1997 Speaches

JONES, DAY, REAVIS & POGUE

ATLANTA
BRUSSELS
CHICAGO
CLEVELAND
COLUMBUS
FRANKFURT
GENEVA
HONG KONG
IRVINE
LONDON
LOS ANGELES
NEW DELHI
NEW YORK
PARIS
PITTSBURGH
RIYADH
TAIPEI
TOKYO
WASHINGTON

2300 TRAMMELL CROW CENTER
2001 ROSS AVENUE
DALLAS, TEXAS 75201

MAILING ADDRESS:
P.O. BOX 660623
DALLAS, TEXAS 75266
TELEPHONE: 214-220-3939
TELEX: 730852
CABLE: ATTORNEYS DALLAS
FACSIMILE: 214-969-5100
DIRECT DIAL NUMBER:

August 1, 1997

Ms. Cynthia M. Stamer
Locke Purnell Rain Harrell
2200 Ross Avenue, Suite 2200
Dallas, Texas 75201

Dear Ms. Stamer:

The time, place and program for the next Dallas Benefits Society meeting are:

Cynthia Marcotte Stamer
Dean Ferguson
Shareholders with Locke Purnell Rain Harrell, P.C.

Employee Benefits and Bankruptcy:
"DEVELOPING A GAME PLAN FOR PLAN SPONSORS AND FIDUCIARIES"

Thursday, August 14, 1997, 7:30 a.m.
Park Cities Club, 5956 Sherry Lane, 17th Floor
$12.50

PLEASE R.S.V.P. by Wednesday, August 13, 1997 by calling Bill Quinn at 972/424-8664 or sending your check to the following address:

Dallas Benefits Society
c/o Jim Klancnik
5956 Sherry Lane, Suite 1000
Dallas, Texas 75225

We look forward to seeing you at the meeting.

Very truly yours,

Judith L. McMillin

DLMAIN02 Doc: 234743_1

BANKRUPTCY AND EMPLOYEE BENEFIT ISSUES

DALLAS BENEFITS SOCIETY
AUGUST 14, 1997

CYNTHIA MARCOTTE STAMER
DEAN FERGUSON
Shareholders
LOCKE PURNELL RAIN HARRELL
(A Professional Corporation)
2200 Ross Avenue, Suite 2200
Dallas, Texas 75201-6776
(214) 740-8000

Handout Prepared by
David J. Kritz
Associate
Locke Purnell Rain Harrell

CYNTHIA MARCOTTE STAMER

SHAREHOLDER
Health Care/Employee Benefits/Labor

Practice Areas

Nationally and internationally recognized for her expertise in health care and other employee benefit matters, Ms. Stamer regularly helps employers and others to design, implement, administer and defend cost-effective, legally compliant self-insured and insured health benefit plans, policies and procedures to achieve the client's business objectives and to manage legal exposures. In this capacity, Ms. Stamer counsels employers, insurers, third-party administrators, and others on a wide range of health plan-related matters including the following:

- design, implementation, documentation and administration of self-insured and insured health and other employee benefit plans, multiple employer welfare benefit arrangements, association plans, group insurance arrangements, and HMO arrangements
- stop-loss and reinsurance policies and other funding alternatives to traditional indemnity arrangements
- service provider contracts with health benefit plan and human resource vendors including payroll service providers, claims administrators, plan trustees and custodians, investment managers, employee leasing companies and others
- claims audit procedures, procedures for coordination of plan benefits with other insurance, Medicare and workers' compensation benefits to control employee benefit and worker's compensation costs, and other cost containment strategies
- litigation and other disputes related to employee benefit plans, occupational injuries, and other tax, labor and insurance matters
  transactional and fiduciary matters affecting employer benefit, employment and insurance coverage
- managed care matters including the managed care contracting, administration, and liability
- design, administration, documentation, licensure, and defense of cost-effective managed health, workers' compensation and disability severance, pension and other employee benefit programs
- health care and insurance regulatory compliance

Education

- J.D., **Loyola Law School, Los Angeles**, 1987
- B.S., **Arizona State University**, 1984

Civic and Professional

- Dallas Bar Association: Member, Sections on Employee Benefits and Executive Compensation, Labor and Health Care
- American Bar Association: Health Care, Tax, Labor and Employment, Tort and Insurance Practice, and Real Property and Probate Sections
- State Bars of Texas and Arizona: Member, Sections on Health Law, Labor and Employment Law, Insurance Law, and Tax
- State Bar of Arizona: Self Insurance Institute of America; National Health Lawyers Association; American Society of Law, Medicine and Ethics; American Association of Hospital Attorneys
- Editorial Advisory Board and Author for The Bureau of National Affairs and Health Cure Portfolio Series, The Health Care Competency and Credentially Report and other selected publications
- Dallas Benefits Society: Member, Past Co-Moderator and Past Board Member
- South West Benefits Association: Member, Past-Board of Directors
- Working in Employee Benefits: Board of Directors

DEAN W. FERGUSON

SHAREHOLDER
Bankruptcy/Creditors Rights

Practice Areas

Substantial experience in:

- all areas of business reorganization, including bankruptcy litigation, workouts and restructuring transactions,
- representing creditors, debtors and trustees, and
- representing parties in connection with the purchase or sale of assets from bankruptcy estates.

Education

- J.D., University of Virginia, 1985
- B.A., *cum laude*, Yale University, 1982

Significant Debtor Representation

- William Herbert Hunt 1988 - 1990
  - ▸ *Second chair representation*
- Trailways Lines, Inc. 1988 - 1990
- Atlanta Midtown Hotel Partners 1993 - 1994
  - ▸ *Co-counsel in hotel bankruptcy*
- Crescent Broadcasting Corporation 1995 - 1996
  - ▸ *Wireless television broadcasting company*

Significant Creditor Committee Representation

- Basin Refining, Inc. 1986 - 1988
- Express One International, Inc. 1995 - 1996
  - ▸ *Represented Committee in bankruptcy of regional airline as co-proponent of consensual plan*

DAVID J. KRITZ

ASSOCIATE
Employee Benefits/Tax/Labor and Employment

Practice Areas

Representation of clients in matters concerning employee benefits and employment law issues, with experience in:

- ERISA and employment litigation matters;
- advising employers about their compliance obligations under laws such as ERISA, the Internal Revenue Code, COBRA, the Family and Medical Leave Act, WARN, and various discrimination laws;
- drafting severance pay plans, cafeteria plans, medical reimbursement plans and dependent care plans;
- evaluating and revising agreements with third-party plan administrators;
- assisting clients with employment and employee benefit exposures and compliance concerns arising out of bankruptcies, workforce reductions, and other business and significant workforce changes; and
- general counseling with respect to pension plans, welfare plans, severance plans, safety and workers' compensation programs, employment agreements, personnel policies, worker classification issues, employee handbooks, and other employment and employee benefit practices and procedures.

Education:

- School of Law, State University of New York at Buffalo, J.D., 1992
- Northwestern University, B.A., History and Music, 1989

Civic and Professional:

- Admitted to Practice in Texas, New York, New Jersey, Pennsylvania, United States District Courts for the District of New Jersey and the Northern District of Texas
- State Bar of Texas: Labor and Employment Law Section
- Dallas Bar Association: Employee Benefits Section; Labor and Employment Law Section


THE MEN WANT TO KNOW HOW THIS WILL AFFECT THEIR PROFIT-SHARING PLAN

BANKRUPTCY AND EMPLOYEE BENEFIT ISSUES

Table of Contents

BANKRUPTCY AND EMPLOYEE BENEFIT ISSUES

I. Basic Bankruptcy Concepts

A. Introduction

Bankruptcy law is exclusively governed by the Bankruptcy Code, a federal law which is codified in Title 11 of the United State Code (the "Bankruptcy Code"). The Bankruptcy Code has several underlying policies: it aims to provide a fair and orderly means for a debtor, whether an individual or business, to get relief from debts and to obtain a fresh start, while at the same time providing for equality in treatment among classes of creditors.

The Bankruptcy Code is divided into several substantive chapters. Chapter 1 contains definitions, general provisions and rules of construction, Chapter 3 deals with case administration and Chapter 5 contains provisions relating to the debtor, creditors, and the estate. The provisions in Chapters 1, 3 and 5 contain provisions that generally apply to bankruptcy cases under Chapter 7 (bankruptcy liquidation), and to cases under Chapters 11 and 13 (generally, bankruptcy reorganizations for businesses and individuals, respectively). There are two other bankruptcy Chapters in the Bankruptcy Code that are not addressed in this outline: Chapter 9 deals with debts of municipalities, and Chapter 12 addresses the debts of certain farmers.

Most liquidation cases are governed by Chapter 7 of the Bankruptcy Code. In a Chapter 7 case, all unencumbered assets of the debtor are sold and the proceeds are used to satisfy the claims of creditors, in the order required by section 726 of the Bankruptcy Code. Some liquidation cases may occur under a Chapter 11 case as well.

A proceeding to reorganize a debtor is governed by either Chapter 11 or 13. Debtors who are engaged in business, including sole proprietors, partnerships and corporations, may file a Chapter 11 bankruptcy petition, under which the debtor may seek an adjustment of debts, either by reducing or by extending time of payment, or by seeking a comprehensive reorganization. An individual debtor or a sole proprietor of a small business who has regular income may seek an arrangement with creditors under Chapter 13. In such reorganization proceedings, under either Chapter 11 or 13, the debt, equity (and, if a Chapter 11 case, business) of the debtor are restructured, and provision is made for payment of all or a portion of the claims against the debtor.

There are significant differences between federal bankruptcy proceedings under the Bankruptcy Code and state debtor-creditor law. Under the Bankruptcy Code, one creditor cannot improve its position in relation to the other creditors by seizing the debtor's assets. By contrast, state laws emphasize prompt action by creditors, often resulting in a "race" to the courthouse to take action with respect to the debtor's property.

the bankruptcy case, the creditor is enjoined from pursuing those debtors further after the stay dissolves.

D. Trustee and the United States Trustee

The trustee is the officer who represents the estate in a bankruptcy case. 11 U.S.C. § 323. The trustee may sue and may be sued on behalf of the estate. Id. In general, the trustee collects and preserves estate assets, and the trustee has the power to avoid certain transfers, executory contracts, and liens. A trustee must be elected or appointed in every Chapter 7 liquidation case. By contrast, a trustee is not appointed in a Chapter 11 reorganization case unless the court, after notice and hearing, determines that there is cause for an appointment. 11 U.S.C. § 1104(a).

In the usual business reorganization case, the debtor will remain in control of its business after a reorganization is commenced. The debtor remaining in control is known as the "debtor-in-possession." The debtor-in-possession performs the functions of the trustee, except that the debtor-in-possession does not receive a trustee's compensation.

The trustee is different than the "United States Trustee" or "U.S. Trustee". The tasks that the U.S. Trustee is authorized to perform are enumerated in 28 U.S.C. § 586(a). The U.S. Trustee establishes, maintains, and supervises a panel of private trustees that are eligible to serve as Chapter 7 (i.e., liquidation) trustees. The U.S. Trustee is charged with the duty of supervising the administration of cases and trustees in all bankruptcy cases. Id. at § 586(a)(3). In a liquidation case, the U.S. Trustee appoints a member of the panel to serve as interim trustee, and this individual will often become the regular trustee. In a Chapter 11 case, the U.S. Trustee must appoint an unsecured creditors' committee and may appoint additional committees of creditors or equity security holders.

E. Committees

Section 1102 of the Bankruptcy Code generally requires the establishment of a committee of unsecured creditors in a Chapter 11 case. In a Chapter 11 case, the U.S. Trustee selects and appoints the members of the unsecured creditors' committee "as soon as practicable" after the order for relief. 11 U.S.C. § 1102(a)(1). The creditors' committee ordinarily consists of the unsecured creditors who hold the largest kinds of claims; there is no fixed ceiling or floor on the number of members that may be on the committee. In addition to the creditors' committee, on request of any party in interest in a Chapter 11 case, the court may order the U.S. Trustee to appoint additional committees of creditors, equity security holders or limited partners as are necessary to ensure adequate representation. 11 U.S.C. § 1102(a).

The committees generally consult with the trustee or debtor about the administration of the bankruptcy case, investigate the debtor's financial condition, participate in formulating

such right to an equitable remedy is reduced to judgment, fixed, contingent, matured, unmatured, disputed, undisputed, secured or unsecured.

Creditors file claims in the bankruptcy by completing a "proof of claim" form in accordance with the Bankruptcy Rules and any local rules of the bankruptcy court. Claims must be filed by the claims bar date. The bar date in a Chapter 7 case is 90 days after the date of the first meeting of creditors unless the court sets a different date. The bar date in a Chapter 11 case is set by order of the bankruptcy court. In some jurisdictions, including the Northern District of Texas, the bar date in Chapter 11 cases is the same as that in Chapter 7 cases. If a creditor does not file a proof of claim for a claim which came into existence prior to the filing of the debtor's petition (a "pre-petition claim"), the court will most likely "disallow" the claim, unless there is a showing of "good cause" as to why the claim was not timely filed.

I. Priorities of Claims Relevant to Employee Benefits

Section 507 of the Bankruptcy Code defines a set of priorities for the payment of unsecured claims. The priority assigned to a claim has a substantial impact upon the amount of the distribution, if any, that will be paid to the creditor. After a claim is filed, the parties will often litigate about whether the claim is entitled to any priority status. The claim priorities that directly impact employee benefits are the following:

- Section 507(a)(1) provides a first priority for administrative expenses allowed under Bankruptcy Code section 503(b). These expenses include the "actual, necessary costs and expenses of preserving the estate, including wages, salaries, or commissions for services rendered after the commencement of the case," certain taxes and compensation for professionals (e.g., attorneys, accountants) involved in the bankruptcy.

- Section 507(a)(3) establishes a priority for allowed unsecured claims for "wages, salaries, or commissions, including vacation, severance and sick leave pay earned by an individual" within 90 days before the filing of the petition or the cessation of the debtor's business, whichever occurs first, up to a limit of $4,000 for each individual or corporation.

- Section 507(a)(4) establishes a priority for "allowed unsecured claims for contributions to an employee benefit plan ... arising from services rendered within 180 days before the filing of the petition or the cessation of the debtor's business, whichever occurs first, up to a limit of $4,000 multiplied by the number of covered employees, less the amount paid as a priority under section 507(a)(3).

litigation in the bankruptcy court over which claims are allowed or disallowed, as well as over the priority of the claims, as well as over other matters concerning the debtor. In the bankruptcy of an individual, the court usually will grant an individual a "discharge" of the individual's debts. However, even if an individual obtains a discharge, certain debts are nondischargeable and survive bankruptcy. For example, certain income taxes, student loans and obligations to pay alimony and child support are not dischargeable in bankruptcy. *See* 11 U.S.C. § 523 (listing exceptions to discharge).[2] Neither corporations nor partnerships are eligible for discharge under a Chapter 7 case. 11 U.S.C. § 727(a)(1). Eventually, the trustee will complete all his duties in administering the estate by collecting and distributing all the estate assets among the secured, priority and general unsecured creditors, according to their rank. At that point, the trustee will file a closing report, the trustee will be dismissed and the court will close the bankruptcy case. The debtor may at any time, upon a motion to the court, convert a liquidation case to a Chapter 11 reorganization or a Chapter 13 individual debt adjustment. 11 U.S.C. § 706(a).

In a Chapter 11 case, the debtor-in-possession will generally continue to operate its business following the bankruptcy filing. The creditors' committee and other committees will meet, creditors will file their proofs of claim with the bankruptcy court, and there will often be litigation over which claims are allowed or disallowed and over the priorities of the claims. During the first 120 days of a voluntary bankruptcy under Chapter 11, the debtor has the exclusive right to file a plan of reorganization with the bankruptcy court. 11 U.S.C. § 1121(b). The debtor loses the exclusive right to file a plan of reorganization if: (1) a trustee is appointed; (2) the 120-day period expires and the debtor has not filed a plan of reorganization; (3) the debtor does not file a plan of reorganization that has been accepted, before 180 days after the order for relief was entered, by each class of claims an interests impaired under the plan; or (4) or after notice and hearing, the court shortens the period for cause shown. 11 U.S.C. § 1121(c). There is required information that must be included in the plan of reorganization, such as a designation of the classes of creditors and a description of the treatment of the claims of each class. The proponent of a plan of reorganization must also file a disclosure statement that summarizes the plan and provides information to creditors to permit a hypothetical, reasonable creditor to make an informed decision as to whether to accept or reject the plan of reorganization. Creditors will then vote upon whether to accept the plan, and the court will hold a hearing to confirm or reject the plan of reorganization. The bankruptcy court's confirmation of the plan of reorganization discharges the debtor from debts that arose prior to the date of confirmation, including liabilities that arose from the rejection of executory contracts and unexpired leases, unless the plan or confirmation order provides otherwise. 11 U.S.C. § 1141(d)(1). This discharge is effective against any creditor, regardless of whether or not the creditor filed a

---

[2] *See McLaughlin v. Ardito*, 10 EBC 1279 (E.D.N.Y. 1988), in which the Department of Labor obtained an order from a bankruptcy court excepting from discharge in bankruptcy a judgment obtained against the bankrupt in connection with his misuse of plan assets. The court made its ruling under Section 523(a)(4) of the Bankruptcy Code, which permits debts arising from fraud or defalcation while acting in a fiduciary capacity, embezzlement, or larceny to be declared nondischargeable.

Plan assets include, but are not limited to, certain employer contributions, funds that a participant or beneficiary pays to an employer, and amounts that a participant has withheld from his or her wages as employee contributions to the plan. Participant contributions paid to an employee benefit plan generally are treated as plan assets and required to be held in trust pursuant to the plan asset regulations promulgated by the Department of Labor.[5] Current regulations require that employee contributions must be transferred to the trust as of the earliest date on which they can reasonably be segregated from the employer's general assets, but not later than either (1) the 15th business day of the month following the month in which the participant contribution amounts are received by the employer (in the case of amounts that a participant pays to an employer), or (2) the 15th business day of the month following the month in which the amounts would otherwise have been paid to the employee in cash (in the case of amounts withheld by an employer from a participant's wages).[6] The regulations provide for an extension of these deadlines in certain instances.

An employer cannot be excused from the obligation to comply with the trust requirement because the employee contributions are used immediately either to pay benefits or to reimburse previous payments of benefits. Department of Labor Regulation Section 2510.3-102 and ERISA Technical Release 92-01 specifically address this question. They indicate that "all amounts that a participant pays to or has withheld by an employer for purposes of obtaining benefits under a plan become plan assets without regard to when related plan expenses or benefits are paid by the employer."

A plan sponsor's failure to maintain plan assets in trust for an employee benefit plan may be held to be a breach of fiduciary duties under ERISA sections 403 and 404(a)(1)(A), 29 U.S.C. §§ 1103, 1104(a)(1)(A), which requires that plan assets and employee contributions be held in trust. All such assets must be used for the exclusive purpose of providing benefits to plan participants and their beneficiaries, or for defraying the reasonable expenses of the Plan.

Unfortunately, too often companies in financial distress and bankruptcy attempt to or actually misuse the assets of employee benefit plans in an effort to keep the company operating on a day-to-day basis. *See, e.g., U.S. v. Todd*, 20 EBC 2676 (March 31, 1997) (discussing employer in financial distress who was convicted for using employee contributions to 401(k) plan for "matters not connected with the funding of the plan"). Theft or embezzlement from an employee benefit plan is a federal crime, punishable by fine, five

---

[5] *See* 29 C.F.R. § 2510.3-102.

[6] Id.

A potential area of bankruptcy/employee benefits litigation is whether the assets of "top hat" plans or "excess benefit plans" are property of the bankruptcy estate.[9] "Top hat" plans are plans that are "unfunded and [are] maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees." 29 U.S.C. §§ 1051(2), 1081(a)(3), 1101(a)(1) (emphasis added).[10] An excess benefit plan, as defined in section 3(36) of ERISA, 29 U.S.C. § 1002(36), is a plan (or a portion of a plan) maintained solely for the purpose of providing benefits in excess of the limitations on qualified plan benefits imposed by IRC section 415 of the Code.

Because top hat plans have the effect of deferring employees' income for periods extending beyond the termination of covered employment, they are "pension plans" and therefore generally subject to Title I of ERISA. However, top hat plans do not have to comply with ERISA's rules concerning participation and vesting (and thus are not subject to ERISA's anti-alienation rules), funding, or fiduciary responsibilities. 29 U.S.C. §§ 1051(2), 1081(a)(3), 1101(a)(1); *see Barrowclough v. Kidder, Peabody & Co.*, 752 F.2d 923, 930-31 (3d Cir. 1985) (Congress did not elect to grant "blanket exemption" for unfunded deferred compensation plans for select or highly compensated employees, but focused the exemption on particular substantive provisions). However, an excess benefit plan is totally exempt from ERISA. ERISA §4(b)(5), 29 U.S.C. § 1003(b)(5).

---

[9] Top hat plans and excess benefit plans may be involved in bankruptcy litigation because the assets for such plans are often held in "rabbi trusts". A rabbi trust is an arrangement whereby an employer transfers assets to an irrevocable trust to provide deferred compensation to under either a top hat or excess benefit plan. Under this type of arrangement, an employee (or the employee's beneficiary) is not entitled to receive a distribution from the trust until the employee retires, dies, or terminates employment without cause. As a result, the employee is not taxed on this deferred compensation until it is actually paid or made available to the employee, whichever is earlier.

Once an employer transfers assets to a rabbi trust, the employer cannot retrieve such assets for corporate use. Thus, a rabbi trust provides an employee with the security of knowing that once the trust is established, the employee will receive a benefit from the trust, unless the employer becomes bankrupt or insolvent. Under those circumstances, the assets of a rabbi trust are considered to be the assets of the employer and are subject to the claims of the employer's general creditors, and any employee of the bankrupt employer who had participated in a rabbi trust arrangement becomes a general unsecured creditor of the employer.

[10] As noted above, a top hat plan must be an "unfunded" plan. The Department of Labor has issued numerous opinion letters that state that a rabbi trust established to aid a company in accumulating funds to provide benefits under a plan will not cause the plan to be unfunded for purposes of ERISA if (1) the benefits remain unfunded contractual liabilities of the company, (2) the benefits are paid from the general assets of a company, (3) the participants and beneficiaries of the plan have no right, title or interest in the specific assets of the trust, and (4) trust assets remain subject to the claims of the creditors of the company. See U.S. Department of Labor Advisory Opinion Letters 92-13A (May 19, 1992), 91-16A (April 5, 1991), and 90-14A (May 8, 1990).

institution being held liable for breach of fiduciary duty under ERISA in the event that a court subsequently determines that the purported top hat plan was not maintained for a "select group" of management or highly compensated employees, but instead allowed employees who were not in the "select group" (i.e., janitors, secretaries, support staff, etc.) to participate in the plan.

Similarly, an institution faced with a demand to turn over the assets of a purported excess benefit plan should examine the plan document and its operation to determine whether the plan is, in fact, an excess benefit plan.

C. Fiduciary Traps

In each particular case, the question of whether a person or entity is a fiduciary must be evaluated in terms of the plan document and the person's or entity's actions. ERISA defines a "fiduciary" to include any person or entity, including partnerships, corporations, joint ventures, trusts, estates, associations, and employee organizations. *See* ERISA § 3(9), 29 U.S.C. § 1002(9). An individual or entity is a fiduciary with respect to an employee benefit plan if (1) the plan document identifies the individual or entity as a named fiduciary (a "named fiduciary"), 29 U.S.C. § 1102(a)(1), or (2) specific facts that show that the individual or entity either (a) actually exercises discretionary authority or control respecting the management of the plan or exercises authority or control respecting management or disposition of its assets, (b) renders investment advice for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or has any authority or responsibility to do so, or (c) has any discretionary authority or discretionary responsibility in the administration of such plan. 29 U.S.C § 1002(21)(A). ERISA thus provides that a person can be a fiduciary either by being named a fiduciary in the plan document, or by virtue of his or her authority and activities.

ERISA's provisions regarding fiduciary duties provide the framework within which plan fiduciaries must act in administering employee benefit plans and managing plan assets. To satisfy the fiduciary requirements of ERISA, a fiduciary must ensure that the company and its agents administer their duties under the plan:

- Solely in the interest of participants and beneficiaries of the plan;
- For the exclusive purpose of providing benefits to participants and beneficiaries and defraying reasonable expenses of administering the plan;
- With the care, skill, prudence and diligence that a prudent person acting with like capacity and familiar with such matters would use under the circumstances;
- In accordance with the terms of the written plan documents;

that it would resign as trustee if salary deferral remittances continued to be delinquent." Id. Finally, the Bank took steps to resign as trustee pursuant to the terms of the plan document. The Bank repeatedly asked Frey, as administrator, to appoint a successor trustee, but Frey failed to take such action. Thereafter, the Bank, in accordance with the plan documents, designated Frey as the successor trustee and in October 1993, the Bank forwarded the Plan's assets to Frey. Frey subsequently converted all of the plan assets to his own use.

In November 1993, the Company filed for bankruptcy under Chapter 7 of the Bankruptcy Code. Shortly thereafter, Jeffrey Ream ("Ream"), a participant in the Plan, demanded payment of his plan benefit from the Bank. Ream was not aware that the Bank had transferred all the plan assets to Frey, and neither the Bank nor Frey "had ever notified Ream of the delays in payments to the plan, of [Bank's] intention to resign, or of [Bank's] final resignation." Id. When Ream learned that the Bank had transferred the plan's assets to Frey, he demanded payment from Frey. Frey send Ream a letter, dated January 4, 1995, in which "Frey acknowledged that he owed Ream $16,206 pursuant to the plan and proposed paying that money in installments." Id. Ream rejected this offer and instituted suit against both Frey and the Bank for breach of fiduciary duty. Ream subsequently "disappeared", and he was dismissed from the lawsuit because the parties did not know his whereabouts. Id.

The Third Circuit held that the Bank's "knowledge of the company's problems in conjunction with Frey's failure to respond to the bank's numerous attempts to communicate about the future administration of the plan" constituted sufficient information for a reasonably prudent trustee to recognize that turning over the plan's assets to Frey posed a "real threat" to the plan's beneficiaries. Id. at 2665. The court further held that "[a]llowing a fiduciary to resign without notice to the plan beneficiaries in a situation in which the fiduciary has information indicating that the beneficiaries may need protection because of the change in trustee would undermine the goals of ERISA." Id. at 2664. The court thus affirmed the court's decision finding that the Bank had breached its fiduciary duties.

The *Ream v. Frey* case could have had more severe consequences than those which actually resulted for the Bank. Ream was the only plan beneficiary who sued the Bank, and the amount of his unpaid benefit was only about $3,000. The Bank was thus fortunate that other beneficiaries with greater benefits did not sue the Bank for their benefits.

A fiduciary has a duty not only to inform a beneficiary of new and relevant information as it arises, but also to advise the beneficiary of circumstances that threaten interests relevant to the relationship. For example, courts have held that a fiduciary bears an affirmative duty to inform a beneficiary of the fiduciary's knowledge of prejudicial acts by an employer -- such as the failure of an employer to contribute to a fund as required. *See Dellacava v. Painters Pension Fund*, 851 F.2d 22, 27 (2d Cir. 1988); *Rosen v. Hotel and Restaurant Employees Union*, 637 F.2d 592, 599-600 (3d Cir.) (holding a fiduciary is under a duty to communicate material facts to a plan beneficiary), *cert. denied*, 454 U.S. 898 (1981).

other plan related expenses should generally be paid by the company rather than with plan assets.

E. Protection of Retiree Medical Benefits in Chapter 11 cases

In a case under Chapter 11 of the Bankruptcy Code, the trustee or debtor-in-possession is required to continue paying "retiree benefits" without modification, under section 1114 of the Bankruptcy Code. Retiree benefits are defined as:

> [P]ayments to any entity or person for the purposes of providing or reimbursing payments for retired employees and their spouses and dependents, for medical, surgical, or hospital care benefits, or benefits in the event of sickness, accident, disability, or death under any plan, fund, or program (through the purchase of insurance or otherwise) maintained or established in whole or in part by the debtor prior to filing a petition commencing a case under this title.

However, section 1114 of the Bankruptcy Code does not protect retiree benefits beyond the contractual obligations of the debtor. *See In re Ionosphere Clubs, Inc.*, 134 B.R. 515, 519 n.4 (Bankr. S.D.N.Y. 1991); *In re Doskocil Companies, Inc.*, 130 B.R. 870, 876 (Bankr. D. Kan. 1991); *see also* 5 Collier on Bankruptcy ¶ 1114.02[1][a] at 1114-13 (15th ed. 1995) ("Section 1114 does not, however, protect retiree benefits beyond the contractual obligations of the debtor."); id. ¶ 1114.02[2] at 1114-16 ("Retirees are protected by section 1114 from the termination of benefits due to the filing of a petition under the Bankruptcy Code, but they are not protected from the termination of rights due to the expiration of the agreement.").

The Bankruptcy Code provides for the creation of a committee to represent the interests of the retirees. 11 U.S.C. § 1114(d). The committee may consist of either a labor union or retired employees. Id. at § 1114(b), (c). If the debtor wants to modify the retiree benefits, it must first submit its proposal to the committee. Any changes that the debtor seeks to make to the retiree benefits must be "necessary modifications" that are "necessary to permit the reorganization of the debtor." Id. at § 1114(f)(1)(A). The retiree committee has the same rights, powers and duties as other committees involved in the bankruptcy, including the right to retain professional expertise at the expense of the bankrupt estate. The trustee or debtor in possession must provide the retiree committee with information so that the representative can evaluate the fairness of the proposal. Id. at § 1114(f)(1)(B).

The trustee or debtor-in-possession and the retiree committee must negotiate in good faith to attempt to reach a mutually satisfactory modification to the retiree benefits. Id. at § 1114(f)(2). A critical portion of these negotiations involves making an actuarial determination of the amount of the liabilities under the debtor's retiree health program. In making these calculations, the actuary must consider the annual claim cost amount, the rate at which medical rates are increasing, mortality of the retirees, and administrative expenses. Even after the

G. Issues Concerning Defined Benefit Plans

The provisions of ERISA and the IRC relating to funding, funding waivers, excise taxes and plan termination are of particular importance if the debtor maintains a defined benefit pension plan.[11] The plan sponsor of a defined benefit plan is required to contribute to the plan each year the amount that is determined to be actuarially required so as to provide the promised benefits under the plan to the minimum level described in the IRC and ERISA. IRC section 412; ERISA section 302, 29 U.S.C. § 1082. All the entities under "common control" with the plan sponsor are jointly and severally liable for these minimum funding obligations to the defined benefit plan. Id. A plan sponsor's failure to pay such contributions when due may result in the imposition of excise taxes under IRC section 4971.

If the plan sponsor of a ERISA-covered defined benefit pension plan files for bankruptcy, and if the pension plan does not have sufficient assets to pay participants all their benefits due under the plan and under ERISA, the Pension Benefit Guaranty Corporation (the "PBGC"), a wholly-owned United States government corporation created under section 4002 of ERISA, 29 U.S.C. § 1302, becomes a significant player in the bankruptcy proceedings. This is because when a covered plan terminates without sufficient funds to pay the promised benefits, the PBGC is required to pay "guaranteed benefits" to the participants in the plan. ERISA § 4022(a), 29 U.S.C. § 1322(a). In such situations, the PBGC will seek to minimize its own liability with respect to the benefits due under the debtors pension plan by maximizing its recovery from the debtor's bankruptcy estate.

Where a debtor/employer maintains a defined benefit pension plan subject to Title IV of ERISA, the PBGC usually files claims in the bankruptcy based on the contingency that the debtor's underfunded defined benefit pension plan may terminate during the debtor's bankruptcy. The PBGC generally files three "types" of claims against the debtor and the members of its controlled group: (1) claims for the unpaid minimum funding contributions (*see* 29 U.S.C. § 1342(d)(1)(B)(ii), granting PBGC authority as statutory trustee to collect any amounts due the plan); (2) claims for the shortfall between the plan's assets and the benefits promised to participants and beneficiaries (29 U.S.C. §§ 1301(a)(18), 1362(b)); and (3) for unpaid premiums, and associated interest and penalties, due the PBGC (29 U.S.C. § 1306, 1307). The PBGC will assert various priorities for these claims, depending upon when the debt first became due to the plan or the PBGC. In an effort to maximize its recovery from the bankruptcy estate, the PBGC has repeatedly litigated the status of its claims in bankruptcy.

However, to the extent that courts grant the PBGC "priority" status for its claims, it reduces the amount of assets available for distribution to other unsecured creditors in the bankruptcy case. Similarly, a greater distribution to the PBGC may result in fewer assets

---

[11] A complete discussion of the laws and cases regarding the interrelationship between ERISA and the Bankruptcy Code as they apply to defined benefit pension plans sponsored or maintained by employers in bankruptcy is beyond the scope of the presentation and this handout.

clause.[13] The company filed for bankruptcy in 1982 and subsequently liquidated. Two years later, Shumate filed a personal bankruptcy that was subsequently converted to a case under Chapter 7 of the Bankruptcy Code. The bankruptcy trustee for the company terminated the plan and distributed plan assets to all participants, except Shumate. The trustee for Shumate's personal bankruptcy then sued the company's bankruptcy trustee to recover the amount of Shumate's interest in the pension plan. In *Patterson*, the Supreme Court held that where a plan is subject to ERISA, is qualified under the IRC, and contains an anti-alienation provision, the anti-alienation provision is a "restriction on the transfer" of the debtor's beneficial interest in the qualified retirement trust, so as to trigger the exclusion under Bankruptcy Code section 541(c)(2). The Supreme Court found that the plan at issue in the *Patterson* case contained the anti-alienation provision required under ERISA, and that the property would therefore be excluded from the bankruptcy estate under section 541(c)(2) of the Bankruptcy Code.

Unfortunately, the Supreme Court repeatedly used the phrase "ERISA qualified plans" in its decision in *Patterson*, but did not define what it meant by the phrase. The Court thus confused the issue of ERISA coverage (which is automatic if the Plan falls within the purview of Title I of ERISA) with qualification of a Plan under the IRC (which is not automatic). An "ERISA qualified plan" could be interpreted to mean a plan that is subject to Title I of ERISA, or a plan that is qualified under IRC section 401(a), or both. Courts have since struggled with the Supreme Court's opinion in *Patterson* as to what the Supreme Court meant by the term "ERISA qualified plan". *Compare In re Hall*, 151 B.R. 412, 419 (Bankr. W.D. Mich. 1993) (finding that, in order for plan benefit to be excluded from the bankruptcy estate, plan had to be subject to ERISA, be tax qualified and contain an anti-alienation clause) *with In re Hanes*, 2 B.R. 733 (Bankr. E.D. Va. 1994) (finding that plan had to be subject to ERISA and contain an anti-alienation clause, but did not have to be tax qualified, in order for pension to be excluded from the bankruptcy estate).[14]

---

[13] Section 206(d)(1) of ERISA, 29 U.S.C. § 1056(d)(1) requires that "each pension plan [] provide that benefits provided under the plan may not be assigned or alienated." Similarly, in order for a pension plan (or the trust funding such a plan) to be a tax qualified under IRC section 401(a), the plan must satisfy the anti-alienation provisions of IRC section 401(a)(13)(A) which provides, in part, that "[a] trust shall not constitute a qualified trust under this section unless the plan of which such trust is a part provides that benefits provided under the plan may not be assigned or alienated." However, if a plan is subject to ERISA, such benefits may be protected even in the absence of an express anti-alienation provision. *See Mackey v. Lanier*, 108 S. Ct. 2182, 2188 (1988) ("Section 206(d)(1) [of ERISA] bars the assignment or alienation of pension plan benefits, and because, as is explained below, ERISA preempts state laws that 'relate to' employee benefit plan, [and] thus prohibits the use of state enforcement mechanisms . . . in so far as they prevent those benefits from being paid to plan participants.").

[14] For a further discussion of these cases, *see* Charles Edward Falk, *Patterson v. Shumate: A Five Year Legacy*, Pension and Benefits Reporter, Vol. 24, No. 25 (June 23, 1997); and Ronald T. Martin, Mervyn S. Gernson & Marcia E. Levine, *Qualified Plans May Not Be Protected In Banrkuptcy*, 23 ACTEC Notes 75, 75-82 (1997) (ACTEC Notes is a publication of the American College of Trust and Estate Counsel).

Finally, it is important to realize that the debtor's interest in a pension plan cannot be greater than the debtor's right to the pension benefit. For example, if a pension plan only permits the debtor to withdraw funds in the event of retirement or death, the bankruptcy estate's rights to compel the turnover of those funds is subject to the same limitations. If the debtor/participant is receiving ongoing benefits under a pension plan, the debtor may consent to payment of the benefits to the trustee. However, among other requirements, the assignment must be voluntary and revocable. Treas. Reg. §§ 1.401(a)-13(d)(1), (e).

Regardless of whether a pension benefit is excludable or exempt from the bankruptcy, a bankruptcy trustee can seek to void a debtor's plan contributions made within twelve months of bankruptcy if the bankruptcy trustee can show that the contributions were made with the intent to hinder, delay or defraud creditors. In addition, some courts have held that contributions made in violation of the terms of a plan are void and are not protected by the plan's anti-alienation provisions. *Bell & Beckwith v. Society Bank and Trust*, 5 F.3d 150 (6th Cir. 1993).

Practice Tip For Institutions Holding Pension Assets: As a practical matter, a bank or other institution that holds pension assets, regardless of the form of that pension asset (i.e., IRA, tax qualified plan, etc.), should consult with qualified counsel before it turns over such assets to the debtor, the bankruptcy trustee, or any other entity. To trustee of a pension plan that is qualified under the IRC should especially resist any attempt by a bankruptcy trustee to include the employee's personal benefit in the bankruptcy estate, as the qualified plan is subject to disqualification if it allows benefits to be assigned or alienated in violation of the IRC. Moreover, if the institution, as fiduciary of an ERISA plan, allows the unlawful assignment of alienation of benefits (*see* section II.C., above), the fiduciary may be subject to making the plan whole under ERISA Section 409, and the participant, beneficiary or Secretary of Labor could bring an action to obtain equitable relief to prevent or correct the violation.

The bank or other institution should, at a minimum, require that the bankruptcy trustee or debtor obtain an order from the bankruptcy court before it releases the pension assets to either of those entities. However, if the plan has an anti-alienation provision, even receipt of a bankruptcy court order requiring distribution of the pension benefit does not provide complete protection to the institution. In such a situation, the institution will be faced with the dilemma of having to choose between complying with a court order that could result in disqualifying the plan under the IRC and causing the institution to possibly incur significant liability under ERISA, or risking the bankruptcy court issuing a contempt of court citation against the institution for not complying with the court's order.

An institution's failure to obtain and prudently review an order of the bankruptcy court concerning the distribution of the debtor's pension benefit could subject the institution to significant liability in the event that it paid the benefit to a party that was not entitled to receive the benefit under the Bankruptcy Code. For example, a fiduciary of an ERISA plan that allows an unlawful assignment or alienation of a plan benefit may be subject to make the plan whole under section 409 of ERISA, 29 U.S.C. § 1109. Moreover, the participant, beneficiary or the Secretary of Labor may obtain equitable relief to correct the violation. To the extent that the

The Internal Revenue Service has issued Notice 97-11, which provides a summary of the statutory requirements and provides sample language that can be used to draft and review QDROs under IRC section 414(p).

Bankruptcy courts are often required to determine whether and how to divide a participant's interest in a pension plan in the participant's bankruptcy case. Courts generally have held that where a nondebtor/ex-spouse's interest in the debtor/participant's pension is created pursuant to a QDRO, there is no debtor-creditor relationship between the ex-spouse and the participant, as the ex-spouse has an independent right to the pension benefit. Moreover, as the debtor/ex-spouse is an owner of a portion of the pension plan, any claim that she has for the pension is against the pension plan and not against the participant. *See In re Brown,* 168 B.R. 331, 334-35 (Bankr. N.D. Ill. 1994) (citing numerous cases finding that a former spouse's interest in a debtor's pension benefit becomes the sole and separate property of the nondebtor spouse upon entry of a final judgment of divorce).

Courts are faced with a more difficult task when they are confronted with the situation where a nondebtor/ex-spouse seeks to obtain a portion of the debtor/participant's pension benefit, but where there is no valid QDRO. Courts have used a variety of innovative legal theories to prevent the ex-spouse from losing a potential interest in a pension payment. *See In re Chandler,* 805 F.2d 555, 557 (5th Cir. 1986), *cert. denied*, 481 U.S. 1049 (1987) (debtor's obligation to turn over a share of pension payments does not become a "debt" until the debtor receives each disbursement from the pension fund; therefore, payments to be made to the nondebtor ex-spouse after the filing of the bankruptcy case are postpetition debts, not subject to discharge); *In re Gendreau*, 191 B.R. 798, 803 (9th Cir. Bankr. App. Panel 1995) (finding that, as of the bankruptcy petition date, the debtor was only entitled to a percentage of the pension funds, with the remaining portion of the pension subject to the ex-spouse's future right to obtain a QDRO); *id.* at 804 (holding that ex-spouse's right to receive a portion of the pension funds should not be forfeited merely because the debtor filed his bankruptcy petition before the ex-spouse obtained a domestic relations order that qualified as a QDRO); *In re Brown, supra*, 168 B.R. at 334-35 (finding that debtor holds pension interest in constructive trust for ex-spouse).

Practice Tip for Institutions Holding Plan Assets: QDROs must be "clear and specific and not left to determination by inference or conjecture." *Hawkins v. Commissioner*, 102 T.C. 61, 74-75 (1994). Even though the plan administrator has the responsibility for determining whether a domestic relations order meets the IRC's and ERISA's requirements so as to constitute a QDRO, the safest road for any trustee holding pension plan assets to follow is to conduct an independent review of the purported QDRO so as to be certain that it meets all the statutory and regulatory requirements so as to constitute a QDRO. A trustee's failure to follow this simple step could subject the trustee (as well as the plan administrator) to a stream of litigation by various claimants to the participant's and/or ex-spouse's interest in a pension plan.

[F:\TAX\99991\60899\DOCS\DBSPAPER]