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Employee Benefits Law Information Memo

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Electronic Dispatch

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IMPACT OF THE NEW BANKRUPTCY REFORM ACT ON EMPLOYEE BENEFITS

On April 20, 2005, President Bush signed the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA"). The new law, generally effective for bankruptcy filings on or after October 17, 2005, was enacted to curb perceived bankruptcy abuses. While BAPCPA makes it more difficult for individuals to file for bankruptcy, it expands or clarifies the federal bankruptcy protections available for certain employee benefits.

Protection for Retirement Benefits

Background

When a debtor seeks to protect his or her assets from the claims of creditors by filing a bankruptcy petition, specified assets of the debtor generally will be turned over to a bankruptcy trustee and become part of the bankruptcy estate. A debtor may protect his or her eligible retirement funds by either claiming an exclusion or an exemption, if certain requirements are satisfied. Certain properties, such as a debtor's interest in an ERISA qualified retirement plan, are automatically excluded from the bankruptcy estate. If no exclusion applies, the retirement funds become part of the bankruptcy estate, but may nonetheless be exempted from creditors' claims if certain requirements are satisified.

Exemption

Under BAPCPA, interests in non-ERISA tax-favored retirement plans such as certain Internal Revenue Code ("Code") Section 403(b) plans, Code Section 457 plans, and traditional and Roth IRAs may now be entitled to exemption. Debtors must prove the retirement fund is tax-exempt before this exemption will be allowed. Therefore, a debtor may need to obtain a copy of any Internal Revenue Service ruling that may exist regarding the plan's tax-favored status or be able to demonstrate that there has been no adverse determination as to the plan's tax-favored status.

Direct transfers and eligible rollovers to and from these plans may also be eligible for the exemption.

Generally, for individuals, there is a limit of $1 million (exclusive of rollover contributions) to the exemption for amounts held in traditional or Roth IRAs.

Contributions

Contributions to ERISA plans, Code Section 403(b) tax-deferred annuities, Code Section 457 deferred compensation plans and Code Section 414(d) governmental plans that are withheld by an employer from an employee's wages, or amounts received by an employer as employee contributions, are automatically excluded from a debtor's bankruptcy estate.

Treatment of Plan Loans Under BAPCPA

Loans to individuals from pension, profit-sharing, stock bonus or other plans established under the Code are not dischargeable in bankruptcy. Further, an employer may continue to withhold loan repayments from an employee's wages and the employee may not materially modify the loan's terms under a plan of reorganization in bankruptcy.

Protection For Health Insurance

Under BAPCPA, employee contributions to a health insurance plan regulated by state law (whether or not subject to ERISA) are automatically excluded from the employee's bankruptcy estate as long as those amounts are withheld by the employer from the employee's wages or are received by the employer as employee contributions.

Protection for Education Savings Accounts

Under BAPCPA, deposits into a Code Section 529 account or an education IRA made more than 720 days before the filing of a bankruptcy petition can generally be excluded from the bankruptcy estate if the designated beneficiary is the debtor's child, stepchild, grandchild, or step-grandchild. Any deposits made within 365 days of the filing of the bankruptcy petition may not be excluded. If deposits are made to an account between 366 and 720 days of filing, up to $5000 per designated beneficiary may be excluded.

BAPCPA Provisions That Affect Employers

Plan Administration

If a bankrupt employer is acting as a plan administrator of an ERISA-covered plan, and there is no trustee assisting the employer, BAPCPA requires the employer to continue to perform all necessary duties to wind down the plan.

Retiree Health Benefits

Under current law, if a bankrupt employer attempts to modify retiree health benefits, a committee of retired employees is appointed to represent the retirees. BAPCPA requires the court to order the U.S. bankruptcy trustee to appoint this committee. Further, if an employer modifies retiree health benefits during the 180-day period ending on the date the bankruptcy petition is filed, and the employer was insolvent on the date of the modification, the court will evaluate whether the health benefits in effect prior to the modification should be reinstated.

Executive Compensation

BAPCPA is particularly restrictive with respect to retention bonuses and severance payments. For example, a bankrupt employer may only make severance payments to an "insider" if the payments do not exceed ten times the amount of the average severance pay given to nonmanagement employees during the calendar year, and the payments are part of a program that is applicable to all full-time employees. Similarly, a bankrupt employer must prove that an "insider" is essential to the survival of the business, and the "insider" has, and will accept, a legitimate job offer for equal or greater compensation before the employer may pay a retention bonus to the "insider." The amount of the bonus may not exceed ten times the amount of similar payments made to nonmanagement employees during the year, or if no such payments were made, the bonus may not exceed 25 percent of the amount of any similar payment made to the "insider," for any purpose, during the previous calendar year.

For these purposes, an "insider" is a director, an officer, a person in control of the employer, a partnership in which the employer is a general partner, a general partner of the employer, or any relative of a general partner, director, officer or person in control.

Conclusion

BAPCPA has several provisions concerning employee benefits that will be of interest to employers. In particular, the new provisions with respect to plan loans and employee contributions should help facilitate plan administration.

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