AMERICAN BANKRUPTCY INSTITUTE

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Pension, Retirement Issues in Bankruptcy

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CONCURRENT SESSION

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Pension and Retirement Issues in Bankruptcy

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I. ERISA DIVIDES ALL QUALIFIED RETIREMENT PLANS INTO TWO SPECIFIC TYPES--DEFINED BENEFIT PLANS AND DEFINED CONTRIBUTION PLANS.

A. Defined contribution plans include profit sharing plans, money purchase pension plans and employee stock ownership plans. 401(k) plans are also a type of defined contribution plan.

1. Defined contribution plans are account plans. They are called defined contribution plans because the plan defines the amount of the contribution that is to be put into the plan.

a. Examples include a contribution equal to a fixed dollar amount, a percentage of compensation, a percentage of company profits or a specific formula.

b. 401(k) plans are actually a plan feature typically built into a profit sharing plan where employees are permitted to contribute amounts from their compensation on a pre-tax basis.

2. Since the amount of the contribution is fixed for a defined contribution plan, all earnings/losses in the plan are borne by the participant. When a participant retires, his or her retirement benefit is the balance of the assets credited to his or her account.

a. For example, if a profit sharing plan contributes $20,000 to a qualified profit sharing plan for a participant, that $20,000 will be allocated to an account in the participant's name.

b. If the $20,000 above in the participant's account above is invested in the stock market and the value of the investments increases to $25,000 at the time of retirement, the participant is entitled to the $5,000 increase and the participant's retirement benefit will be $25,000.

c. Likewise, if the $20,000 above is invested in the stock market and the value of the investments decreases to $15,000 at the time of retirement, the participant is entitled to only the decreased value of the assets and the participant's retirement benefit will be $15,000.

B. Unlike defined contribution plans, a defined benefit plan defines the amount of the benefit the participant will received upon retirement. The plan must determine how much money it needs to pay the benefit and the plan funds that amount over the participant's years until retirement.

1. Examples include a retirement benefit equal to $100 per month for the participant's life, 50% of the participant's average pay while at the company, or a fixed amount of $100,000 when the participant retires.

2. Once the retirement benefit is set, the Plan Sponsor must figure out how much money the plan will need to pay the benefit and the Plan Sponsor must fund that benefit over the years leading up to the participant's retirement.

    a. For example, assume that the Plan Sponsor provides for a benefit of $100 a month for the life expectancy of the participant commencing at age 65.

        i. First, the Plan Sponsor must determine how much money the plan will need to set aside to pay a benefit of $100 per month for life commencing at age 65.

        ii. The Plan Sponsor engages an actuary (a licensed professional trained to compute retirement benefits) that helps the Plan Sponsor determine how much they need to fund the plan.

        iii. Each year, the Plan Sponsor contributes enough money to accumulate the appropriate amount the Plan will need to pay the benefit. Each year, the Plan Sponsor looks at plan earnings and adjusts how much the Plan Sponsor contributes to make sure enough money is in the plan to pay the benefit.

    b. In the example above, assume the participant is 35 and is to be paid $100 per month for life commencing at age 65.

        i. First, the Plan Sponsor determines how much money it will need to pay the participant $100 per month for life. Assume that the Plan Sponsor determines that it will need $100,000 in 35 years to pay the benefit to the participant.

        ii. The Plan Sponsor then estimates what kind of earnings the Plan will achieve over the next 35 years and the Plan Sponsor will contribute amounts each year determined by the Plan Actuary. If the Plan investments earn higher than estimated, contributions may be adjusted downward. If the Plan investments under-perform, the Plan Sponsor may need to increase contributions.

c. If thirty-five years pass and the Plan has $100,000 set aside to pay the participant's benefit, the Plan either starts paying the participant $100 per month for the rest of the participant's life or the plan buys an annuity from an insurance company to pay the participant $100 per month.

i. If the Plan elects to pay the participant $100 per month, the Plan must continue to monitor how much it has left to pay the participant's benefit. If the plan runs out of money, it is still obligated to pay the $100 a month to the participant.

(a) If the Plan does not have enough money, the Plan Sponsor will be required to put in additional amounts to pay the benefit.

(b) If the participant dies, the obligation to pay the benefit ceases. If the Plan still holds money to pay the benefit, that amount is forfeited and the Plan may use it pay benefits to other participants.

d. If thirty-five years pass and the Plan has only $80,000 to pay the participant $100 per month for life commencing at age 65, the Plan Sponsor will have to contribute $20,000 to make sure the Plan has enough money to pay the $100 per month benefit.

e. If thirty-five years pass and the Plan has $130,000 to pay the participant $100 per month for life commencing at age 65, the Plan Sponsor needs only $100,000 in reserve and the Plan may use the excess $30,000 to pay benefits for other participants.

C. Funding Liabilities

1. Defined contribution plans rarely have funding issues in bankruptcy. Plan contributions in defined contribution plans usually do not accrue until the end of a plan year. Plan Sponsors often have discretion whether to contribute amounts each year, so Plan Sponsors often do not decide to make a contribution unless the Plan Sponsor has sufficient funds to pay the contribution.

a. There are exceptions. Money purchase pension plans have mandatory contributions each year. Once a participant completes 1,000 Hours of Service (usually around five months of full-time employment), the participant accrues a right to the defined contribution plan contribution.

i. Likewise, once a contribution is declared by the Plan Sponsor, the obligation "accrues" and the Plan Sponsor may become obligated to fund the defined contribution plan.

2. Defined benefit plans accrue funding obligations and frequently have funding issues that arise in bankruptcy. While defined benefit plans accrue funding obligations while the plan continues to operate, special funding obligations arise when a defined benefit plan is terminated.

a. When a defined benefit plan terminates, two things occur.

i. All accrued benefits for all participants in the defined benefit plan fully vest and become non-forfeitable.

ii. All vested benefits must be fully funded.

(A) Defined benefit funding obligations for an operating plan are typically funded during a participant's working years prior to retirement. The amount of funding is determined by the plan actuary each year and the assets held in the trust must be at specific levels (usually at least 80% of the benefit accrued at the time of the contribution).

(B) When a defined benefit plan is terminated, all fully-vested benefits have to be fully funded as of the termination.

(C) The funding obligation at termination is usually higher than the funding obligation for an on-going plan because the funding obligation is set using very conservative rates of return which are often much lower than the interest rate used for an on-going plan. For example, an on-going plan might fund benefits using a 5% or 6% interest rate assumption, but a terminating plan is often forced to use a much lower interest rate such as 3% or 4%.

D. Plan Termination Insurance (PBGC).

1. Since the employer bears the risk of loss in a defined benefit plan, the Internal Revenue Code and the Employee Retirement Income Security Act of 1974 ("ERISA") have a number of provisions that require the plan sponsor to fund promised benefits (see the discussion above).

2. The Pension Benefit Guaranty Corporation ("PBGC")was formed to provide termination insurance to make sure that when a plan terminates, there are sufficient funds to pay benefits promised to the participants in the plan. The PBGC applies only to defined benefit pension plans.

   i. The PBGC insures defined benefit plan benefits up to certain limits to make sure that employees will receive some, but not all, of the promised benefit.

3. To the PBGC, all defined benefit pension plans are either single employer plans, where the plan has one company is the sole contributor to the plan, or multiple employer plans, where a number of employers contribute to a single plan. Multiple employer plans include union plans and plans sponsored by a number of companies are related, but not part of a controlled group of corporations (like wholly-owned subsidiaries of a parent corporation).

   i. Single employer plans are much less complicated than multiple employer plans in that the PBGC is dealing with one plan, with one employer and the termination of the defined benefit plan is usually terminating.

   ii. Multiple employer plans are much more complicated. For example, a union plan may have dozens of employers contributing to provide benefits for their respective employees. In most cases, one plan may be withdrawing as a contributor to the plan while the remaining contributing employers may continue contributing to and providing benefits for their employees.

4. Single employer plan terminations are either a Standard Termination, a Distress Termination or an Involuntary Termination.

a. A Standard Termination occurs where the defined benefit plan has sufficient assets to cover all vested benefits promised to participants. If there are excess assets, the excess assets are returned to the employer. The amount returned to the employer is taxable as ordinary income and is subject to an excise tax of 20% (if the company adopts another retirement plan) or 50% (if no new retirement plan is adopted).

b. A Distress Termination usually involves either an insolvent employer, an employer that has filed for bankruptcy or an employer that would be unduly stressed financially by the continuation of the plan.

c. Involuntary Terminations occur either by agreement between the employer and the PBGC or by court order, usually initiated by the PBGC.

5. Multiple employer plan terminations can involve a single or a number of single employers leaving the plan as a contributing employer or it can involve the insolvency of the plan itself.

II. ISSUES WITH 401K PLANS IN BANKRUPTCY CASES

A. 11 U.S.C. § 704(a)(11): "The trustee shall . . . if, at the time of the commencement of the case, the debtor (or any entity designated by the debtor) served as the administrator (as defined in section 3 of the Employee Retirement Income Security Act of 1974) of an employee benefit plan , continue to perform the obligations required of the administrator."

1. This section has the effect of rendering the trustee a fiduciary under ERISA. *See* 29 C.F.R. § 2509.75-8 at D-3 (plan administrator is automatically considered an ERISA fiduciary given inherent discretionary nature of that role).

2. Rendering the trustee a fiduciary subjects the trustee to numerous fiduciary obligations and potential personal liability for a breach of those obligations. *See* 29 U.S.C. § 1109(a)(providing that a fiduciary who breaches any ERISA fiduciary obligations, responsibilities, or duties "shall be personally liable to make good to such plan any losses to the plan resulting from each such breach . . . .").

a. The trustee must discharge duties with respect to the plan solely in the interest of its participants and beneficiaries. *See* 29 U.S.C. § 1104(a)(1)(A)

b. The trustee must act "with the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims[.]" 29 U.S.C. § 1104(a)(1)(B).

3. The assets of the plan are not property of the estate because they are held in trust. *See* 11 U.S.C. § 541(d)(assets that a debtor holds in trust are not property of the estate). As a result, the assets of the plan cannot insure to the benefit of the sponsoring employer or, by extension, the estate. *See* 29 U.S.C. § 1103(a), (c).

B. In Chapter 7 cases, issues arising with the requirement that trustees assume the debtor's responsibilities as the plan administrator

1. The trustee's efforts in fulfilling obligations under § 704(a)(11) have no benefit to the estate and carry potential risk to the trustee

2. The DOL generally objects to the jurisdiction of the bankruptcy court to enter orders giving the trustee guidance with respect to fulfilling duties under § 704(a)(11), claiming that the court lacks jurisdiction because plan assets are not property of the estate, the outcome of the administration of a plan has no effect on the administration of the estate in bankruptcy, and because implementation of decisions as a fiduciary are governed by ERISA. Bankruptcy court are split on this issue. *See The Robert Plan Corp.*, 439 B.R. 29 (Bankr. E.D.N.Y. 2010)(holding that a trustee's motion for authority to terminate a 401(k) plan, to retain professionals to assist him in fulfilling his duties as an administrator, and to pay certain expenses related to administration of the 401(k) plan was within the core jurisdiction of the court because "[t]o hold otherwise would effectively place the Trustee outside the reach of the Bankruptcy Court while the Trustee is carrying out a duty mandated by the Bankruptcy Code."; *see also In re Franchi Equip. Co.*, 452 B.R. 352, 360 (Bankr. D. Mass. 2011)(same). *But see In re Mid States Express, Inc.*, 433 B.R. 688 (Bankr. N.D. Ill. 2010)(reaching the contrary conclusion).

3. Trustees can retain an independent fiduciary to assist them in fulfilling their duties in connection with the plan. If the plan documents so provide, expenses for certain administrative functions may be compensable from the assets of the plan. *See* 29 U.S.C. § 1108(b)(2).

4. Options for termination of the plan

a. Termination of the plan in a manner consistent with the plan
   i. requires a resolution terminating the plan as of a date certain
   ii. may require amendments to the plan to conform to the current version of the IRC
   iii. prior notice to plan participants of the termination, which informs them over their right to take a tax-free rollover
   iv. missing employee or employer contributions are ideally made
   v. any forfeitures (such as of non-vested benefits) should be reallocated in accordance with the plan, usually on a pro rata basis to participants
   vi. efforts must be made to locate missing plan participants
   vii. The IRS allows 12 months to distribute a plan's assets upon termination
   viii. Form 5500s must continue to be filed as required by the IRC

b. Treat it as an abandoned plan if (i) the plan sponsor is liquidating under the Bankruptcy Code and (ii) the plan sponsor no longer exists, cannot be located, or is unable to maintain the plan. *See* 29 C.F.R. §§ 2578.1(1)(i)(A) and (B); 29 C.F.R. § 2578.1(b)(ii)(A)-(C). Once abandoned the plan is officially deemed terminated 90 days after the date a letter is received from the EBSA's office acknowledging receipt of the notice of plan abandonment. *See* 29 C.F.R. § 2578.1(c). Advantages to this process, which has not yet been formally approved by the DOL for use by trustees) include the following:

   i. Streamlined process to wind up the affairs of individual account plans, which include updating the plan's records, calculating benefits payable to each participant, reporting delinquent contributions, engaging service providers, paying reasonable expenses associated with carrying out these tasks, providing written notice to plan participants, distributing the benefits, and filing a Special Terminal Report for Abandoned Plans. *See* 29 C.F.R. § 2578.1(d).

   ii. Under this process, the trustee is considered a Qualified Termination Administrator ("QTA") and is deemed to have satisfied the fiduciary requirements of ERISA with respect to winding up the plan, except for selecting and monitoring the service providers used to terminate the plan. Delinquent contributions do not have to be collected and the QTA is not responsible for filing a Form 5500 report, although the QTA does have to file a "summary terminal report" with the DOL once the winding up process is completed. There is also no need to update the plan.

III. PENSION PLANS

A. Identification of different issues facing public and private plans.

1. Private pension plans
   a. Are usually voluntary
   b. Because of the funding obligations imposed by the Internal Revenue Code and ERISA, private pension plans often have future obligations to fund benefits and those obligations are not necessarily excusable by bankruptcy.
   c. Partially insured by the PBGC
   d. Different accounting standards from public pension plans, including a shorter limit on amortization periods as opposed to public plans and private plans must adopt the corporate bond yield rate as the discount rate (currently 3.8%).

2. Public pension plans
   a. Are usually created by statute.
   b. The obligations to fund public pension plans also have funding rules, but these rules are typically imposed by federal, state or local statute (as opposed to the Internal Revenue Code and ERISA). The statutes authorizing public pensions are less strict that those mandated by ERISA and the Code.
   c. Use different accounting standards set by Governmental Accounting Standards Board (GASB). Reforms have been made since 2012, including a 25-year limit on amortization periods (private plans have a 7-year limit), net pension obligations must be reflected in government balance sheets, and assets and liabilities must be assessed based on their current fair value, rather than a "smooth" actuarial basis (which is more volatile, but also more accurate). The average discount rate used by public plans is 7.7%.
   d. Not insured by the PBGC

B. Underfunding issues.

1. Underfunded private pensions are usually an issue where the plan sponsor is experiencing financial difficulties or where the business is being purchased or sold. Underfunding equals the net present value of benefits payable under the pension plan, minus the present value of plan assets. One major issue is that there is an incentive on the part of the plan sponsor to assume a high rate of return on assets, which is used as the discount rate to determine the present value of liabilities. The higher the discount rate, the lower the net present value of future benefits, the lower the underfunding amount, and lower current funding levels. This encourages risky investments.

a. The economics of an underfunded private pension typically generate financial concerns that should always be addressed in the resolution of the organization through bankruptcy, insolvency or an acquisition. The amount of the deficit and the parties to be responsible for the shortage should always be identified, quantified and allocated. Many of the rules impose personal liability to the employer and possible plan fiduciaries.

b. Underfunded private pension plan can be terminated only though involuntary termination by the PBGC or as a distress termination by the plan sponsor.

i. 29 U.S.C. § 1341(c) permits a distress termination by the plan sponsor where the plan administrator gives 60-day notice of the intent to terminate to affected parties, the plan administrator provides certain information to the PBGC, and the PBGC determines that the "necessary distress criteria" are present The latter factor can be ground where there is a liquidation in bankruptcy or other insolvency proceedings, a reorganization where the bankruptcy court has determined that plan termination is critical to reorganization, the debtor cannot pay debts as they come due and will not continue to operate absent termination of the plan, or the costs of maintaining the plan have become unreasonably burdensome because of a declining workforce.

ii. The PBGC can initiate an involuntary termination if one of the following circumstances exists: (a) the required minimum funding contributions have not been made by the plan sponsor, (b) the plan does not have sufficient funds to pay benefits when due, (c) there has been a distribution to a substantial owner under 29 U.S.C. § 1343(c)(7), or (d) the PBGC reasonably expects that its long term losses will unreasonably increase if the plan is not terminated.

iii. Termination will likely result in the PBGC having a claim against the estate for the unfunded liabilities, unpaid minimum funding contributions owed to the plan by the plan sponsor, and/or unpaid pension plan termination insurance premiums.

iv. Under ERISA, not only will the plan sponsor have liability for the PBGC's claims, but members of the plan sponsor's "controlled group" are also jointly and severally liable. A controlled group is generally defined to include a parent corporation and all of its 80% owned subsidiaries. Sibling corporations of a common parent are also typically members of the same controlled group.

v. Before termination of a private pension plan, if a plan sponsor misses its minimum funding contributions, an automatic lien is created in favor of the PBGC against the assets of the entities in the controlled group if the aggregate amount of the unpaid contributions is more than $1 million. 29 U.S.C. § 1082(f). The lien automatically arises 60 days after a missed contribution. On termination, the PBGC receives an automatic lien on all assets in the controlled group for the total amount of unfunded benefits liabilities.

2. Underfunded public pensions are an obligation of the government agency sponsoring the plan. They are often the result of inflated assumed rates of return under GASB, volatile returns on risky plan investments, failure to make the annual required contribution, and alternative uses of pension funds (such as diverting funds to other governmental uses)

a. As a result of the relaxed funding rules, pension funding obligations are often more significant than private pensions. Like employee wages, the funding obligations are recognized in governmental budgets, but the obligation may be less recognizable in terms of the actual amount of owed contributions.

b. There are constitutional barriers to adjusting pension liabilities. Many state constitutions expressly forbid the impairment or modification of public pension benefits (i.e., Illinois, Oregon and Michigan). In addition, where pension benefits are deemed a property right, there may be issues with violations of federal or state constitutional Takings Clauses. In addition, changes to pension benefits may trigger a violation of state or federal Contracts Clauses, which limit a government's ability to impair its contractual agreements (impairment may still be possible where it is "reasonable and necessary to serve an important public purpose")

c, Options for Restructuring Public Pension Liabilities

i. Nonbankruptcy options include increasing the required employer or employee contributions, limiting cost of living adjustments, increasing the minimum retirement age or vesting period, reducing pension accrual rates for active employees, switching to a defined contribution plan or a defined benefit/contribution hybrid, and requiring full payment of annual required contributions.

ii. Municipal bankruptcy is an option, but it isn't available to states due to federalism concerns. Only insolvent municipalities or instrumentalities authorized to file by state law are eligible.