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2013 Expert Series

What Trustees in Bankruptcy Need to Know About Pension Plans

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On September 18, 2013, PenChecks Trust hosted "What Trustees in Bankruptcy Need to Know About Pension Plans," an online seminar as part of its 2013 Expert Series. The session featured leading ERISA attorney Marcia Wagner, Esq., Managing Director, Wagner Law Group and PenChecks' Chief Compliance Officer, Mike McWherter in discussion of relevant and trending issues regarding liabilities and responsibilities in qualified plan terminations.

This expert paper authored by Marcia Wagner augments the webinar discussion with coverage of issues, trends, and information for trustees dealing with abandoned or terminated plans.

To watch the webinar reply and learn more about the PenChecks Trust 2013 Expert Series, please visit www.penchecks.com/webinars.aspx.

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What Bankruptcy Trustees Need to Know About Pension Plans

by Marcia S. Wagner, Esq.

ERISA Fiduciary Duties Imposed on Bankruptcy Trustee

The Employee Retirement Income Security Act of 1974, as amended ("ERISA"), contains powerful safeguards for plans that can even impact bankruptcy trustees. Generally speaking, ERISA imposes the highest fiduciary standards known to the law on any employer sponsoring a private pension or retirement savings plan as well as any other person acting in a fiduciary capacity. Ordinarily, the plan sponsor serves as the fiduciary with primary oversight responsibilities for the plan. However, when an employer commences bankruptcy proceedings in a Chapter 7 filing, the bankruptcy trustee steps into the "fiduciary shoes" of the plan sponsor.

Although a bankruptcy trustee's core function is to take possession of and liquidate the assets of the debtor-employer for the benefit of its creditors, the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 added several new duties to Chapter 7 trustees, including a new plan-related duty under Section 704(a)(11) of the U.S. Bankruptcy Code (the "Code"). Under this rule, a bankruptcy trustee must serve as the plan's "administrator" as defined under Section 3(16) of ERISA. The term "administrator" may sound innocuous, but under ERISA, the plan's fiduciary administrator is charged with many key fiduciary responsibilities by operation of law. For this reason, the position of the U.S. Department of Labor (the "DOL") is that a bankruptcy trustee is a fiduciary and subject to the requirements of ERISA when it unwinds a plan.

Conflict between ERISA and Bankruptcy Code

There are some "big picture" conflicts that arise for the bankruptcy trustee under ERISA and the Code. As an ERISA fiduciary, the bankruptcy trustee owes a duty of loyalty to the participants. (This is somewhat ironic, because the plan and its assets are actually carved out of the bankruptcy estate.)[1] On the other hand, under the Code, the bankruptcy trustee has a duty to manage and liquidate the assets of the estate for the beneficiaries of the estate, meaning the creditors and the debtor.

ERISA and the Code impose potentially conflicting duties on the trustee, and it is important for bankruptcy trustees to keep in mind how they "incentivize" the trustee to obey the law in 2 radically different ways. ERISA would impose personal liability for any fiduciary breaches committed by the bankruptcy trustee. In addition to personal liability, the DOL may impose a 20% civil penalty and the Internal Revenue Service (the "IRS") may assess punitive excise taxes on any prohibited transactions committed by the trustee.[2]

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[1] Under Code Section 541(b)(7), plan assets are specifically exempt from a debtor-employer's bankruptcy estate.

[2] ERISA Section 502(l); Section 4975 of the Internal Revenue Code of 1986, as amended ("IRC").

In contrast to ERISA whose rules are designed to keep fiduciaries accountable for their actions on an ongoing basis, the Code reflects the policy goal of preserving the bankruptcy trustee. Of course, a bankruptcy trustee would be held accountable for its negligence or gross negligence, as applicable. However, the bankruptcy court routinely provides immunity and liability protection for acts that are specifically authorized by the court.[3]

DOL's Position in Bankruptcy Court

The DOL has become active in recent years in bankruptcy proceedings. In many instances, once it receives news of a Chapter 7 bankruptcy, the DOL will send an information letter to the bankruptcy trustee. The standard DOL letter includes a reminder that the trustee now has fiduciary duties to the debtor-employer's plan, and that it is also subject to personal liability for any fiduciary violations of ERISA.

The DOL takes the position that the plan should always be able to recover against a fiduciary in the event of a fiduciary breach. The DOL is aware of the fact that bankruptcy courts routinely provide judicial immunity to trustees for any specific acts that are authorized by the court. Such immunity gives trustees an incentive to seek the court's authorization for every specific act involved in a plan termination. In order to stop the court from shielding trustees in this manner, the DOL will intervene in bankruptcy court proceedings, in objection to the court's approval of specific acts. And even though it is customary for bankruptcy courts to rule that the trustee has fulfilled all of its duties at the conclusion of the proceedings and provide a general release from liability, the DOL will object if the court attempts to provide a release from any ERISA liability.[4]

Plan Termination and Potential Fiduciary Liability

As discussed, when a bankruptcy trustee steps into the shoes of a plan sponsor, it becomes subject to ERISA's fiduciary standards. It is also subject to personal liability for any losses sustained by the plan as a result of its fiduciary breaches. As a practical matter, the trustee's liability risks are heightened when a plan is terminated. Once assets are liquidated and distributed to the plan's participants, it becomes almost impossible to make any corrective adjustments to participants' benefits. And so, if contributions or expenses are incorrectly allocated to participant accounts, any dissatisfied participants would have little recourse against the plan once it has been liquidated, and they would most likely go after the responsible fiduciary (*i.e.*, the bankruptcy trustee).

To minimize the risk of any personal liability under ERISA, bankruptcy trustees should take their fiduciary duties seriously and educate themselves on ERISA's requirements. A plan's fiduciary "administrator" has a general duty to ensure that the plan maintains its tax-qualified status, and it must also ensure that the plan's annual information returns are properly filed on the Form 5500. A plan needs to satisfy a myriad of requirements in order to remain tax-qualified, including nondiscrimination testing and required disclosures for participants. And so, bankruptcy trustees should perform some basic due diligence whenever they take over a plan.

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[3] <u>LeBlanc v. Salem</u> (<u>In re Mailman Steam Carpet Cleaning Corp</u>.), 196 F.3d 1 (1st Cir. 1999).
[4] See, *e.g.*, <u>In re AB & C Group, Inc.</u>, 411 B.R. 284 (Bankr. N.D.W. Va. 2009).

The plan termination process is a complex one, and both the IRS and DOL will often examine a plan's level of compliance during or through the termination process.

Plan Documentation Considerations

Under ERISA, a plan must be operated in accordance with its plan document. To terminate a plan, the plan's governing document must be amended beforehand. Specifically, a formal resolution must be adopted to terminate the plan. Additionally, for a plan to remain qualified when it is terminated, the plan document must be updated to include all required provisions under the Internal Revenue Code and IRS rules as of the termination date. This requirement to update the plan document is in addition to all the other required amendments that should have been made to update the plan document in the past.

Since the IRS is constantly issuing new rules in this area, plan documents are typically amended numerous times in order to adopt the required amendments. The bad news is that if a required amendment was missed (or if it was adopted after an IRS deadline), the plan has a qualification failure. The good news is that the IRS has an amnesty program for late amendments under the Employee Plan Compliance Resolution System ("EPCRS"). To obtain formal assurance that the plan document as amended is in full compliance with the law, a filing may be made with the IRS on Form 5310, requesting a favorable determination letter during the plan termination process. However, because it often takes 12 to 18 months to receive a favorable determination letter, many bankruptcy trustees will take their chances and terminate the plan without applying for an IRS determination letter. Due to the complexity of this area, any bankruptcy trustee acting as a plan's fiduciary "administrator" for ERISA purposes should be sure to discuss these issues with the plan's document provider and ERISA counsel before proceeding.

Form 5500 Considerations

As tax-exempt entities, benefit plans do not have to file income tax returns. However, benefit plans generally must file annual information returns on the Form 5500. If the plan is a "large plan" for purposes of the 5500 reporting rules, which typically means that it has at least 100 participants, audited financials must also be included with the filing. Consistent with the DOL's position that a bankruptcy trustee is a fiduciary "administrator" for ERISA purposes, the trustee must approve and sign the Form 5500 under penalty of perjury. For this reason, the bankruptcy trustee should work closely with the plan's providers and get comfortable with the content of the Form 5500.

Form 5500 filings must continue to be filed annually until the plan's assets have been fully distributed. Since there is usually a gap between the plan's formal termination date and the final liquidation date, a Form 5500 typically needs to be filed after the year of plan termination. When the final Form 5500 is filed, the DOL will routinely check to see if the plan's historical filings have been filed on a timely basis. If any historical 5500 filings were made incorrectly or missed, a corrective filing may be made under the DOL's amnesty program, the Delinquent Filer Voluntary Compliance Program (the "DFVCP"). Once again, because of the technical aspects of this area of the law, trustees should consider consulting ERISA counsel if they believe a 5500 compliance problem exists.

Participant Considerations

A plan is liquidated by making a final distribution to the plan's participants. Participants automatically become fully vested in their accounts when a plan is terminated, and they must also receive notice that the plan is being terminated and liquidated. Unless there is an application for an IRS determination letter, there is no rigid deadline for providing notices to participants. However, it would be prudent to provide adequate notice to participants reasonably in advance of the plan's scheduled termination date.

Participants typically have the following 2 distribution options from a terminating plan: (1) a lump sum cash distribution, or (2) a rollover distribution to an individual retirement account ("IRA") or another tax-qualified plan. The bankruptcy trustee should ensure that reasonable efforts are made to locate any missing participants that cannot be located, which may include using a letter-forwarding or a private locator service.

Under applicable DOL guidance, the accounts of missing participants may be transferred to automatic IRAs established on their behalf.[5] The use of automatic IRAs for this purpose basically follows the same DOL rules used to allow automatic rollovers for small balances ($5,000 or less), except that larger balances may also be rolled over in the case of missing participants. In any event, the accounts for all missing participants must be identified and distributed. Under the relevant IRS rules, the plan's assets must be fully distributed within 12 months after the date of plan termination.[6]

DOL's Abandoned Plan Program

Plans may be abandoned for any number of reasons, but in many instances they are abandoned by a small employer after a significant business event, such as a bankruptcy or a corporate transaction. In recognition of the fact that third parties ordinarily do not want to service any abandoned plans, the DOL has created the Abandoned Plan Program (the "Program"). Created in 2006, the Program provides a voluntary, safe and streamlined process that a third party can use to wind up the affairs of an abandoned 401(k) plan or any other defined contribution plan. It provides limited fiduciary relief, so that the third party cannot be held liable for certain types of compliance defects that are commonly found in abandoned plans. And the Program's rules are designed to simplify the termination process, reducing the administrative burdens and costs associated with terminating a plan.

Under the DOL's Abandoned Plan Program, the third party that is willing to take on the abandoned plan and administer its termination must assume the role of a qualified termination administrator ("QTA") for purposes of the applicable DOL regulations.[7] The QTA must be a qualifying financial institution, such as a bank or trust company, and it must follow specific procedures established under the Program. For example, it must contact the DOL prior to and after it winds up the affairs of the abandoned plan. It must also update the plan's records, and notify participants that the plan is being terminated.

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5 DOL Field Assistance Bulletin 2004-02.

6 Revenue Ruling 89-87.

7 29 C.F.R. 2578.1.

The Program provides special fiduciary relief for distributions to missing participants. Thus, the QTA cannot be held responsible for any losses incurred when the accounts of missing participants are rolled over to automatic IRAs. The Program also provides fiduciary relief for Form 5500 filings. The QTA does not have to make a 5500 filing for the year of termination or confirm any prior years' filings. At the end of the winding-up process, the QTA only needs to file a Summary Terminal Report, a form which is must simpler than a full-blown 5500. In addition, the QTA is not obligated to update the plan document or otherwise arrange for the adoption of any required plan amendments. The Program also gives the QTA a special exemption from ERISA's prohibited transaction rules, which gives the QTA the ability to use plan assets to pay its own compensation for the services rendered to terminate the plan.

Program Availability to Bankruptcy Trustees?

When practitioners first heard about the DOL's Abandoned Plan Program, many thought that this Program would be the perfect solution for plans abandoned in connection with a liquidation bankruptcy. Unfortunately, back in 2006 when the Program was initially launched, the DOL took a contrary position. From the DOL's perspective, since a bankruptcy trustee has the obligation to serve as the fiduciary "administrator" of the plan under the U.S. Bankruptcy Code, the plan has not actually been abandoned.[8] And so, under the current rules of the Program, bankruptcy trustees are not able to serve as QTAs, and they do not qualify for any of the fiduciary relief available to QTAs under the Program. In fact, on a number of occasions where the bankruptcy court has tried to approve the use of the Abandoned Plan Program, the DOL has interjected itself into the court's proceedings, and held that bankruptcy trustees are not permitted to serve as QTAs under the Program.[9]

DOL's Proposal to Expand Program Eligibility

The good news is that the DOL has finally changed its mind. In December 2012, the DOL issued proposed regulations that would amend and expand its Abandoned Plan Program to allow Chapter 7 bankruptcy trustees. If adopted, the new rules would give a bankruptcy trustee the ability to serve as a QTA that will terminate the debtor-employer's plan. As proposed, a plan would automatically be considered "abandoned" on the date the bankruptcy proceedings commence. The trustee itself may serve as a QTA and wrap up the affairs of the plan directly, or it may appoint a designee (which must be a qualifying financial institution) to serve as the QTA.

In either case, the bankruptcy trustee may determine the reasonable compensation for itself and/or its designee for the QTA-related services provided, and such compensation may be paid from the plan's assets. If there are any delinquent contributions to the plan, the bankruptcy trustee would have a duty to try to collect such monies if it makes financial sense to pursue such claims. The trustee would also have a general duty to report any evidence of breaches

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8 Preamble to DOL's "Abandoned Plan Program" regulations at 71 FR 20820 (April 21, 2006).

9 For example, the DOL's *2012 ERISA Litigation and Significant Issues in Litigation* posted on its website indicates that the DOL negotiated an out-of-court settlement, dated August 17, 2012, arising from its investigations into bankruptcy trustees attempting to qualify the Bio-Med Plus 401(k) Plan, First NLC 401(k) Plan, and Pharmed Group 401(k) Plan for the Abandoned Plan Program.

committed by a prior plan fiduciary (such as embezzlement by the plan sponsor) to the DOL. The trustee would have no other duty with respect to breaches by prior plan fiduciaries, other than this reporting obligation or pursuing delinquent contributions when if makes financial sense to do so.

Suggested Best Practices: Fee-Related Restrictions

The use of plan assets to pay a service provider's fees is permitted under ERISA, but numerous restrictions apply. First, a fiduciary can never use plan assets to pay its own fees. If a bankruptcy trustee were to authorize the plan's payment of its own compensation for plan-related services, the trustee would be viewed as engaging in an impermissible act of fiduciary self-dealing. Unless the proposal to expand the Abandoned Plan Program is actually adopted, bankruptcy trustees should not use plan assets to pay themselves. Plan assets may only be used to compensate third party providers.

Second, to determine if third party fees may be paid from the plan, the fee-related terms of the plan document should be reviewed. Typically, the plan document will specifically address the extent to which plan assets may be used to pay for a third party provider's fees. Furthermore, as a matter of law, only reasonable compensation for services that are necessary for the administration of the plan may be charged to the plan.[10] Thus, in accordance with the DOL's longstanding guidance on evaluating a provider's services and compensation, before approving the payment of any plan fees, a trustee should always consider (1) the qualifications of the provider, (2) the quality of the services provided, and (3) the reasonableness of the provider's fee, taking into account the prevailing fee rates in the marketplace.[11]

Suggested Best Practices: Specialized Providers

As discussed, under the current DOL rules, a bankruptcy trustee should not try to pay itself from plan assets. However, it may authorize the payment of a third party provider's fees. Thus, as a practical matter, trustees should strongly consider hiring a third party provider to administer the termination of the debtor-employer's plan. Bankruptcy trustees should consider engaging a specialized provider that routinely handles abandoned plans, to ensure that all relevant compliance requirements are satisfied. Even though a bankruptcy trustee cannot currently utilize the DOL's Abandoned Plan Program, it may make sense to hire a third party provider with QTA-abilities, since this will ensure that the provider has experience with missing participants and can handle any other termination-related issues.

Because of the plan documentation requirements, bankruptcy trustees should also consider engaging qualified ERISA counsel. If there are any plan document or 5500 problems, ERISA counsel can provide assistance with the necessary filings under the relevant amnesty programs. The plan's existing third party administrator or TPA can also provide assistance. However, when bankruptcy trustees take over plans, in many cases, they will find that the plan's TPA has

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[10] ERISA Section 404(a)(1)(A)(ii).

[11] See, *e.g.*, DOL Information Letters to D. Ceresi (February 19, 1998) and to T. Konshak (December 1, 1997).

resigned because the employer wasn't able to pay the TPA's fees. Often times, the TPA has vital historical information, so it is important to have some level of contact with the plan's TPA. For example, it may make sense to ask the TPA simply to provide certain missing information, and not engage the TPA to provide termination-related services.

Suggested Best Practices: Timing

It is important for bankruptcy trustees to prioritize the winding down of the employer's plan as early as possible in the process. As discussed, there are a lot of compliance matters that need to be addressed before a plan can be terminated, and if any compliance defects are identified, additional time will need to be budgeted to resolve them. For example, if it is discovered that a required plan amendment was missed, it may take several months to correct the problem under the IRS amnesty program. It is also important to keep in mind that if the plan has not been officially terminated, there is nothing to stop participants from cashing out and taking distributions from the plan at will. If the termination of the plan is delayed for too long and only a few participants remain in the plan, it may become difficult to justify charging all of the plan's termination expenses against the remaining participant accounts. Accordingly, it is important to commence the termination process as quickly as practicable. This strategy would also help the plan's providers, by giving them more time to research missing participants and also transition their accounts.

In terms of timing, bankruptcy trustees should also be sure to check on the status of the DOL's proposal to expand its Abandoned Plan Program. According to the DOL's most recent regulatory agenda, the Program is scheduled to be formally amended in January 2014. Once the amended Program has been implemented by the DOL, bankruptcy trustees should strongly consider taking advantage of the fiduciary relief available to QTAs.

Suggested Best Practices: Bankruptcy Court Approval

When it comes to the intersection of ERISA and the U.S. Bankruptcy Code, the law is murky and the jurisdictional issues with the DOL are still evolving. The DOL seeks to preserve ERISA's fiduciary liability scheme, and it clearly wants to ensure that bankruptcy trustees remain accountable for any fiduciary breaches. However, bankruptcy trustees have a natural incentive to seek the court's approval of any specific actions taken in connection with the plan termination, since it provides immunity and liability protection for the trustee. Although there can be no assurance that the DOL will not intervene, as a practical matter, the risk of DOL intervention in bankruptcy proceedings can be reduced if the trustee seeks the bankruptcy court's general approval for plan termination and its selection of third party providers as early as possible and <u>before</u> the plan is terminated. If a trustee were to seek the court's approval <u>after</u> the plan has been terminated for specific actions taken, it is likely that the DOL will view this as an attempt to limit the trustee's ERISA liability after the fact. As discussed, the DOL's position is that this type of liability release is not permissible under ERISA.

Bankruptcy trustees are placed in an uneasy position in light of ERISA's statutory framework. The fiduciary duties imposed on them are complicated, and the DOL's policy is to ensure the trustee remains personally liable for any and all fiduciary breaches. But the good news is that the trustee can rely on third party providers and experts to help them unwind the plan. They should prioritize the plan's termination as early as possible in the process, and they should work with qualified providers that have experience in liquidating abandoned plans.

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