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Bankruptcy and Benefits Beyond a Crisis: How Chapters 11 and 7 Affect Retirement and Welfare Plans

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Businesses large and small have been affected by the coronavirus crisis. It seems that no industry has been spared economic hardship. As many states prepare to reopen their economies, there are some businesses that will not be able to resume operations—it is too little, too late. Even with massive spending by the federal government to counteract the economic downturn, it appears that a large number of business bankruptcies may be on the horizon.

Generally, a business that is considering entering into bankruptcy will need to decide whether to file under one of two provisions of the United States Bankruptcy Code:

- Chapter 11 (reorganization)
    - Subchapter 5 (small employers)
- Chapter 7 (liquidation)

A business that files under Chapter 11 typically continues to operate under the court's protection while attempting to reorganize. A filing under Chapter 11 may or may not affect the business's employee benefit offerings. Under a Chapter 7 filing, however, the business liquidates its assets to pay its creditors and the business ceases to exist. Typically, under a Chapter 7 filing, all benefit plans will be terminated.

Retirement Plans

Generally, there are two types of retirement plans:

- Defined benefit (traditional pension plan)
- Defined contribution (profit-sharing plan or 401(k) plan)

Retirement plan assets (whether under a defined benefit or defined contribution plan) should not be at risk when a business declares bankruptcy. The Employee Retirement Income Security Act of 1974 (ERISA) requires that qualified plan benefits be kept separate from an employer's general assets. Thus, if a business declares bankruptcy, the retirement funds should be protected from the business's creditors. The participants have the right to their vested retirement benefits. In addition, defined benefit plan assets are protected by the Pension Benefit Guaranty Corporation (PBGC), the federal backstop for private defined benefit plans. For example, if a defined benefit plan is terminated because an employer has financial difficulty and cannot fund the plan or pay the promised benefits, the PBGC will assume responsibility for the plan. The PBGC pays benefits after termination up to a maximum guaranteed amount, which is adjusted annually.

The type of bankruptcy filing will have an effect on an employer's decisions about its retirement plans. Under a Chapter 11 filing, the employer may reduce plan-related expenses by reducing or suspending employer contributions. The process required to accomplish either of these actions will depend on various factors such as the type of plan and plan document language. On the other hand, a Chapter 7 filing would all but guarantee the termination of the plan. Generally, the steps to terminate a retirement plan include the following:

- Amending the plan to establish the termination date and updating the plan for all required legal changes and any discretionary modifications
- Communicating with participants and beneficiaries regarding the plan termination
- Vesting all "affected participants" 100 percent (applies to any employees or former employees with account balances as of the termination date)
- Distributing plan assets as soon as administratively feasible (generally within 12 months) following plan termination
- Filing a determination letter request with the Internal Revenue Service seeking a determination of the plan's qualification status at termination
- Filing applicable federal disclosures (e.g., Form 5500, Annual Returns/Reports of Employee Benefits Plans) until all plan assets have been distributed.

Additional steps may be required based on the type of retirement plan that is being terminated.

Welfare Plans

If a business files for Chapter 11 bankruptcy protection, it may have to review its welfare benefit plans and decide whether to reduce or eliminate healthcare benefits. When making this decision, the business will need to be aware of protections provided to participants under the Affordable Care Act (ACA). This will include analyzing whether a termination of healthcare coverage or a reduction in the employer-paid portion of cost will result in the business's being subject to penalties for failure to offer coverage or affordable coverage. In addition, the timing of such changes matters since the ACA requires a plan sponsor to provide 60-day notice to participants of any material modifications to health benefits.

If a business files a Chapter 7 bankruptcy petition, all benefits generally will be terminated, including healthcare benefits. If a healthcare plan is terminated and no other plans are offered by the business, the requirement to provide continuing health benefits coverage under the Consolidated Omnibus Budget Reconciliation Act of 1985 will also be canceled.

There are many factors that a business must consider when contemplating a bankruptcy filing. Employee benefits issues are only some of the many considerations that cannot be overlooked.

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