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EMPLOYEE BENEFITS IN BANKRUPTCY: UPDATE ON KEY ISSUES

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The Employee Retirement Income Security Act of 1974 (ERISA) codifies employee benefits law at the federal level and broadly preempts state law. For employee benefits issues in bankruptcy, therefore, ERISA generally provides the "underlying substantive law."[1] In some cases, the Bankruptcy Code overrides ERISA, in others Congress has harmonized the two bodies of law, and in others the relationship is unclear.

This article shows how ERISA interacts with the Bankruptcy Code in several areas: defined benefit pension plan termination and withdrawal and resulting claims, fiduciary duties in plan administration and termination, and an individual debtor's ability to protect retirement income from creditor claims. In addition, the article addresses how the Code treats top-hat plans, severance, and bonus arrangements.

Defined Benefit Pension Plans

Defined benefit pension plans provide lifetime benefits based on length of service. For salaried workers, compensation is also a factor, such as an annual benefit of 1.5% of final compensation per year of service. Plans for hourly workers may use a flat dollar amount per year of service or another measure, such as a percentage of contributions made for the worker's service.

Employers must fund defined benefit plans by making annual contributions equal to the present value of pension obligations incurred during the year and annual expenses (normal cost), plus amortization of unfunded past service obligations.[2] These obligations can be volatile, given the effect of interest rates on liabilities and market performance on assets, though Congress's recent extension of the amortization period from seven to fifteen years and other relief lessen the burden.[3] For collectively bargained multiemployer plans, the labor contract allocates the funding obligation among employers through a formula (such as a certain amount per hour worked).

The employer and all members of its controlled group are jointly and severally liable for minimum funding contributions to a single-employer plan, and for the other obligations discussed in this section. A controlled group consists of all corporations or unincorporated trades or businesses under common control. Specifically, this includes: a parent-subsidiary group (one or more chains of organizations connected through ownership with a common parent organization that owns, directly or indirectly, at least 80% of the other organizations); a brother-sister group (two or more organizations in which five or fewer individuals own at least 80% of each organization and more than 50% of each organization, taking into account each individual's ownership only to the extent it is identical across organizations); or a combined, parent-subsidiary/brother-sister group.[4]

Single-Employer Plans

If a single-employer defined benefit plan does not have enough assets to meet its benefit liabilities, the plan may be terminated in a distress termination initiated by the employer or in an involuntary termination initiated by the Pension Benefit Guaranty Corporation (PBGC). When an underfunded plan terminates, PBGC becomes its trustee and pays benefits at statutory levels.

A plan can terminate in a distress termination only if the sponsor and each controlled group member meets one of the statutory tests, including (a) liquidation in bankruptcy; (b) in a Chapter 11 case, if the court determines that "unless the plan is terminated, [the debtor] will be unable to pay all its debts pursuant to a plan of reorganization and will be unable to continue in business outside the chapter 11 reorganization process"; or, (c) outside bankruptcy, if PBGC determines that "unless a distress termination occurs, [the organization] will be unable to pay [its] debts when due and will be unable to continue in business."[5]

The second test "does not permit a distress termination simply because a particular plan [of reorganization] requires it; rather the test is whether the debtor can obtain confirmation of *any* plan of reorganization without termination of the retirement plan."[6] Other relevant factors include whether the debtor's projected cash flow will be adequate to support projected minimum funding contributions; the debtor has considered benefit freezes and other measures to reduce costs, trimmed other fixed costs, and identified discretionary spending; and the debtor can obtain exit financing or an equity infusion.

Courts have reached varying results when the exit loan or equity infusion is conditioned on plan termination.[7] Courts have also differed over whether the debtor may terminate all defined benefit plans, when it can afford one but not all of them.[8]

[1] Raleigh v. Illinois Department of Revenue, 530 U.S. 15, 24 (2000).

[2] See I. Goldowitz, *Defined Benefit Pension Issues Expected in the Next Wave of Bankruptcies*, 33 AIRA Journal 46, 47-48 (Nov. 1, 2020).

[3] The American Rescue Plan Act of 2021, § 9701 *et seq.*, Pub. L. No. 117-2, 135 Stat. 184-206 (2021).

[4] 29 U.S.C. § 1301(a)(14), (b)(1); 29 CFR § 4001.3, *incorporating by reference* 26 CFR § 1.414(c)-2(a), (b), (c).

[5] 29 U.S.C. § 1341(c)(2)(B)(ii)(IV), (iii)(I).

[6] In re US Airways Group, Inc., 296 B.R. 734, 743-44 (Bankr. E.D. Va. 2003) (emphasis in original).

[7] *Compare* In re Harry & David Holdings, Inc., No. 11-10884 (Bankr. D. Del. Aug. 8, 2011) (investors entitled to insist that they not be placed behind the plan), *with* In re Philip Servs. Corp., 310 B.R. 802, 808 (Bankr. S.D. Tex. 2004) ("existential financial realities" showed that "the pension terminations were not necessary even though they were desired by the [i]nvestor.").

[8] *Compare* In re US Airways Group, Inc., 365 B.R. 624 (Bankr. E.D. Va. 2007), *with* In re Kaiser Aluminum Corp., 456 F.3d 328 (3d Cir. 2006).

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To effect a distress termination under the second test, the debtor submits a motion to terminate the plan, typically with a declaration and documentary evidence showing that it meets the reorganization test. The PBGC may or may not object to the motion. But the termination cannot be completed if a collective bargaining agreement prohibits plan termination, which may lead to modification of the collective bargaining agreement.[9]

PBGC may initiate termination when the plan has not met the minimum funding standard, the plan will be unable to pay benefits when due, or PBGC's possible long-run loss with respect to the plan may reasonably be expected to increase unreasonably if the plan is not terminated.[10] Under the "long-run loss" criterion, PBGC has successfully terminated plans in advance of a controlled group breakup that would allow a strong company to escape liability and to curtail benefit accruals where the plan was inherently unsustainable.[11]

Usually, the plan administrator signs an agreement terminating the plan and appointing the PBGC as the statutory trustee. If termination is contested, PBGC can file suit in a United States district court to seek a decree terminating the plan and appointing the agency as the trustee.[12]

PBGC claims in bankruptcy are often among the largest. They typically are for the pension plan's unfunded benefit liabilities, unpaid minimum funding contributions, unpaid premiums, and termination premiums. Generally, the courts hold that these claims are not entitled to priority.[13]

Outside bankruptcy, the termination liability and minimum funding claims may have the status of a federal tax lien, which PBGC may perfect and enforce. Specifically, lien treatment applies to termination liability up to 30% of controlled group net worth and to unpaid minimum funding contributions when they exceed $1 million.[14] While the automatic stay prevents the liens from attaching to the debtor's property, the liens also attach to non-debtor controlled group members' property.[15]

The amount of the unfunded benefit liabilities claim is the value of the benefit liabilities under the plan determined as of the plan's termination date and based on PBGC assumptions, minus the value of plan assets as of that date. A PBGC regulation requires that liability values be based on annuity prices, which vary inversely with interest rates.[16] The regulatory interest assumption can have a substantial effect on the amount of the claim, and courts have differed over its applicability in bankruptcy.[17] Courts have also differed over whether the employer liability duplicates the claim for unpaid contributions.[18]

The termination liability claim is contingent on plan termination, and PBGC's right to pursue unpaid contributions is contingent on PBGC trusteeship of the plan.

The termination premium applies when there is an involuntary termination or a distress termination where the sponsor or at least one controlled group member meets the second or third distress test.[19] In bankruptcy, the termination premium arises only after discharge, so in a true reorganization, it represents a liability of the reorganized debtor.[20]

An employer considering bankruptcy should have its actuary calculate projected minimum funding contributions, including the effect of a freeze on benefit accruals if the plan is not yet frozen, the underfunding using ongoing plan assumptions, and the termination liability using PBGC assumptions.

The debtor will often seek permission to make pension contributions in a first-day order. Though the debtor may not be compelled to make contributions, maintaining the plan can help in retaining employees and preserving going concern value. It may also prevent an involuntary termination, which would dilute the claims of noncontingent creditors, the attachment of liens to the assets of non-debtor controlled group members, and the assessment of termination premiums against the reorganized debtor.[21]

If the plan has sufficient assets to fund all benefit liabilities, or nearly so, the debtor should consider closing the plan out in a standard termination, which may include a "top-up" contribution.[22] The cost of a standard termination depends on the price of closeout annuities or ERISA's minimum standards for valuing lump sum benefit payments, both of which are sensitive to interest rates.

The same is true of a distress or involuntary termination, as a termination liability claim is based on interest factors derived from quarterly annuity price surveys. For example, the PBGC "select" interest factor increased from less than 200 basis points to more than 500 basis points between 2021 and 2023, which would significantly decrease the value of liabilities. To the extent

[9] See 29 U.S.C. §§ 1113, 1341(a)(3).

[10] 29 U.S.C. § 1342(a)(1), (2), (4).

[11] PBGC v. FEL Corp., 798 F. Supp. 239 (D.N.J. 1992); In re UAL Corp. (Pilots' Pension Plan Termination), 468 F.3d 444, 451-52 (7th Cir. 2006).

[12] 29 U.S.C. § 1342(b)(1).

[13] E.g., In re Bayly Corp., 163 F.3d 1205 (10th Cir. 1998) (employer liability); In re Sunarhauserman, Inc., 126 F.3d 811 (6th Cir. 1997) (priority of minimum funding contributions limited to normal cost portion); In re Kent Plastics Corp., 183 B.R. 841 (Bankr. S.D. Ind. 1995) (premiums).

[14] 29 U.S.C. §§ 1083(k), 1368(a).

[15] 29 U.S.C. §§ 1362(a), 1368(a).

[16] *See* 29 U.S.C. § 1344; 29 CFR pt. 4044.41 et seq.

[17] *Compare* Pension Benefit Guaranty Corp. v. CF&I Fabricators of Utah, Inc., 150 F.3d 1293 (10th Cir.1998) (use of a "prudent investor" rate to discount liabilities), *with*, e.g., In re U.S. Airways Group, Inc., 303 B.R. 784 (Bankr. E.D. Va. 2003) (use of PBGC regulatory assumption required by bankruptcy choice of law principles); *accord*, In re Rhodes, Inc., 382 B.R. 550 (Bankr. N.D. Ga. 2008).

[18] *Compare* In re CF&I Fabricators of Utah, Inc., 16 Employee Benefits Cas. 1364 (Bankr. D. Utah Dec. 31, 1992) (employer liability claim reduced by probable collectible value of the contributions claim), *with* In re Finley, Kumble, Wagner, Heine, Underberg, Manley, Myerson & Casey, 160 B.R. 882, 893–894, (Bankr. S.D.N.Y. 1993) (reduction by collectible value only is at odds with bankruptcy policy of equality of distribution).

[19] 29 U.S.C. § 1306(a)(7); 29 CFR § 4007.13(a)(1).

[20] Pension Ben. Guar. Corp. v. Oneida Ltd., 562 F.3d 154 (2d Cir. 2009).

[21] That claim also runs against controlled group members. PBGC v. Asahi Tec Corp., 829 F.Supp.3d 118 (D.D.C. 2012).

[22] In either case, bargaining with the union will be required if the plan is maintained pursuant to a collective bargaining agreement.

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that the debtor controls the timing of plan termination, the debtor should consider the likely direction of interest rates.

PBGC is authorized to settle its claims, and it typically does. Often, the agency settles for a single allowed claim, with partial priority.

Multiemployer Plans

A multiemployer pension plan covers the employees of more than one unrelated employer and is collectively bargained.[23] PBGC does not take over failed multiemployer plans. Rather, multiemployer plans can restructure contribution and benefit obligations under ERISA, and if they do not succeed, PBGC provides special financial assistance to allow them to continue paying benefits at adjusted levels.[24]

ERISA imposes withdrawal liability on an employer who withdraws from a multiemployer plan, representing the employer's share of the plan's underfunding. An employer withdraws from a multiemployer plan when it permanently ceases to have an obligation to contribute under the plan or permanently ceases all covered operations under the plan. A partial withdrawal occurs when an employer has a 70% decline in contribution base units (for example, hours worked) or its obligation to contribute ceases under one but not all collective bargaining agreements or at one but not all facilities and it continues the same type of work on a non-contributory basis.[25]

Withdrawal liability is the employer's allocable share of unfunded vested benefits, subject to certain adjustments. Like plan termination liability, withdrawal liability is based on the difference between the present value of benefits (in this case, only those benefits that are vested), and the value of plan assets. And like termination liability, withdrawal liability is the obligation of all controlled group members.[26]

In bankruptcy, withdrawal liability is generally not considered a priority claim. The Second Circuit has held that withdrawal liability represents benefits already earned, and that the consideration is pre-petition labor. The Third Circuit has held, however, that the post-petition portion of the claim would be entitled to priority.[27]

As with termination liability, employers may challenge the valuation of liabilities if the plan's actuary uses conservative assumptions.[28] But PBGC assumptions are required if the plan has received special financial assistance from the PBGC.[29]

A withdrawal would not occur if the debtor assumes the collective bargaining agreement and emerges as a going concern. In that case, the withdrawal liability claim would remain contingent and should ride through the bankruptcy.[30]

Fiduciary Duties in the Administration and Termination of Pension and Welfare Plans

A bankruptcy trustee's core function is to take possession of and administer or liquidate the assets of the debtor-employer for the benefit of its creditors. The trustee is a fiduciary with respect to the estate.[31]

The trustee also succeeds to the debtor's rights and obligations.[32] When the debtor was the administrator of an ERISA plan, the trustee succeeds to the plan administrator's duties.[33] The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 (BAPCPA) codified that result for both the trustee and the debtor in possession.[34]

ERISA defines a fiduciary as a person or entity exercising "any discretionary authority or discretionary control respecting management" of a plan or "any authority or control respecting management or disposition of its assets."[35] A bankruptcy trustee or debtor in possession would succeed to the debtor's duties as plan administrator with respect to benefit payments, reporting and disclosure, investment of plan assets, and implementing a plan termination, among other things. Accordingly, the Labor Department takes the position that a bankruptcy trustee is a fiduciary and subject to the requirements of ERISA when it administers or terminates a plan.[36]

As an ERISA fiduciary, the trustee is subject to personal liability for any losses sustained by the plan as a result of a breach of its fiduciary duties.[37] The trustee also has standing as an ERISA fiduciary to sue other fiduciaries for breach of fiduciary duty on behalf of the plan.[38]

Any amounts withheld from employee wages for contribution to a plan that have not been transferred to the plan at the time of the bankruptcy filing are not property of the bankruptcy estate.[39] The trustee or debtor in possession has a fiduciary duty to segregate and transfer those assets to the plan and participant accounts.[40] Similarly, in an individual bankruptcy, amounts withheld from the debtor's employee wages for contribution to

[23] 29 U.S.C. §§ 1002(37), 1301(a)(3).

[24] 29 U.S.C. §§ 1085, 1432.

[25] 29 U.S.C. §§ 1383(a), 1385(a).

[26] 29 U.S.C. §§ 1301(b)(1), 1381.

[27] *Compare* Trustees of Amalgamated Ins. Fund v. McFarlin's, Inc., 789 F.2d 98, (2d Cir. 1986), *with* In re Marcal Paper Mill, Inc., 650 F.3d 311 (3d Cir. 2011).

[28] E.g., United Mine Workers of America v. Energy West Mining Co., 39 F.4th 730 (D.C. Cir. 2022), *cert. denied* 143 S. Ct. 1024 (2023). A PBGC proposed rule would permit the use of PBGC assumptions, among other approaches. Actuarial Assumptions for Determining an Employer's Withdrawal Liability, 87 FR 62316 (Oct. 14, 2022).

[29] 29 U.S.C. § 1432(m); 29 CFR § 4262.16(g).

[30] CPT Holdings v. Indus. & Allied Employers Union Pension Plan, 162 F.3d 405 (6th Cir. 1998).

[31] *See* In re NSCO, Inc., 427 B.R. 165, 174 (Bankr. D. Mass. 2010), *citing* Hartford Underwriters Ins. Co. v. Union Planters Bank, N.A., 530 U.S. 1, 12, (2000).

[32] *See* Hays and Co. v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 885 F.2d 1149, 1154–62 (3rd Cir.1989).

[33] *See* In re New Ctr. Hosp., 200 B.R. 592, 593 (E.D. Mich. 1996).

[34] 11 U.S.C. §§ 521(a)(7), 704(a)(11).

[35] 29 U.S.C. § 1002(21).

[36] *See*, for example, Department of Labor amicus brief in In Re 1 Point Solutions, LLC et al v. Regions Bank, 10-5480 (6th Cir.).

[37] 29 U.S.C. § 1109(a).

[38] In re Trans-Industries, Inc., 538 B.R. 323 (Bankr. E.D. Mich. 2015).

[39] In Patterson v. Shumate, 504 U.S. 753 (1992), the Supreme Court held that ERISA's prohibition against assignment or alienation of pension plan benefits is enforceable nonbankruptcy law under Bankruptcy Code §541(c)(2) and that those benefits are excluded from the bankruptcy estate. First-day wage motions will generally seek approval to contribute previously withheld amounts to the 401(k) plan.

[40] IRM 4.71.23.4 General Bankruptcy Principles (4) (12-03-2018), https://www.irs.gov/irm/part4/irm_04-071-023#idm139977016846464 (last visited 9-5-2023).

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a plan should be promptly transferred to the plan and treated as excluded from the estate.[41]

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. If contributions or expenses are incorrectly allocated to participant accounts or other errors are made in benefits administration, an aggrieved participant would have little recourse against the plan once it has been liquidated and must turn to the trustee for recourse.

To minimize the risk of personal liability under ERISA, bankruptcy trustees should take their fiduciary duties seriously and educate themselves on ERISA's requirements and those of the governing plan document and trust instrument.

A pension plan administrator has a duty to ensure that the plan maintains its tax-qualified status, and it must also ensure that the plan's annual Form 5500 and other required reports are properly filed. In addition, an ERISA fiduciary must make any distributions to plan participants owed under the plan documents, ensure that plan assets are invested prudently, and ensure that fees for services provided to the plan are reasonable.[42] And, in a Chapter 7 or liquidating Chapter 11 case, the trustee will generally need to terminate the plan, complying with ERISA's requirements and those of the plan document.[43]

Healthcare and other welfare plans are subject to the same fiduciary provisions of ERISA as pension plans. They are generally unfunded, so there are usually no plan assets. But they otherwise present similar challenges.

The debtor may need to reduce or eliminate welfare benefits if it is to reorganize. In making that decision, the debtor will need to consider protections provided by the Affordable Care Act (the "ACA"). An employer with 50 or more full-time or full-time equivalent employees may be subject to penalties if it terminates healthcare coverage or reduces the employer-paid portion of the cost of coverage. In addition, the ACA requires a plan sponsor to provide a 60-day notice to participants before making any material modifications to health benefits unless the changes are being made during the plan's regular open enrollment period.[44]

Expenses for retiree health care can be significant for employers facing bankruptcy. The Bankruptcy Code contains special protection for retiree health benefits that limit 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.[45] An employer may propose modifications to retiree health coverage to a representative of the retirees and to negotiate in good faith to reach an agreement. If that process fails, a court may order modification of retiree health benefits only when the retirees' representative has refused to accept the proposal without good cause, the modification is necessary to allow reorganization, and the modification assures that all creditors and other affected parties are treated fairly and equitably.[46]

The debtor should also consider its obligations to provide continued healthcare coverage under the Consolidated Omnibus Budget Reconciliation Act of 1985 (COBRA). A bankruptcy filing is not a COBRA-qualifying event for active employees. Retirees will have a qualifying event, however, if they experience a "substantial elimination of coverage" within one year of the bankruptcy filing.[47] Substantial elimination of retiree medical coverage may entitle a qualified beneficiary to COBRA coverage for life[48]—a significant extension from the normal COBRA period—and the coverage may not be terminated if the beneficiary becomes entitled to Medicare.[49]

These COBRA rights are only applicable, however, if the sponsoring employer 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 plan sponsor will not be required to offer COBRA coverage to retirees who lose coverage in connection with the bankruptcy proceeding.[50] That may well be the case in a Chapter 7 liquidation.

Debtors should also monitor insurance premiums and other costs of providing welfare benefits. The Supreme Court has held that participants in defined benefit pension plans generally do not have standing to challenge fiduciary breaches.[51] Lower courts have found welfare plans to be similar for that purpose, but absent a Supreme Court decision, the law remains unsettled.[52]

Treatment of Top-Hat Plans and Other Executive Compensation Arrangements

Top-hat and excess benefit plans are non-qualified plans for management and highly compensated employees. They permit tax deferral of amounts above those that can be provided by qualified plans.[53]

Benefits under such arrangements are subject to the claims of the employer's general creditors even if they are funded by a "rabbi

[41] IRC §401(a)(1); 26 CFR §1.401-1(b); IRC §401(a)(2); 26 CFR §1.401-2.

[42] See, e.g., USDOL v. Kirschenbaum, 508 BR 257 (E.D.N.Y. 2014), *aff'd sub nom* Kirschenbaum v. USDOL (In re Robert Plan Corp.), 777 F.3d 594 (2d Cir. 2015).

[43] Reasonable plan expenses may be paid from plan assets. *See* In re Franchi Equip., 452 B.R. 352 (Bankr. D. Mass. 2011). Expenses for "settlor" functions, such as plan design, should be paid from estate assets. See ERISA Adv. Op. 2001-01A, https://www.dol.gov/agencies/ebsa/about-ebsa/our-activities/resource-center/advisory-opinions/2001-01a. The trustee's Final Report may provide exoneration on this issue, though the Labor Department would not be bound if it has not been put on notice.

[44] 29 U.S.C. § 1024(b)(1); 29 CFR § 2520.104(b)-3.

[45] 11 U.S.C. § 1114.

[46] 11 U.S.C. § 1114(e), (g), (h).

[47] 29 U.S.C. § 1163; 26 CFR § 54.4980B-4 Q/A1(c).

[48] IRC § 4980B(f)(2)(B)(iv)(III); 29 U.S.C. § 1162(2)(A)(iii); 26 CFR § 54.4980B-7, Q&A-4(e).

[49] IRC § 4980B(f)(2)(B)(iv)(II); 29 U.S.C. § 1162(2)(D)(ii).

[50] IRC § 4980B(f)(2)(B)(ii); 29 U.S.C. § 1162; 26 CFR § 54.4980B-7, Q&A-1(a)(3).

[51] Thole v. U.S. Bank, N.A., 140 S Ct. 1615 (2020), holds that participants in a defined benefit pension plan do not have Article III standing to bring breach of fiduciary duty claims against defined benefit plan fiduciaries based on investment losses. The Court contrasted the rights of participants in defined benefit plans, who receive fixed regular benefit payments funded by employer and employee contributions, from participants in defined contribution plans, whose benefits are directly tied to the value of the assets in their individual accounts time to time. In the former case, the risk of loss is borne by the employer, so participants do not have Article III standing. In the latter case, the participants bear the risk of loss, which can support Article III standing.

[52] *See* Winsor v. Sequoia Benefits & Insurance Services, 62 F. 4th 517 (9th Cir. 2023); Knudsen v. Met Life Group, Inc., 2:23-cv-00426 (D. N.J. July 18, 2023); Gonzalez de Fuente v. Preferred Home Care of New York, LLC, 2020 WL 5994957 (E.D.N.Y. 10/09/20).

[53] See B. McNeil, Nonqualified Deferred Compensation Plans § 1:1 (West 2021).

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trust."[54] That risk was magnified by the 2005 adoption of Section 409A of the Internal Revenue Code. Section 409A was enacted, in part, as a response to Enron executives' accelerating payments under their deferred compensation arrangements ahead of Enron's bankruptcy.[55] Section 409A significantly restricted participant control over payment, including acceleration of payment and the termination of such arrangements. Termination restrictions under Section 409A have even resulted in executives losing their nonqualified deferred compensation arrangements where the plan was terminated well before the plan sponsor filed for bankruptcy.[56]

Such plans may be rejected as executory contracts under the Bankruptcy Code, resulting in unsecured claims for rejection damages.[57] Although retired executives have satisfied all conditions for receiving benefits, the arrangement may be treated as executory for both active and retired executives to achieve equality of treatment.[58] Rejection damages claims may be brought to present value using the mortality and interest assumptions used for financial statement disclosure.[59]

A severance pay plan may be either a pension plan or a welfare plan.[60] Under ERISA, a plan or program that provides retirement income or defers income "for periods extending to the termination of covered employment or beyond" is a pension plan.[61] A severance plan that meets this definition would be subject to ERISA's "anti-alienation" rule, and the severance benefits would likely be excluded from an individual debtor's estate.[62] If a severance plan is a welfare plan, the severance benefits would be includable in the estate unless excluded or exempted by the provisions of state law.[63]

An employee's claim for severance pay is generally not entitled to administrative expense priority when the employee terminates employment post-petition.[64] The courts have reasoned that severance pay is mainly attributable to prepetition service.[65]

Under the Bankruptcy Act, the Second Circuit had held that severance pay becomes due when the employee separates from employment, and therefore is entitled to administrative priority if he separates from employment post-petition.[66] Later decisions questioned the applicability of these decisions under the Bankruptcy Code,[67] and most lower courts in the Second Circuit find another basis to deny administrative expense priority to severance pay.[68]

The Fourth Circuit has followed the Second Circuit Bankruptcy Act cases in holding that severance benefit claims are entitled to fourth priority, which grants priority up to a statutory cap to "wages, salaries, or commissions, including vacation, severance, and sick leave pay earned by individual" within 180 days before the filing of debtor's bankruptcy petition, for employees terminated in that 180-day period.[69] That holding may be limited to cases in which fourth priority is claimed.[70]

BAPCPA imposed limits on bonus and severance programs for insiders:

- a bonus unless it is essential to employee retention because of a competing job offer, the employee's services are essential to survival of the business, and the amount is no greater than ten times the mean for nonmanagement employees during the calendar year or (if none) 25 percent of the bonus payments to the employee during the previous calendar year;
- a severance payment unless it is part of a program that is generally applicable to all full-time employees and the payment is no greater than ten times the mean for nonmanagement employees during the calendar year; and
- other transfers or obligations that are outside the ordinary course of business and not justified by the facts and circumstances of the case.[71]

Thus, key employee retention plans are subject to specific limits, but key employee *incentive* plans, which require that insiders meet performance objectives, are not.[72] Courts are skeptical

[54] See J. Kagan, Rabbi Trust: Definition, Origin, Advantages & Disadvantages, Investopedia (2020), https://www.investopedia.com/terms/r/rabbitrust.asp.

[55] *See* STAFF OF THE JOINT COMMITTEE ON TAXATION, 107TH CONG., REPORT OF INVESTIGATION OF ENRON CORPORATION AND RELATED ENTITIES REGARDING FEDERAL TAX AND COMPENSATION ISSUES AND POLICY RECOMMENDATIONS 627 (Comm. Print 2003), www.gpo.gov/congress/joint/jcs-3-03/vol1/index.html.

[56] *See* In re RTI Holding Co., No. 20-12456 (Bankr. D. Del. Aug. 4, 2021).

[57] 11 U.S.C. §§ 365, 502.

[58] In re Peabody Energy Corp., 579 B.R. 208 (Bankr. E.D. Mo. 2017).

[59] 11 U.S.C. § 502(b); see In re JCK Legacy Co., 20-10418 (MEW) (Bankr. S.D.N.Y. Mar. 3, 2022).

[60] Labor Department regulations generally provide that a severance pay plan will be deemed a welfare plan rather than a pension plan if: (a) payments are not contingent upon retirement; (b) the total amount of payments is no more than twice the employee's compensation for the year immediately preceding his termination of service; and (c) all payments are completed within 24 months. 29 C.F.R. § 2510.3-2(b)(1).

[61] 29 U.S.C. § 1002(2)(A).

[62] See TREATMENT OF PENSION RIGHTS IN INDIVIDUAL BANKRUPTCIES, *post*.

[63] In re Jokiel, 447 B.R. 868 (Bankr. N.D. Ill. 2011), *subsequent determination,* 2012 WL 33246 (Bankr. N.D. Ill. 2012) (post-petition severance payment to debtor subject to turnover to chapter 7 trustee as property of the estate).

[64] See 11 U.S.C. §§ 503(b)(1)(A), 507(a)(2).

[65] See, e.g., In re Marcal Paper Mills, Inc., 650 F.3d 311 (3d Cir. 2011); In re Roth American, Inc., 975 F.2d 949 (3d Cir. 1992); see also Matter of Health Maintenance Foundation, 680 F.2d 619 (9th Cir. 1982); In re Mammoth Mart, Inc., 536 F.2d 950, 955 (1st Cir. 1976) (Bankruptcy Act cases).

[66] In re W. T. Grant Co., 620 F.2d 319 (2d Cir. 1980); Matter of Unishops, Inc., 553 F.2d 305 (2d Cir. 1977); 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).

[67] See, e.g., In re Jamesway Corp., 199 B.R. 836, 840 (Bankr. S.D. N.Y. 1996); In re Hooker Investments, Inc., 145 B.R. 138 (Bankr. S.D. N.Y. 1992); In re Drexel Burnham Lambert Group Inc., 134 B.R. 482, 489 (Bankr. S.D. N.Y. 1991).

[68] See, e.g., In re Applied Theory Corp., 312 B.R. 225 (Bankr. S.D. N.Y. 2004) (*Straus-Duparquet* not applicable where claimed entitlement arises from termination of a rejected prepetition contract and amounts at issue do not constitute the kind of "severance" *Straus-Duparquet* deemed worthy of priority status); In re Jamesway Corp., 199 B.R. 836 (payments under employment agreement not severance pay where promised as inducement to former executive to give up benefits at his former employment to work with the debtor); In re Child World, Inc., 147 B.R. 847, 853 (Bankr. S.D. N.Y. 1992) (amounts payable under employment agreement upon termination not severance pay because they were an inducement to employees to remain with company during financially troubled times).

[69] Matson v. Alarcon, 651 F.3d 404 (4th Cir. 2011); 11 U.S.C. § 507(a)(4)(A).

[70] E.g., In re New WEI, Inc., 2018 WL 1115200, *4 (Bankr. N.D. Ala. 2018).

[71] 11 U.S.C. § 503(c).

[72] In re Journal Register Co., 407 B.R. 520 (Bankr. S.D. N.Y. 2009).

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about attempts to characterize retention programs as incentive programs.[73]

A bonus or severance program might also be approved under Code § 363, as an "ordinary course" transaction. Courts have applied both "horizontal" and "vertical" tests to determine the reasonableness of a transaction and whether it is ordinary course.[74] The horizontal test examines whether the transaction is unusual or reasonably common. The vertical test "reviews the transaction from the perspective of creditors, asking whether the transaction is one that creditors would reasonably expect the debtor or trustee to enter into."[75] A plan that is primarily incentivizing and not retentive is reviewed under both Sections 503(c)(3) and 363(b). Under these provisions, an incentive plan will be approved so long as it is within the debtor's "sound business judgment."[76]

Treatment of Pension Rights in Individual Bankruptcies

In an individual bankruptcy, the debtor's right to retirement income may be excluded from property of the estate. Property of the estate includes "all legal and equitable interests of the debtor." But a restriction on transfer of the debtor's beneficial interest in a trust enforceable under "applicable nonbankruptcy law" is enforceable in bankruptcy.[77]

Under ERISA, a pension plan must provide that benefits "may not be assigned or alienated," and the Internal Revenue Code makes that a condition of tax qualification.[78] In *Patterson v. Shumate*, the Supreme Court held that ERISA creates a federal restriction on the alienation of pension benefits that is "enforceable under applicable non-bankruptcy law."[79] The Court reasoned that when an "ERISA qualified" pension plan contains the required anti-alienation language, ERISA's anti-alienation rule is "applicable nonbankruptcy law."

It is not clear what the Court meant by "ERISA qualified." A "qualified plan" is one that satisfies the Internal Revenue Code's requirements to qualify the related trust as a tax-exempt entity. But a plan does not "qualify" under ERISA. ERISA applies to any plan that "provides retirement income to employees" and is not exempt, whether it is tax-qualified or not.[80] Lower courts have therefore split on whether *Shumate* applies to all plans covered by ERISA or only those that are also tax qualified.[81]

ERISA's anti-alienation provision does not apply, for instance, to unfunded top-hat plans, individual retirement accounts (IRAs), governmental plans, church plans, unfunded excess benefit plans, or "owner-only" plans.[82] Governmental and church plans may be tax qualified, and if so, they must contain an anti-alienation provision, but that provision would be enforceable if at all under state law and not ERISA.

Assuming "ERISA qualified" means tax qualified, it may be possible to challenge a plan's tax qualification. It is not clear whether the bankruptcy court has authority to make that determination, and some courts have therefore deferred to IRS's determination of tax qualification.[83] The trustee might challenge the tax qualification as part of a turnover proceeding, however, and creditors might object to the debtor's claim of exemption.

Conversely, plans that are not covered by ERISA or not subject to ERISA's anti-alienation requirement may be excluded from property of the estate under state or other federal transfer restrictions. Examples have included Keogh plans and IRAs (though some courts have required that the IRA document contain a restriction on transfer) and plans for state or federal employees.[84]

In addition, certain property may be exempt from the estate, including "a payment under a stock bonus, pension, profit-sharing, annuity, or similar plan ... on account of illness, disability, death, age, or length of service, to the extent reasonably necessary for the support of the debtor and any dependent of the debtor."[85] In addition, "retirement funds" are exempted, including interests in qualified plans, annuities, conventional and Roth IRAs, deferred compensation arrangements for government and tax-exempt

[73] See In re PG&E Corporation, 2019 WL 4686765, *1 (Bankr. N.D. Cal. 2019); In re Foothills Texas, Inc., 408 B.R. 573 (Bankr. D. Del. 2009); In re Dana Corp., 351 B.R. 96, 47 (Bankr. S.D. N.Y. 2006); In re Mesa Air Group, Inc., 2010 WL 3810899 (Bankr. S.D. N.Y. 2010).

[74] In re Mesa Air Group, Inc., 2010 WL 3810899, *3 (Bankr. S.D. N.Y. 2010), *quoting* In re Crystal Apparel, Inc., 207 B.R. 406, 409, 30 (S.D. N.Y. 1997) ("t]he inquiry deemed horizontal is whether, from an industry-wide perspective, the transaction is of the sort commonly undertaken by companies in that industry. The inquiry deemed vertical analyzes the transactions 'from the vantage point of a hypothetical creditor and [asks] whether the transaction subjects a creditor to economic risk of a nature different from those he accepted when he decided to extend credit")).

[75] In re Mesa Air Group, Inc., 2010 WL 3810899, *3 (Bankr. S.D. N.Y. 2010).

[76] In re Aralez Pharmaceuticals US, Inc., 2018 WL 6060356, *6 (Bankr. S.D. N.Y. 2018). Courts generally consider the following factors in determining whether to approve a compensation proposal under the business judgment rule: (1) whether there is a reasonable relationship between the plan proposed and results to be obtained; (2) whether the plan's cost is reasonable in light of debtor's assets, liabilities, and earning potential; (3) whether plan's scope is fair and reasonable; (4) whether plan is consistent with industry standards; (5) what due diligence the debtor exercised when investigating the need for the plan; and (6) whether the debtor received independent counsel in performing due diligence and in establishing the incentive program. In re Borders Group, Inc., 453 B.R. 459, 474 (Bankr. S.D. N.Y. 2011), *quoting* In re Dana Corp., 358 B.R. 567, 575, 47 (Bankr. S.D. N.Y. 2006).

[77] 11 U.S.C. § 541(1), (c)(2).

[78] 29 U.S.C. § 1106(d)(1); 26 U.S.C. § 401(a)(13).

[79] 504 U.S. 753, 759 (1992).

[80] 29 U.S.C. § 1002(a).

[81] *Compare* In re Hall, 151 B.R. 412 789, 16 Employee Benefits Cas. (BNA) 2768, Bankr. L. Rep. (CCH) ¶75166 (Bankr. W.D. Mich. 1993), *with* In re Hanes, 162 B.R. 733 (Bankr. E.D. Va. 1994).

[82] An owner-only plan may be tax qualified, treating the self-employed owner as an "employee." I.R.C. §401(c)(1).

[83] *Compare* Matter of Youngblood, 29 F.3d 225 (5th Cir. 1994), *with* In re Plunk, 481 F.3d 302 (5th Cir. 2007) (limiting *Youngblood* to situations where IRS declined to disqualify plan).

[84] In re Silviera, 186 B.R. 168 (Bankr. D. Mass. 1995); Whetzal v. Alderson, 32 F.3d 1302 (8th Cir. 1994); In re Sawyers, 135 B.R. 371 (Bankr. W.D. Mo. 1992).

[85] 11 U.S.C. § 522(d)(10((E).

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organizations, and plans funded only with employee contributions, subject to a dollar cap on the non-rollover portion of an IRA (currently $1,512,350).[86] But "retirement funds" does not include an inherited IRA.[87]

Finally, property of the estate does not include amounts withheld from wages or received by an employee for contributions to an ERISA or government plan, a deferred compensation plan, or a tax-deferred annuity that do not constitute disposable income.[88]

Debtor interests in retirement funds may be vulnerable where they result from fraudulent transfers or other abuses. Generally, debtors may convert nonexempt assets into exempt assets.[89] But the court may deny a discharge to a debtor who "with intent to hinder, delay or defraud a creditor" transferred, removed, or concealed property within one year before filing the petition.[90]

The trustee may also recover plan contributions that constitute fraudulent transfers[91] or preferences.[92] For qualified plans, ERISA provides that plan assets "shall never inure to the benefit of any employer" and limits the circumstances in which contributions may be returned.[93] ERISA may therefore conflict with the Code in this area.

[86] 11 U.S.C. § 522(b). In this context, tax qualification can be shown by a current IRS determination or substantial compliance with the qualification requirements (though the exemption applies if the debtor is not materially responsible for a substantial compliance failure).

[87] Clark v. Rameker, 573 U.S. 122 (2014). State exemptions may apply, however. In re Kapsinow, 220 A.3d 1231 (R.I. 2019); In re Pacheco, 537 B.R. 935, 940 (Bankr. D. Ariz. 2015).

[88] 11 U.S.C. §§ 541(b)(7), §1325(b)(2); see In re Perkins, 2023 Bankr. LEXIS 946 (Bankr. S. D. Tex. 2023) (401(k) plan contributions are excluded from disposable income under a Ch. 13 plan, even if they exceed historical contributions and the amount subject to employer match).

89 See, e.g., In re Carey, 938 F.2d 1073, 1076 (10th Cir. 1991); In re Addison, 540 F.3d 805, 813 (8th Cir. 2008); In re Stern, 345 F.3d 1036, 1043 (9th Cir. 2003); In re Soza, 542 F.3d 1060, 1068 (5th Cir. 2008).

90 11 U.S.C. § 727(a)(2); see, e.g., In re Davis, 911 F.2d 560 (11th Cir. 1990).

91 *Compare* In re Springfield Furniture, Inc., 145 B.R. 520 (Bankr. E.D. Va. 1992), *with* Matter of Loomer, 198 B.R. 755 (Bankr. D. Neb. 1996). For a fuller discussion see Norton Ch. 176:17.

92 *Compare* In re Jones Truck Lines, Inc., 130 F.3d 323 (8th Cir. 1997) (contributions to multiemployer plan were "contemporaneous exchanges" for "new value," employee labor), and In re WCI Steel, Inc., 313 B.R. 414, 33 Employee Benefits Cas. (BNA) 1613 (Bankr. N.D. Ohio 2004) (post-petition contributions required under unmodified collective bargaining agreement were not avoidable under Section 349), *with* In re Pulaski Highway Exp., Inc., 41 B.R. 305 (Bankr. M.D. Tenn. 1984) (denying summary judgment to multiemployer plan in preference action).

93 29 U.S.C. § 1103(c).

Conclusion

Addressing employee benefits and executive compensation issues in bankruptcy requires an understanding of ERISA and the Internal Revenue Code, the Bankruptcy Code, and the principles governing choice of law in bankruptcy. Counsel, trustees, and other bankruptcy professionals should keep this in mind when confronting such issues and should confer with employee benefits counsel as necessary.

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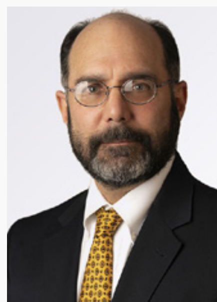

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