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BAP Agrees: No Bankruptcy for Puerto Rico Church Pension Plan

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On April 18, 2019, in *In re Catholic School Employees Pension Trust (Abreu, et al. v. Catholic School Employees Pension Trust)*,[2] the First Circuit Bankruptcy Appellate Panel (BAP) upheld the dismissal of the bankruptcy petition of the pension plan for employees of the schools of the Archdiocese of Puerto Rico. The case has been closely watched by the employee benefits and bankruptcy communities, and by those working to help Puerto Rico regain its footing. The case illustrates defined benefit plans' struggles to find solutions to declining membership and unsustainable benefit promises.

The BAP held that the Catholic School Employees Pension Trust was not a "business trust" eligible to file a bankruptcy petition. This decision could affect other troubled church plans that might be considering bankruptcy as an option and that would face the same gating issue under the Bankruptcy Code.

Church plans are exempt from coverage under the Employee Retirement Income Security Act of 1974, as amended (ERISA). ERISA has its own insolvency regime, so the BAP decision should not affect ERISA-covered plans. Government plans are also exempt from coverage under ERISA, but the BAP decision should not affect government plans, as the adjustment of benefits is possible in the bankruptcy of the sponsoring governmental unit.

Nevertheless, the decision raises policy concerns that cut across various pension and retirement programs. For example, Puerto Rico's public pension system is one of several Puerto Rico governmental units that is restructuring under special enabling legislation. This case could be a bellwether on whether the pension promise can be broken, as the *Detroit* bankruptcy was a few years ago. Similarly, Pension Benefit Guaranty Corp. (PBGC)-covered multiemployer plans might suspend benefits to avoid insolvency, and Congress is considering reforms in that area.

ERISA Minimum Requirements and ERISA-Exempt Plans

ERISA generally requires defined-benefit pension plans to provide "nonforfeitable" or vested benefits after five years of service and protects accrued benefits through the "anti-cutback rule." It requires employers to fund promised benefits through annual contributions designed to cover current accruals and to pay off unfunded benefits over time. Finally, ERISA establishes the PBGC as a backstop if a covered plan terminates without enough assets to cover all benefit liabilities (or, in the case of a multiemployer plan, without enough assets to meet current benefit obligations).

ERISA exempts government plans and church plans, but there are sound policy reasons for these exemptions. State and local government plans are supported by taxpayers and do not need a federal backstop. In addition, Congress did not want the federal government poring over the books and records of religious institutions.

The *Catholic School Employees Pension Trust* Bankruptcy

The Catholic School Employees Pension Trust filed for chapter 11 reorganization in the U.S. Bankruptcy Court for the District of Puerto Rico in 2018. According to the testimony, employer participation had declined steeply, as 43 of 76 schools had closed and simply "disappeared."[3] Asserting that the pension plan had terminated, the trustees stopped making benefit payments and stopped collecting contributions, except for accounts receivable.

Hundreds of participants sued to recover unpaid benefits. The Catholic School Employees Pension Trust filed for bankruptcy to obtain a "breathing spell," intending to eventually make an "equitable" division of plan assets among participants.[4]

Three of the named plaintiffs moved to dismiss the bankruptcy, asserting that the Catholic School Employees Pension Trust is not a "business trust" as meant by § 101(9)(A)(v) of the Bankruptcy Code and therefore is not eligible for bankruptcy protection under § 109 of the Bankruptcy Code. In support of their motion, they asserted that the Catholic School Employees Pension Trust was "not created for a business purpose," had "no ongoing income generating activities," and "prohibit[ed] the transferability of ... beneficial interests."[5]

As is typical of pension trusts, the Catholic School Employees Pension Trust's income was derived from employer contributions and invest-

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2 BAP P.R. 18-011, 2019 WL 1747250 (Bankr. App. 1st Cir. April 18, 2019).

3 *Id* .at 5.

4 *Id.* at 1.

5 *Id.* at 2.

ment earnings. Again, as is typical, the Catholic School Employees Pension Trust instrument authorized the trustees to invest in various classes of securities and other property, enter into contracts, and employ professionals, and conferred other customary trustee powers. It provided that the fund was to be used for the exclusive benefit of participants and beneficiaries; permitted termination on notice by the settlor (the superintendent of Schools for the Archdiocese); and, upon termination, provided for the liquidation and distribution of plan assets among participants and beneficiaries and for a return of plan assets to employers, but only if a surplus remained after all liabilities had been satisfied.[6]

The threshold issue was whether the Catholic School Employees Pension Trust was a "person" eligible to file for bankruptcy protection. The Bankruptcy Code authorizes a "person" and a "municipality" to file for bankruptcy protection.[7] A "person" includes a "corporation," and a "corporation" in turn includes a "business trust."[8] The bankruptcy court held that the Catholic School Employees Pension Trust was not a business trust, as it was "*not* conducting business activity but preserving the trust funds to allocate the same to the beneficiaries upon termination."[9] It therefore dismissed the case.

The BAP Opinion

The three-judge BAP affirmed. In an opinion by Chief Judge **Joan N. Feeney** of the U.S. Bankruptcy Court of the District of Massachusetts (who retired from the bench in May 2019), the BAP confirmed that trusts generally are not eligible for bankruptcy, and that only "business trusts" are eligible.

As the BAP opinion noted, courts have generally looked to federal law and to the trust instrument in deciding whether a trust is a business trust. Within the First Circuit, courts have proceeded from the premise that *inter vivos* and testamentary trusts are the province of probate courts, while trusts created to transact business and whose beneficiaries are investors are what Congress had in mind when it authorized a "business trust" to file for bankruptcy.[10] Courts in the First Circuit have been in the forefront, in large part because of the existence of the "Massachusetts business trust." Other circuits have developed a six-factor test, a "primary purposes" test and a simplified two-factor test.[11]

Two courts had held that pension trusts are not "business trusts," as they lacked transferable interests or outside investors, or business activities and business profits. By contrast, two courts had held that multiemployer health trusts were "business trusts," as they help employers reduce health care costs, a "tangible financial benefit" if not a "critical business arrangement."[12]

Noting that decisions are always fact-specific and based on the totality of the circumstances, the BAP adopted the simplified two-factor test from *Murphy v. Bernstein (In re Dille Family Trust)*.[13] Under that distillation, the trust must have been created "for the purpose of transacting business for a profit (as opposed to merely preserving a *res* for beneficiaries)," and it must have "all the indicia of a corporate entity" and thus be "more than a gratuitous or ordinary trust."[14]

Although the bankruptcy court had applied prior formulations, the BAP concluded that those formulations were consistent with the formulation in *Dille*, and that the bankruptcy court had made a fact-specific analysis based on the totality of the circumstances. After first disposing of an assertion that the lower court had looked only to the Catholic School Employees Pension Trust's "post-termination" activities, the BAP agreed that the Catholic School Employees Pension Trust was intended as a passive investment vehicle, and that while the trustees sought asset growth, their underlying purpose was to preserve the *res* so that they could pay benefits as they came due. The investment purpose was therefore "incidental."[15]

The BAP also agreed that the Catholic School Employees Pension Trust lacked corporate attributes, such as holding inventory or operating assets, and, more important, that the participants and beneficiaries were unlike investors with an expectation of a return on investment. So it was "more akin to a traditional trust," formed to "effect ... preserv[e], and protect ... a gift or contribution" rather than to a "profit-generating corporation."[16]

The Importance of the Decision

Unless the U.S. Supreme Court decides to hear *Catholic School Employees Pension Trust*, the decision will be the law in the First Circuit (Maine, Massachusetts, New Hampshire, Puerto Rico and Rhode Island). As it is extensively researched, well reasoned and written by a leading bankruptcy judge, it is also likely to be influential elsewhere.

As noted, troubled ERISA-covered defined-benefit plans have a PBGC backstop. For example, the sponsor of a single-employer plan can seek a "distress termination," whether the sponsor is in bankruptcy or not, by showing that the plan is unaffordable and the sponsor (and its "controlled group") would be forced out of business if they had to meet ERISA's funding requirements.[17] In bankruptcy, the court makes the determination; outside of bankruptcy, the PBGC does. A multiemployer plan must seek PBGC financial assistance when it runs out of money to pay benefits, usually when most employers have withdrawn and are unable to pay their withdrawal liability.[18]

However, this is not so for church plans or government plans. In *Advocate Health Care Network v. Stapleton*,[19] the Supreme Court held that the church plan exemption applies not only to plans covering church employees, but also to plans of entities closely associated with a church, such as hospitals and schools. The BAP noted that the Puerto Rico Supreme Court had determined that the "ecclesiastical plans exemption applies."[20]

6 *Id.* at 2-3.
7 11 U.S.C. § 109(a).
8 11 U.S.C. § 101(9)(A)(v).
9 *Catholic Sch. Employees Pension Tr.*, 2019 WL 1747250 at 11.
10 *Id.* at 14.
11 *Id.* at 16-19.
12 *Id.*
13 598 B.R. 179 (Bankr. W.D. Pa. 2019).
14 *Catholic Sch. Employees Pension Tr.*, 2019 WL 1747250 at 22.
15 *Id.* at 23-25.
16 *Id.* at 26.
17 *See* 29 U.S.C. § 1341(c).
18 *See* 29 U.S.C. § 1429(f).
19 137 S. Ct. 1652 (2017).
20 *Catholic Sch. Employees Pension Tr.*, 2019 WL 1747250 at 2, n.7.

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A church plan would not be subject to ERISA's vesting, anti-cutback or funding rules, although a court might apply contract or trust law to limit an attempt to cut benefits. More than 30 lawsuits are pending, challenging the church plan status of hospitals and health care systems. Several of them have settled, typically with an agreement to fund the plan for an agreed period as if ERISA applied, without any concession that it does apply.

Benefits under a government plan might be subject to state constitutional or statutory protections similar to the anti-cutback rule and, in some cases, more stringent. Municipalities might seek to adjust their debts under chapter 9 of the Bankruptcy Code, if state law permits it. In such cases, the Code might trump state law protections, which can promote compromise of benefit claims. Notably, in *In re City of Detroit*, an intensively negotiated adjustment plan included a 4.5 percent benefit cut and elimination of COLAs, among the concessions made by all stakeholders.[21]

However, a government plan itself is probably not eligible to file for bankruptcy protection. Only those governmental units that qualify as "municipalities" may do so (and then only if authorized by state law). In a 2012 decision on a question of first impression, the district court held that the pension plan for the Northern Marianas was a governmental unit but not a municipality, and, as such, was ineligible for bankruptcy protection. Recognizing the difficult policy issues, the court wrote:

> The trustees find themselves in an intolerable position. The Fund for which they are responsible is caught between an irresistible force — obligations to retirees which it cannot pay — and an immovable object — the government, which has persistently failed to pay its debt to the Fund. The trustees' attempt to find a solution to this dilemma is creative and praiseworthy even though it cannot succeed. Congress did not intend that the Bankruptcy Code could solve all problems, least of all the financial problems of governmental units.[22]

Conclusion

The First Circuit BAP's decision in *Catholic Schools Employees Pension Trust* reflects a reluctance to step into policy disputes over the funding of pensions or the adjustment of pension benefits. However, stakeholders would be well advised to take responsibility for these issues before it is too late, as bankruptcies sometimes call for desperate measures. The *City of Detroit* case serves as a warning, and the Puerto Rico public pension case will be closely watched. abi

21 15-CV-10036, 2015 WL 5697779, at 3 (E.D. Mich. Sept. 29, 2015), *aff'd*, 838 F.3d 792 (6th Cir. 2016).

22 *In re N. Mariana Islands Ret. Fund*, 12-00003, 2012 WL 8654317, at 3 (D. N. Mar. Is. June 13, 2012).

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