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Colleen Hart and Elizabeth Down, Proskauer Rose

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Bankruptcy Impact on Employee Benefit Plans

Contributed by Colleen Hart and Elizabeth Down, Proskauer Rose

As some companies experience financial hardship as a consequence of the Covid-19 pandemic, bankruptcy filings under Chapter 11 of the U.S. Bankruptcy Code are on the rise. Companies looking to restructure and streamline costs in the bankruptcy process often look to employee benefit plans as one area for change.

This article broadly addresses the impact of a Chapter 11 bankruptcy on employee benefit plans and some of the significant employee benefits issues that debtors face in a Chapter 11 restructuring, including a potential sale of the debtor's assets under 11 U.S.C. §363 of the Bankruptcy Code.

Companies with significant benefits liabilities are sometimes forced to file for bankruptcy to facilitate a transaction that would not otherwise be possible outside of the bankruptcy process. Following a bankruptcy filing, a debtor must examine whether to continue or terminate its employee benefit plans as part of the restructuring. The laws applicable to employee benefit plans in bankruptcy are complex, and their application to any particular debtor is very fact-specific.

Qualified Retirement Plans

The assets of tax-qualified retirement plans governed by the Employee Retirement Income Security Act of 1974, as amended are not subject to the claims of creditors in bankruptcy due to ERISA's trust and anti-alienation rules. These rules require funds for employee retirement benefits to be set aside in a trust and prohibit their use for unrelated expenses. **29** U.S.C. § 1103. Of the two types of tax-qualified retirement plans—defined benefit and defined contribution plans—defined benefit pension plans raise more complex issues in bankruptcy than defined contribution plans.

Defined Benefit Plans

Defined benefit pension plans promise a certain level of benefits to participants upon retirement, often based on a formula using the participant's compensation and years of service with the company. Defined benefit plans are subject to minimum funding standards set forth in ERISA and the Internal Revenue Code of 1986, as amended (Code). 29 U.S.C. §1083; 26 U.S.C. § 430. The funding level of a defined benefit plan depends on the amount of employer contributions made to the plan and the investment performance of the trust assets.

The Pension Benefit Guaranty Corporation insures benefit payments from defined benefit plans up to a certain amount. Defined benefit plans are required to pay insurance premiums to PBGC, and PBGC must be informed of all defined benefit pension plan terminations, both inside and outside of bankruptcy. ERISA requires notification to PBGC of certain "reportable events" that might indicate that a plan or its sponsor is in trouble, including failure to make required payments, inability to pay benefits, application for minimum funding waiver, liquidation, insolvency, and cumulative underpayments of $1 million or more. 29 U.S.C. § 1343.

Filing for bankruptcy under Chapter 11 does not automatically result in termination of a defined benefit pension plan. As part of the restructuring process, a debtor must determine, often in consultation with PBGC, whether to continue or terminate its defined benefit plan. In theory, if a debtor's pension plan is adequately funded and the debtor has sufficient funds to continue making the required contributions to maintain that funding status after restructuring, the pension plan could continue through the restructuring and survive the bankruptcy.

However, debtors often have significantly underfunded pension plans and typically fail to make the required minimum contributions to maintain adequate plan funding and PBGC premium payments. The burden of funding a defined benefit pension plan is often a contributing factor in a company's decision to file for bankruptcy. Most debtors seek to reduce their pension plan liability either by transferring sponsorship of the plan to another member of the controlled group or by terminating the plan altogether. PBGC is often one of the largest creditors in a Chapter 11 bankruptcy proceeding if there is a defined benefit plan involved. It typically files three claims in a bankruptcy proceeding for:

- Unfunded benefit liabilities (contingent on termination of the plan)
- Unpaid minimum funding contributions owed to the plan
- Any unpaid PBGC premiums

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Distress Termination

Under ERISA, a defined benefit pension plan may only permissibly terminate in a standard termination under ERISA § 4041(b), a distress termination under ERISA § 4041(c), or an involuntary termination under ERISA § 4042. The debtor may initiate a "distress termination" if the debtor and all members of its controlled group satisfy one of the four statutory distress criteria, one of which is reorganization in bankruptcy or insolvency proceedings with court approval of the termination. 29 U.S.C. § 1341(c).

To satisfy the requirements of a distress termination in a bankruptcy-related reorganization, the bankruptcy court must determine that the debtor cannot continue in business unless it terminates the plan as part of its reorganization. 29 U.S.C. § 1341(c)(2)(B)(ii). As part of the process, the debtor will take the following actions:.

- Schedule a pre-filing consultation with PBGC (a company that plans to file for bankruptcy might consider whether to start a dialogue with PBGC prior to filing the bankruptcy petition)
- Select a proposed termination date
- Send a notice of intent to terminate to affected parties (participants, beneficiaries, alternate payees under qualified domestic relations orders, unions representing participants, and PBGC) at least 60 and no more than 90 days before the proposed termination date. Select a proposed termination date
- Reduce the pension benefits of participants in pay status to PBGC-guaranteed amounts
- File a Distress Termination Notice with PBGC within 120 days after the proposed termination date

If PBGC determines that the plan has insufficient assets to pay benefits, PBGC will take over the plan and pay benefits.

Involuntary Termination

PBGC may also initiate an "involuntary termination" of a debtor's defined benefit pension plan in connection with a Chapter 11 bankruptcy proceeding. ERISA requires PBGC to intervene and terminate a plan if PBGC determines that the plan does not have sufficient assets to pay benefits currently due. 29 U.S.C. § 1342(a). Additionally, PBGC may seek to involuntarily terminate a plan if it determines that any of the following events has occurred:

- The plan sponsor has not made its required minimum funding contributions under § 302 of ERISA and § 412 of the Code
- The plan will be unable to pay its benefit liabilities in the future
- There has been a distribution of $10,000 or more to a substantial owner of the company that caused the plan to be underfunded
- The PBGC's long-run loss with respect to the plan may "reasonably be expected to increase unreasonably if the plan is not terminated." 29 U.S.C. § 1342(a)

When PBGC succeeds in an involuntary termination, it takes over the plan as the trustee and assumes responsibility for administration and benefit payments at the guaranteed level.

Termination Liability in Bankruptcy

Prior to a bankruptcy filing, if a plan sponsor missed required minimum contributions to its defined benefit plan that, with interest, add up more than $1 million in the aggregate, PBGC will have an automatic lien on the assets of the sponsor and all members of its controlled group. 29 U.S.C. § 1083(k); 26 U.S.C. § 430(k). Termination of the plan prior to a bankruptcy filing also results in an automatic PBGC lien on the assets of all controlled group members for the plan's unfunded benefit liabilities, capped at 30% of the controlled group's collective net worth.

If these liens are perfected prior to the bankruptcy filing, PBGC's claims for these amounts are considered secured claims. Once the plan sponsor files for bankruptcy, however, the imposition of the automatic stay, whose purpose is to create order among the creditors and preserve going concern value, prevents new liens from attaching to the debtor's assets. If

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the debtor misses funding contributions after filing for bankruptcy, or if the plan is terminated after the bankruptcy filing during the restructuring process, PBGC cannot attach a new lien or perfect an existing lien and PBGC's claims for these amounts are generally unsecured claims.

Importantly, the automatic stay does not apply to members of the controlled group that did not file for bankruptcy. Accordingly, PBGC may still attach and perfect liens against other members of the controlled group since all members of the controlled group are jointly and severally liable for termination liability. 29 U.S.C. § 1362(a).

PBGC also imposes a termination premium of $1,250 per participant per year for three years on plans that are terminated in a distress or involuntary termination. 29 U.S.C. § 1306(a)(7)(A), (C). When a plan is terminated in bankruptcy, the premium becomes due after the bankruptcy discharge, so bankruptcy courts may not discharge these debts. *Pension Benefit Guar. Corp. v. Oneida Ltd.*, 562 F.3d 154 (2d Cir. 2009).

Collectively Bargained Plans

Defined benefit pension plans are sometimes maintained pursuant to the terms of a collective bargaining agreement between a debtor and a union representing its employees. If a debtor's plan is subject to the terms of a CBA, the debtor may not proceed with a distress termination without obtaining the agreement of the union. 29 U.S.C. § 1341(a)(3). Alternatively, the debtor may seek to reject the CBA as an executory contract through the special process set forth in 11 U.S.C. §1113 under which the debtor must meet with union representatives to negotiate an agreement on modifications to the CBA in good faith.

PBGC may proceed with an involuntary termination of a pension plan regardless of any applicable collective bargaining obligations.

Partial Termination

Even if a debtor's defined benefit plan is not terminated during the bankruptcy process, a workforce reduction as part of the Chapter 11 restructuring may inadvertently trigger a partial termination of the plan if more than 20% of participants are terminated during the restructuring. Partial termination is also a concern for defined contribution plans. When a partial plan termination occurs, participants who terminated (either voluntarily or involuntarily) during the plan year in which the termination took place must be 100% vested in their benefits under the plan. 26 U.S.C. § 411(d)(3).

Defined Contribution Plans

Account-based defined contribution plans such as 401(k) plans avoid the potential underfunding issues that befall defined benefit plans. Defined contribution plans are always fully funded because participants bear the investment risk, not the plan sponsor. For this reason, defined contribution plans are not insured by PBGC. However, a debtor in Chapter 11 bankruptcy must still determine the treatment of its 401(k) plan and be mindful of a few different issues that could arise, including the potential partial termination issue described above.

As an initial matter, amounts that an employer withholds from employee wages as contributions to a defined contribution plan are excluded from the bankruptcy estate and are not subject to the claims of creditors. First-day wage motions filed with the bankruptcy court will generally include approval to contribute previously withheld amounts to the 401(k) plan.

A debtor sponsoring a 401(k) plan may either continue or terminate the plan during the Chapter 11 restructuring process. To the extent a debtor decides to continue a 401(k) plan, the debtor may wish to eliminate any employer matching or profit-sharing contribution.

Terminating a defined contribution plan is more straightforward than terminating a defined benefit plan, and the process is substantially the same during bankruptcy as it is outside of bankruptcy. Broadly, the debtor must:

- Take whatever formal action is required to terminate the plan (i.e., a board or committee resolution)
- Amend the plan to stop employees' elective deferrals and vest all employer contributions
- Communicate the details of the termination to participants and other affected parties

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- Distribute all assets to participants and beneficiaries (certain procedures should be followed to locate missing participants to ensure that all assets are distributed)

- Obtain a determination letter from the IRS

- File a final Form 5500

Non-Qualified Retirement Plans

Unlike qualified retirement plans, non-qualified plans are generally unfunded and subject to the claims of creditors in bankruptcy. Sponsors of non-qualified plans may set assets aside in a “rabbi trust” to help pay non-qualified plan benefits, but amounts in a rabbi trust are treated as general assets of the plan sponsor in bankruptcy and are subject to the claims of creditors like any other assets of the company. Participants in non-qualified retirement plans therefore become general unsecured creditors of the debtor when their employer files for bankruptcy, and they must file a claim with the bankruptcy court for any benefits they are owed.

Health and Welfare Plans

Active Health Coverage

As with retirement plans, debtors may choose whether to continue or terminate health coverage for active employees, either in its current form or through less expensive or reduced coverage options. The requirements of the Patient Protection and Affordable Care Act (ACA) still apply after a bankruptcy restructuring. If, after restructuring, the debtor will be considered an “applicable large employer” as defined in the ACA, the debtor will be required to provide affordable health coverage meeting certain basic standards to its full-time employees or be subject to penalties. Accordingly, terminating health coverage altogether may not be a realistic option for many debtors with continued operations.

Restructuring debtors should also consider potential obligations under the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA) arising from bankruptcy. Bankruptcy in and of itself is not a qualifying event under COBRA for active employees, but in connection with a bankruptcy filing, changes to the company's workforce (such as layoffs or reductions in hours) could result in COBRA-qualifying events.

Retiree Health Coverage

Expenses for retiree health care can be significant for many employers facing bankruptcy. Although a debtor may be economically incentivized to reduce expensive retiree health benefit costs, the Bankruptcy Code contains special protection for retiree health benefits. Section 1114 of the Bankruptcy Code limits a debtor's ability to terminate or modify retiree health benefits without a court order or an agreement with an authorized representative of the retirees. 11 U.S.C. § 1114.

The statute sets forth a process through which a debtor may propose modifications to retiree health coverage to a representative of the retirees and negotiate in good faith to reach an agreement. Should that process fail, a court may order modification of retiree health benefits only when the retirees’ representative refused to accept the proposal without good cause, and the modification is necessary to permit reorganization of the debtor and assures that all creditors, the debtor, and all of the affected parties are treated fairly and equitably.

A debtor seeking to change or terminate retiree health benefits must also be mindful of its COBRA obligations to retirees. Commencement of a bankruptcy proceeding is not a COBRA-qualifying event for active employees. However, retirees will have a qualifying event if they experience a “substantial elimination of coverage” within one year of the bankruptcy. 29 U.S.C. § 1163; Treas. Reg. § 54.4980B-4 Q/A1(c).

Substantial elimination of retiree medical coverage may entitle a qualified beneficiary to COBRA coverage for life—a significant extension from the normal COBRA period—and the coverage may not be terminated if the beneficiary becomes entitled to Medicare. These COBRA rights are only applicable, however, if the debtor or any entity in its controlled group continues to offer group health plan coverage. If all group health plan coverage within the controlled group is terminated, the debtor will not be required to offer COBRA coverage to retirees who lose coverage in connection with the bankruptcy proceeding.

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Retirees between ages 55 – 64 receiving benefits from a defined benefit pension plan that has been taken over by PBGC may also be eligible for a federal Health Coverage Tax Credit to offset the cost of health coverage. The HCTC has been extended through 2020, and it may be extended again in the future. 26 U.S.C. § 35.

Health and Welfare Employee Benefits in a Section 363 Sale of Assets

Section 363(f) of the Bankruptcy Code provides a mechanism through which substantially all of a debtor's assets may be sold in a bankruptcy court-approved transaction, free and clear of all liens, claims and encumbrances. In a Chapter 11 proceeding, this may be a faster and less complicated alternative to traditional restructuring. As a result, many Chapter 11 bankruptcy proceedings result in Section 363 sales. After the sale, the debtor's remaining assets in the bankruptcy estate are liquidated and the proceeds of the liquidation and sale are used to pay claims of creditors.

A buyer may purchase a debtor's assets free and clear of any benefit liabilities, including defined benefit pension plan liability, but it then must determine how to provide benefits to any continuing employees, potentially on a very short timeline. A buyer may not already have benefit plans in place in which the debtor's continuing employees can participate, and some buyers may consider choosing to take on the liability of the debtor's existing benefit plans depending on what the transaction's diligence process reveals. Alternatively, a buyer may look to establish new benefit plans quickly following the sale.

Retiree Health COBRA Liability in a Section 363 Sale

A Section 363 sale functions similarly to an asset sale outside of bankruptcy, and many of the same benefits issues arise. The asset sale will trigger a termination of employment for any of the debtor's employees that will transition to the new entity, which may cause those employees to lose coverage under the debtor's health plan and incur a COBRA-qualifying event. Generally, the obligation to offer COBRA will be the debtor's, unless the debtor terminates all of its group health plans, which may happen in a post-sale liquidation. When the debtor terminates all of its health plans in connection with the asset sale, the buyer must offer COBRA coverage if it is considered a "successor" employer.

Although an asset sale under 11 U.S.C. §363 is "free and clear" of all liabilities, the COBRA regulations indicate that a buyer may still be a successor employer in an asset sale in a Chapter 11 bankruptcy proceeding. Treas. Reg. § 54.4980B-9, Q/A-8(c)(1). To address this potential issue, the parties in a Section 363 asset sale that is intended to be "free and clear" should consider requesting that the bankruptcy court make clear in its order that the sale is free and clear of all liabilities, including COBRA claims.

Defined Benefit Pension Plans in a Section 363 Sale

If the debtor has an underfunded single employer defined benefit pension plan, a buyer is unlikely to assume that liability. After the sale, the debtor could either continue the plan or it may be terminated by the bankruptcy estate in a distress termination or by PBGC in an involuntary termination, as described above. PBGC would then have a claim against the bankruptcy estate in the proceeding liquidating the remaining assets. This would likely be a general unsecured claim because the automatic stay prevents new PBGC liens from attaching in bankruptcy, and the buyer would purchase the assets free and clear of PBGC's claims. PBGC's claim may then be liquidated in the post-sale disposition of the bankruptcy estate.

Defined Contribution Plans in a Section 363 Sale

If the debtor has a 401(k) plan that the buyer does not assume, the plan must be terminated by the bankruptcy estate, and distributions must be made to participants. If the buyer has an existing 401(k) plan or intends to establish one, it may consider accepting rollovers of account balances and/or outstanding plan loans for continuing employees if buyer's plan permits such rollovers.

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