's terms restrict diversification of employer stock, a plan fiduciary may have an obligation to either permit or require diversification if it determines that expanded diversification is necessary to comply with the general prudence rules under ERISA Sec. 404. This decision may also be made by a company via plan amendment. However, due to a potential conflict between their dual roles as a sponsoring employer and plan fiduciary, some employers elect to appoint an independent fiduciary to evaluate the merits of continuing to hold company stock as a plan investment, thus reducing, but not completely eliminating, their fiduciary liability.

- **ESOP Put Options**. Under Code Secs. 409(h) and 4975(e)(7), an ESOP is required to allow ESOP participants to sell their company stock to the ESOP if the stock ceases to be "readily tradable" on an established market. Similar rules also apply to leveraged ESOPs. Treas. Reg. Sec. 54.4975-7(b)(10). As a publicly traded company approaches and enters bankruptcy, it may face delisting from its major stock exchange (*e.g.*, the NYSE or NASDAQ). If a company is delisted, the company stock is no longer treated as "readily tradable," even if trading of the stock has continued on the "pink sheets" or an equivalent exchange. Priv. Ltr. Rul. 200052014 (Sep. 27, 2000).

Several issues face plan sponsors and plan fiduciaries when the delisting of company stock becomes an possibility. Because an employee benefit plan is a separate legal entity from a plan sponsor, a corporate bankruptcy does not stay put option claims against an employee benefit plan. However, even though claims against a plan may proceed, the plan may lack the funds necessary to pay the fair market value of company stock sold back to the plan. If the stock is tradable on the pink sheets, it may be possible to liquidate stock on the pink sheets and pay the proceeds to plan participants. However, if the company stock is not tradable on a securities exchange, it may be effectively impossible to buy back shares of stock due to the unavailability of funds.

- **Continued Obligation to Contribute Elective Deferrals**. Department of Labor Reg. Sec. 2510.3-102(b)(1) requires that participant contributions to an employee benefit plan must be credited to a plan's trust as soon as administratively practicable, but not later than the 15th day of the month following the month in which an employer withholds the contributions from wages, or, if an after-tax contribution, receives the after-tax contribution. Plan sponsors approaching or in bankruptcy are not relieved of this obligation. Failure to make contributions in accordance with this requirement may subject the employer to liability for the prohibited transaction under ERISA Sec. 406(a)(1)(B) of extending credit from an employee benefit plan to a plan sponsor – even if the bankruptcy laws restrict a plan's ability to collect on these contribution obligations.

- **Elimination of Employer Matching Contributions**. As a company approaches bankruptcy and its financial obligations mount, it may want to consider modifying its employer matching contributions. A company may elect to make employer matching contributions in a different form (*e.g.*, the use of cash contributions rather than company stock) or may elect to eliminate employer matching contributions altogether. Plan sponsors should consider this issue as early in the bankruptcy process as possible.

- **Partial Termination**. A bankruptcy or potential bankruptcy can often result in significant reductions in a company's workforce. These reductions may trigger a partial termination of the company's employee benefit plans under Code Sec. 411(d)(3). When a partial termination occurs, all "affected employees" must be 100% vested in their plan benefits. The term "affected employees" is not defined in the Code or Treasury Regulations. The determination of who is an "affected employee" is made on the facts and circumstances of each situation. Special rules may also apply to previously terminated participants who are not fully vested in their plan benefits. Gen. Couns. Mem. 39,310 (Nov. 29, 1984); *Flanagan v. Inland Empire*, 3 F.3d 1246 (9th Cir. 1993).

- **Employees as Litigants**. In the post-Enron world, it is more likely than ever that as a company's stock declines, employees holding company stock in the company's defined contribution plan will assert claims against the company, the plan, and its fiduciaries for losses incurred on account of the decline in value of their company stock. These claims may be raised in pre-bankruptcy suits or as claims against the company's bankruptcy estate.

Unfortunately, it may be difficult for many companies to avoid these claims. However, a company's exposure may be limited by addressing the potential for these claims early in the pre-bankruptcy process. Accordingly, careful review of current case law on the prudence of investing in company stock is necessary. In addition, because even close attention to these issues may not prevent litigation, plan fiduciaries should review their plan document language to ensure that it maximizes fiduciary protection and should review and potentially increase their fiduciary insurance coverage in expectation of the future litigation.

- **Department of Labor Investigation**. As evidenced by the Department of Labor's active involvement in the Enron-bankruptcy litigation, the fiduciaries of a plan face potential Department of Labor investigations and claims against the bankruptcy estate under ERISA Sec. 502(l). Plan fiduciaries of companies facing bankruptcy should be aware of this potential risk and, accordingly, take extreme care in making and properly documenting their fiduciary actions.

Defined Benefit Plans. Defined benefit plans[3] of employers in bankruptcy may face issues similar to those issues faced by defined contribution plans, such as partial termination concerns and potential investigations by the Department of Labor. However, defined benefit plans also face several unique issues. These issues include:

- **PBGC Reportable Event**. When a company in a controlled group enters bankruptcy, the bankruptcy is a "reportable event" under ERISA Sec. 4043 and PBGC Reg. Sec. 4043.35 that triggers a Pension Benefit Guaranty Corporation reporting obligation. This report must generally be made to the PBGC within 30 days after the date the plan administrator or contributing sponsor has knowledge or has reason to know that the bankruptcy has occurred. This 30-day period is extended (if the bankrupt entity is not the contributing sponsor to the plan) until the plan administrator or contributing sponsor has actual knowledge of the bankruptcy. In addition, certain non-public companies must provide advance notice of the bankruptcy. PBGC Reg. Sec. 4043.68. Failure to comply with these requirements may result in a penalty of up to $1,100 per day. ERISA Sec. 4071.

- **Funding Obligation**. A bankruptcy filing will not eliminate a company's obligation to continue funding its defined benefit plan under Code Sec. 412 and ERISA Sec. 302. Failure to make ongoing funding payments may (1) result in a funding deficiency, (2) trigger a PBGC reporting obligation (*i.e.*, the required filing of PBGC Form 200 within 10 days of the due date for a required payment), and (3) subject a company to a lien under Code Sec. 412(n). However, some courts have determined that only the "normal cost" of funding a plan under Code Sec. 412(b)(2)(A) and ERISA Sec. 302(b)(2)(A) – rather than both normal cost and past-service liability – may receive administrative priority in bankruptcy. *In re Sunarhauserman, Inc.*, 126 F.3d 811 (6th Cir. 1997). In addition, funding obligations accrued prior to bankruptcy may not be entitled to the same level of priority and may be limited to a maximum of $4,650 per employee. Bankr. Code Sec. 507(a)(4). This dollar limitation is subject to adjustment in 2004. Bankr. Code Sec. 104(b)(1).

A company should also note that a failure to meet funding standards in bankruptcy may result in excise taxes under Code Sec. 4971, although the priority of an Internal Revenue Service excise tax bankruptcy claim is subject to dispute.

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[3] Some of these defined benefit plan issues are also applicable to money purchase plans subject to the Code Sec. 412 and ERISA Sec. 302 funding requirements.

United States v. Reorganized CF&I Fabricators of Utah, Inc., 518 U.S. 213 (1996); Chief Counsel Advice 200005001 (Oct. 13, 1999).

- **Funding Waivers**. Funds may not always be available for a company to make its minimum funding contribution. As bankruptcy approaches, a company's liquidity may be severely stretched. In order to avoid potential penalties for failures to make required funding contributions, a company may consider filing a request for a funding waiver under Code Sec. 412(d) and Revenue Procedure 94-41. In order to obtain a funding waiver, a company must show that (1) the company, and entities in the company's controlled group, are unable to satisfy the minimum funding standard for a plan year without temporary substantial business hardship, and (2) the application of the minimum funding standard would be adverse to the interests of plan participants in the aggregate. Rev. Proc. 94-41. If granted, the minimum funding amount waived may be amortized over a period of up to five years (subject to interest charges under Code Sec. 412(d)(1)).

- **Plan Amendments**. When a company enters bankruptcy, its ability to amend its defined benefit plan may be limited. Under Code Sec. 401(a)(33), a company in chapter 11 bankruptcy may not amend its defined benefit plan in a manner that increases plan liabilities on account of an increase in benefits, a change in the accrual of benefits, or a change in a plan's vesting schedule. However, an amendment is permitted if (1) the plan would have a funded current liability percentage of 100% or more after implementation of the amendment, (2) the amendment repeals a retroactive plan amendment under Code Sec. 412(c)(8), (3) the amendment is required for plan qualification under Code Sec. 401(a), or (4) the company has obtained Internal Revenue Service approval that concludes the amendment is reasonable and provides for only a de minimis increase in the liabilities of the plan with respect to the company's employees. To obtain this Internal Revenue Service approval, a company must submit a private letter ruling request under Revenue Procedure 79-62 demonstrating that it meets these two criteria.

- **Termination and Reversion of Assets**. A company is under no obligation to continue its fully-funded defined benefit plan. A company, either before or during bankruptcy, may terminate its fully-funded defined benefit plan, provided it has included the proper language in the plan document and taken the proper steps to terminate the plan.

If a defined benefit plan is overfunded, a company may wish to terminate the plan and receive a reversion of the surplus assets. In order for a company to elect to receive a reversion, a defined benefit plan must provide that a reversion is permitted and this plan provision must not have been added within the past five calendar years. ERISA Sec. 4044(d). A reversion will be subject to an excise tax of 50% of the reversion amount under Code Sec. 4980. However, if a company provides either a qualified replacement plan, as described in Code Sec. 4980(d)(2), or a pro rata benefit increase, as described in Code Sec. 4980(d)(3), the excise tax is reduced to 20% of the reversion amount. A company considering a reversion should note that, in bankruptcy, a reversion "tax" under Code Sec. 4980, may or may not be treated as a penalty, and thus subject to a lower level of bankruptcy priority. Chief Counsel Advice 200005001 (Oct. 13, 1999).

Executive Plans. Executive plans – which go by many names including SERPs, top-hat plans, and non-qualified deferred compensation plans – face a unique set of issues when a company is facing bankruptcy. These plans are generally not subject to the substantive requirements of ERISA and may often be forfeited in a bankruptcy proceeding.

- **Funding Vehicle**. Although executive plans, because they are not subject to ERISA's participation and vesting, funding, and fiduciary rules, need not be funded, many sponsors establish separate "funding" vehicles for these benefits – although for ERISA purposes, these plans remain "unfunded." The most common form of funding for these benefits is a "rabbi trust." The Internal Revenue Service has provided a model "rabbi trust" in Revenue Procedure 92-64. A rabbi trust allows a company to set aside assets to fund executive plan obligations in a separate trust that is not subject to the claims of creditors unless the company enters bankruptcy. However, in bankruptcy, all assets of the trust are available to creditors. For federal income tax purposes, the assets of the rabbi trust are treated as assets of the company and executives benefiting under the executive plan are not generally subject to taxation on the value of the assets placed in the rabbi trust or any earnings on these assets.

If a company is using a rabbi trust or a company is funding its executive compensation out of general assets and bankruptcy becomes an option, the company should consider whether it wishes to secure the executive plan benefits by putting the assets into a trust that will not be subject to the claims of creditors – often called a secular trust. However, due to the preference rules in Sec. 547 of the Bankruptcy Code, an employer may need to make this shift to a secular trust at a date before the preference rules would allow the transfer to be invalidated in bankruptcy. In addition, a company should consider whether all future executive plan benefits will be funded through a secular trust or whether future accruals will be funded through a rabbi trust and/or general asset funding mechanism. Upon adopting a secular trust, the employees whose benefits are held in the secular trust will be subject to current income taxation on their vested benefits. Furthermore, the executive plan will become subject to all of ERISA's rules.

Lastly, before taking the step of placing executive plan benefits in a separate trust, a company may want to consider the public relations aspect of this step, as recent events have raised non-legal public relations issues with both employee bargaining units and public opinion.

- **Haircut Provisions**. Many executive plans include "haircut" provisions, allowing employees to accelerate distribution of their benefits if they forfeit a specified percentage of their executive plan benefit. If these "haircut" elections are made or these "haircut" provisions are added to an executive plan within the preference period before bankruptcy, these steps may not be sufficient to protect the executive plan assets in bankruptcy.

- **"Select Group" Litigation Risk**. Unlike tax-qualified plans, executive plans are not subject to periodic review under a determination letter process. As such, a company may not update its executive plans for long periods of time. Many executive plans establish compensation or other thresholds for participation to ensure that the plan only covers "a select group of management or highly compensated employees." This limitation is designed to ensure that ERISA's participation and vesting, funding, and fiduciary rules do not become applicable to the executive plan. However, as time passes, compensation levels may increase and management ranks may grow with the result that the executive plan, in operation, may fail to satisfy this "select group" requirement.

As a company approaches bankruptcy, it should review its executive plans to ensure that this "select group" test is still satisfied. Because of the potential loss of benefits in bankruptcy, participants under the executive plan may attempt to assert the plan is no longer for a "select group" and thus subject to ERISA's vesting, funding, and fiduciary requirements. Careful design and administration prior to bankruptcy can avoid this litigation risk.

Welfare Benefits. Although often unfunded, welfare benefits plans may be a costly expense for bankrupt companies. Several issues should be considered if bankruptcy becomes an option.

- **Reduction or Elimination of Retiree Health Programs**. Many companies facing a potential bankruptcy filing have medical programs for their retired employees. Although welfare plan benefits are not required to be vested under ERISA, the right to continued benefits may be contractually vested based on plan provisions or communications to participants. *Am. Fed'n of Grain Millers, AFL-CIO v. Int'l Multifoods Corp.*, 116 F.3d 976 (2d Cir. 1997). In addition, once a company enters bankruptcy, Sec. 1114 of the Bankruptcy Code requires bankruptcy court approval for modification of retiree health benefits. However, some courts have not applied Section 1114 of the Bankruptcy Code to retiree health benefits that a debtor is not contractually obligated to provide. *In re Doskocil Companies, Inc.*, 130 B.R. 870 (Bankr. D. Kan. 1991). Accordingly, a company considering modifications to its retiree health care benefits may wish to consider making the adjustments prior to bankruptcy.

- **COBRA Rights**. Employees terminated during a chapter 11 bankruptcy may be entitled to COBRA benefits under Code Sec. 4980B. However, depending on the restructuring undertaken in bankruptcy, COBRA liabilities may attach to the surviving controlled group as a whole. In addition, a company's chapter 11 bankruptcy may trigger a lifetime COBRA right for certain retired employees (rather than the general COBRA coverage periods). Code Sec. 4980B(f). As such, a company facing bankruptcy or in bankruptcy should evaluate any restructuring proposals in light of potential risks of COBRA liability.

- **Severance Plans**. A severance plan may or may not be governed by ERISA. However, upon entering bankruptcy the priority of severance payable to a terminated employee under Sec. 507 of the Bankruptcy Code may come into dispute. In some circuits, severance pay has been held to be an administrative expense entitled to priority under the Bankruptcy Code. *Straus-Duparquet, Inc. v. Local Union No. 3 Intern. Broth. of Elec. Workers, A F of L, CIO*, 386 F.2d 649 (2d. Cir 1967). However, other circuits have held that severance pay may not be an administrative expense entitled to priority. *In re Mammoth Mart, Inc.*, 536 F.2d 950 (1st Cir. 1976). Accordingly, severance rights might be an issue taken into consideration in selecting a bankruptcy filing venue.

Conclusion. Filing for bankruptcy under chapter 11 of the Bankruptcy Code is often a needed and useful means of allowing a viable company to continue its operations without being saddled with obligations that are unnecessarily holding back pursuit of a company's objectives. As bankruptcy looms, employee benefits may not be the primary focus of companies in financial distress. However, by taking the time to focus on its employee benefit plans before and during bankruptcy, a company may be able to lighten the burdens it will face as it enters the bankruptcy process and thus maximize the entity's value after it emerges from bankruptcy.