Lowenstein Sandler's Employee Benefits & Executive Compensation Podcast: Just Compensation

Episode 9 - Common Benefits Issues in Bankruptcy

By [Megan Monson](), [Taryn E. Cannataro](), [Nicole Fulfree]()
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Megan Monson: Welcome back to the latest episode of Just Compensation. I'm one of your hosts, Megan Monson, Counsel in Lowenstein Sandler's Employee Benefits & Executive Compensation practice group, and I'm joined by two of my colleagues today. I'll turn it over to Taryn to introduce herself.

Taryn Cannataro: Hi, I'm Taryn Cannataro. I am an Associate in Lowenstein's Executive Compensation & Employee Benefits group.

Nicole Fulfree: Hi everybody. I'm Nicole Fulfree and I'm Counsel in Lowenstein's Bankruptcy & Restructuring department.

Megan Monson: Today we plan to focus on a topic that we hope it does not ultimately impact most companies, which are benefits considerations in bankruptcy.

However, our goal is to raise some of these issues to give you food for thought in the event that you find yourself in a situation contemplating bankruptcy, or having to navigate through these issues yourself. This may be helpful in terms of strategic planning and understanding what alternatives are available as it relates to certain benefit plans as you're contemplating bankruptcy.

We are not planning to go into detail on all benefits, considerations, or cover every single topic of things to think about in the bankruptcy context. But we are aiming to touch on common issues that we see arise with our clients. Throughout this podcast Taryn and I are going to focus on some of these items for consideration, specifically as it relates to benefit plans. But we've asked our colleague Nicole to join us in helping set the stage and describing the different types of bankruptcies.

Nicole Fulfree: Thanks Megan and Taryn for having me on today, before you get into the real substance of your discussion on benefits related considerations for bankrupt companies, I wanted to give your listeners some helpful context by explaining the key differences between the two main types of corporate bankruptcy, which are Chapter 7 and Chapter 11.

In a Chapter 7 bankruptcy a court appointed trustee is charged with supervising the liquidation and orderly winding down of the company. The business typically stops operating and the company's assets are liquidated typically in a piecemeal fashion.

Any property of the bankrupt estate, including the proceeds of any liquidated assets are used to pay creditors.

And the particular order described in the bankruptcy code, generally speaking, secured claims are paid first followed by administrative and other claims that are given priority under the code. Including wage claims, then unsecured creditors, and finally equity interests. Although technically a corporate Chapter 7 debtor does not receive a discharge for all intents and purposes the company ceases to exist following a Chapter 7.

Now Chapter 11, typically thought of as the reorganization chapter of the bankruptcy code, now in a Chapter 11, filing a company continues its operations. Typically keeping many of its employees onboard while it negotiates with its various creditor constituencies to restructure it's debt.

The objective of a Chapter 11 filing is to give the company a breathing spell to take a close look at its operations and implement cost reduction strategies. With the goal of exiting bankruptcy as a viable business. That being said, it's also really common in recent practice for companies to use Chapter 11, to effectuate an asset sale.

In which case the company continues to operate while trying to locate a going concern purchaser. The Chapter 11 process culminates with the courts confirmation of the Chapter 11 plan, which describes the amount of the company will pay on its claims and the timing of those payments to creditors. Other than, as set forth in the plan, the reorganizing Chapter 11 debtor will typically be discharged from all claims against it that erodes prior to the plan.

Megan Monson: Thanks, Nic. That's really helpful. As we get into this discussion, we're going to talk about how to approach various benefit plans in the context of Chapter 11 versus Chapter 7 bankruptcies. So I think that was really informational for our listeners.

Taryn Cannataro: Great. Why don't we begin with retirement plans—Megan, what do companies facing bankruptcy have to consider with respect to tax qualified retirement plans?

Megan Monson: So in general, tax qualified retirement plans are usually one of two types, either defined contribution plans, such as a 401k plan, or a defined benefit plan, which is commonly known as a pension plan.

And how to treat tax qualified retirement plans and bankruptcy is going to impart depend on what type of bankruptcy the company is in fact filing. In the context of a Chapter 11 bankruptcy, the company needs to consider on a going forward basis, whether to terminate the plans. Even though there'll be continuing an operation or otherwise look for ways to reduce their expenses.

In that context, we typically see companies that try to suspend employer contributions, if their plan permits, or look at other ways where they can save costs. In general tax qualified retirement plan assets are protected from creditors in the bankruptcy context. So that's good from the individuals who are participating in the plans. In the context of a Chapter 7 bankruptcy, it's most likely that the company would need to terminate any outstanding retirement plans.

If a company is going through a Chapter 11 process and relatedly terminating the plans, there are certain steps that need to be followed in terms of the termination process, which will vary based upon whether you're dealing with defined contribution or defined benefit plans.

In particular, the process and requirements for terminating such plans are outlined not only by legal requirements, but by the plan documents as well. So any company looking down that route should really make sure to not only coordinate with their legal providers, but also their plan administrators to make sure that they're following the appropriate procedures in terminating those plans.

Taryn Cannataro: That's a great point, Megan. I would also note that depending on the type of plan, for example, with defined benefit pension plans, other members of the control group could be jointly and severally liable for any obligation. So just another thing to keep in mind.

Megan Monson: That's actually a great point, Taryn. One other item I forgot to mention is that in general terminating retirement plans. Whether of the defined contribution or defined benefit nature, there could also be an impact more generally on other entities in the controlled group. So it's also important to understand not only the relationship between other related entities, but also what retirement plans those other entities offer.

Taryn Cannataro: Great. That was very helpful. What about health and welfare plans? Are there any special considerations?

Megan Monson: So similar to the context of looking at qualified retirement plans, it's going to depend upon what type of bankruptcy the company is facing. If the company is going to be facing a Chapter 11 bankruptcy and continuing an operation, similar to again, the tax qualified retirement plans, the company should consider whether it wants to continue offering the welfare plans.

And if there's anything that could be done to reduce or eliminate the cost associated with those plans. I note that in general, if the company has more than 50 employees, they may be required to provide healthcare benefits under the Affordable Care Act. So that's another consideration that they would have if they are going to be continuing in operation.

But there may be ways for them to limit the costs or reduce or eliminate all their welfare benefit plans, such as dental, vision, life insurance, things like that. If a company is filing a Chapter seven bankruptcy, again, there's a lot more flexibility and we'd expect those types of plans to be terminated.

And if that's the case, There are certain communications that would be needed to be sent to employees and any notifications required in particular, if there are employees that are on medical coverage and kind of how that would impact their coverage, and if they'd be eligible for COBRA on the COBRA piece, if there are other related entities in their controlled group, those other entities may be required to offer COBRA to any terminated employees of the bankrupt company.

So just something to keep in mind again, you know, the it's important to understand not only the interaction between the company that's going bankrupt, what that company offers, but also what other related entities are offering.

Taryn Cannataro: Exactly. And one other point that I would add is that for smaller companies that may not be within the purview of federal COBRA laws, there are also state mini COBRA laws that create similar responsibilities under state law. So that's another thing to be mindful of it as well.

Megan Monson: Yeah, that's a great point Taryn, because I think in general, while companies are kind of working through this process, they're also trying to think about if they are able to continue an operation, if there's ways that they can try to protect their employees. And that would be, you know, one thing to look at.

Taryn Cannataro: So another area that is talked about a lot with respect to bankruptcy are KEIP and KERP plans. What are these arrangements and why are they used?

Megan Monson: So KERPs are Key Employee Retention Plans and KEIPs our Key Employee Incentive Plans. So very similar acronyms and kind of have similar goals. For companies that are undergoing a Chapter 11 bankruptcy, this is really where these two arrangements will come into play. Because these entities are going to be continuing an operation, but they may be struggling to keep key employees that they want around to help and revive the restructured company. So companies look for ways to try to incentivize and keep these employees around. On the KERPs side these are typically structured as lump sum retention payments that will be paid out at a particular period of time in the future. The trouble with KERPs is historically, they were used by a lot of companies that were contemplating bankruptcy. And so now they're subject to a much higher level of scrutiny in the bankruptcy court context, which is what tended to result in more companies looking at the KEIPs. On the KEIPs side to withstand scrutiny by the bankruptcy court, the arrangement must be viewed as a payment for value rather than actually a payment to stay with the debtor. So it's a little bit different in terms of how it's being structured. So for example, you may have a payment under a KEIP that's tied to the consummation of a sale of the company at a later point in time, or the achievement of certain financial metrics. Instead of simply requiring continued employment, which was more typical in the KERP context.

Taryn Cannataro: Also another thing that companies can do to help withstand scrutiny would be to consider adding performance goals to these plans, which could help overcome Section 503C requirements.

Megan Monson: Yeah, that's a great point. And that again also tends to show not only that the relationship is intended to be a payment for value, that's helping drive value of the company. It's not just tied to their continuing employment.

Taryn Cannataro: So Megan, we've seen many bankrupt companies ultimately undergo a sale process. Are there any special items to think about here?

Megan Monson: So one of the biggest things that we focus on is just the proper scope of the representations in the purchase agreement. As Nicole mentioned, you know, a lot of companies may be going through a sale process in the asset sale context, if they're undergoing bankruptcy.

And so approaching an asset sale in the bankruptcy context is a little bit different than a traditional asset sale because there's not necessarily an entity that's going to be continuing an operation or have assets to go after. So approaching the representations it's a little bit kind of in between I'd say an asset and a stock sale in terms of the level of protection you're looking for and things like that.

And related to that, I think it's also really important to have an opportunity to complete due diligence on the company that's being acquired for that particular reason. Understanding, at least in the benefits side, the arrangements that they had, the arrangements that will continue. And some that a purchaser may be obligated to take or pay benefits under. Something else to think about in the bankruptcy context is the possibility of successor liability. And this could apply irrespective of whether certain plans are assumed. This most frequently comes up in the pension plan context, where you could be deemed to have successor liability, even though you're not assuming a plan thats it's being left behind with the bankrupt company who's selling those assets.

So that's again an area where it's not only important to have more fulsome reps and depending upon what your recourse is, if there is a breach of those representations, but also doing complete due diligence to get a really good picture of what potential exposure there is, and factoring that into any sort of purchase price that's being negotiated in the deal.

Something that we see come up in the context of deals is whether or not to 280G applies. 280G is a section of the internal revenue code that governs change of controls of entities tax to C corporations. In general, individuals are subject to a potential excise tax. If they receive amounts in connection with the transaction in excess of a base amount, which it gets very complicated, but is in general the executive's annual compensation with the company over the past five years. And the types of payments that are considered in connection with the change of control is a whole discussion for another time, but it can be items such as severance, increases in compensation, retention bonuses, accelerated vesting, things like that.

So when you're dealing in particular with a bankrupt company to 280G can apply, not only whether it's a private company that is taxed as a C corporation, or which sometimes is more common, is a company that was previously public but has since been delisted as a result of either the bankruptcy or planning for the bankruptcy. If there's a 280G issue in a deal, dealing with private companies, there's a 280G vote available that can cleanse the unfortunate excise tax I mentioned. And so with a company that was previously delisted, that allows for the opportunity for that company now to seek that shareholder cleansing vote.

Taryn Cannataro: That's a great point, Megan. And one thing I would mention about this shareholder cleansing vote is that individuals who are going to be subject to the vote will need to agree to waive payments if they're not approved by more than 75% of the shareholder. So it's just something to keep in mind in the context of bankruptcy, where the shareholders might be subject to different bankruptcy considerations.

Megan Monson: Yeah. That's a great point, Taryn. And I'll just kind of add on in general, Section 280G is a very complicated area, which is why we're not going to get into the details of it here, but it's just something to have on your radar. If your company is undergoing a sale process and relatedly, if your company has filed bankruptcy, you may have already cut executives compensation over the past couple of years in 280G issue that needs to be dealt with.

Taryn Cannataro: Let's close out with a key issue related to employees and whether to continue employment. If employees are being laid off as a result of bankruptcy, WARN impacts need to be considered. Megan, could you talk a little bit about what WARN is and who does it apply to?

Megan Monson: Sure. So WARN is the Worker Adjustment and Retraining Notification Act. And this is a section of labor law that deals with essentially when companies are having mass layoffs of employees, we're having plant closings. Typically it's going to arise and apply to employers that have more than a hundred employees. So it's not going to come up for all employers, but if you are a larger employer or you're considering having a mass layoff, it's something that needs to be considered. In general, WARN requires certain advanced notice of these mass layoffs. And so if it's triggered, you're typically required to provide employees with 60 days advanced notice for certain terminations of employment. If you fail to do so, you would be required to pay them for that period of time. There are however, some exceptions to this notice requirement.

The most common are natural disasters. Obviously that's something that can't be accounted for, in advance, unforeseen business circumstances, and faltering employees. Now for the faltering company exception and the unforeseen business circumstances exception. Those are really going to be facts and circumstances based.

And so it can be difficult to prove, after the fact, if you've fallen under one of those situations. Typically in the context of bankruptcy, you have a sense that the company is failing and that you're going down that route. And so more often than not, you're going to have to comply with the 60-day notice requirement.

And again, as I mentioned, since that would require paying employees out. If the notice is not required, that's just another cost to be considered and potential claims that employees could have against the bankrupt company. If they're not paid out. As Nicole mentioned earlier, if there are employee claims related to compensation, any sort of WARN notice or issue that occurs pre-petition would be treated the same.

And so individuals who are entitled to pay on that basis would typically have the same priority as any other unpaid wage claims

Taryn Cannataro: And similar to the mini COBRA laws we were discussing earlier, certain states have their own WARN or mini WARN requirements. So even if you're under the hundred employee threshold, you would need to consider this at a state level as well.

Megan Monson: That's a great point, Taryn. Thanks.

So overall, while we've tried to give you some food for thought, the impact of bankruptcy on employee benefit plans is very complicated and application to a particular circumstance is also going to be very fact specific. We wanted to provide some guidance on some common issues that we see, but this is not intended by any means to be an exhaustive list and may not apply to your particular circumstances.

If you do find yourself facing bankruptcy or acquiring a bankrupt company, we encourage you to consult with counsel if you're navigating through any of these issues or could be in the near future.

Thank you so much for joining us today. We look forward to having you back for our next episode of just compensation and appreciate Nicole and Taryn for joining us today as well.

Nicole Fulfree: Thanks for having me.

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