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Venable Bankruptcy Law Alert

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ERISA and Employment Law Highlights of The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005

The bankruptcy reform legislation, known as The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, was passed by Congress on April 14, 2005, and signed into law by President Bush on April 20, 2005.

Despite the focus in the media on the consumer bankruptcy aspects of the legislation, it contains many changes of significance to businesses. Highlights of the ERISA and employment law aspects of the new legislation are summarized below.

I. ERISA Plan Issues.

A. Exemption of IRA's and Other Retirement Plans

Retirement funds held in a fund or account that is "exempt from taxation" can now be claimed by a debtor as exempt, and thereby protected from liquidation by a bankruptcy trustee. The new law protects most broad-based employee retirement plans and individual retirement accounts that are accorded special tax treatment. (See 11 U.S.C. §§ 522(b)(c)(3), 522(d)(12).)

The new law clarifies treatment of retirement funds, which are subject to a variety of state and federal exemption provisions under current law.

Note: Funds held in special executive compensation and other non-qualified plans generally are not included in the new protections.

B. Limitation on Exemption of IRA's

The new law imposes a $1,000,000 limit on the amount an individual can claim as exempt in an IRA, although the amount of the cap "may be increased if the interests of justice so require." Rollover contributions are excluded from determination of the $1,000,000 limit. (See 11 U.S.C. § 522(n).)

C. Exclusion of Education IRA's from Bankruptcy Estate

Funds placed in an Education IRA more than 720 days prior to bankruptcy are now excluded from a debtor's bankruptcy estate, and thus cannot be liquidated by a bankruptcy trustee. Funds placed in such an account between 720 and 365 days before bankruptcy are also given limited protection up to $5,000 per beneficiary. (See 11 U.S.C. § 541(b)(5).)

In order for funds to qualify for the protection, the designated beneficiary of the account must be the child, stepchild, grandchild or stepgrandchild of the debtor for the taxable year when the funds were placed into the account and the funds cannot be (1) pledged or promised in connection with the extension of credit, or (2) excess contributions.

There is also now similar protection for funds used to purchase a tuition credit or certificate, or contributed to an account under a qualified State tuition program. (See 11 U.S.C. § 541(b)(6).)

D. Exclusion of Withholding and Contributions to Benefit Plans

Under the new law, amounts withheld or received by an employer as contributions to most employee benefit plans, deferred compensation plans, tax deferred annuities and health insurance plans are not a part of a debtor's bankruptcy estate and therefore not subject to the claims of the debtor's general creditors. (See 11 U.S.C. § 541(b)(7).)

E. Exception from Discharge and Automatic Stay of Loans from Plans

Under the new law, a bankruptcy discharge does not eliminate a debtor's obligation to repay certain loans from most broad-based employee retirement plans that are accorded special tax treatment. Also, the automatic stay does not apply to the withholding of payments or application of amounts withheld pursuant to a debtor's agreement to repay such a loan, so a debtor's employer may continue to withhold the loan payments from a debtor's post-bankruptcy wages and the funds may be applied to repayment of the loan. (See 11 U.S.C. §§ 523(a)(18), 362(b)(19).)

These changes appear to have been intended to ameliorate the adverse tax consequences stemming from application of the discharge and automatic stay provisions of current law to a debtor's default on loans from retirement plans.

F. Continuation of Administration of ERISA Plans

A Chapter 7 Trustee must now continue to perform "the obligations required of the administrator" if the debtor (or its designee) was serving as an administrator of an employee benefit plan at the time the case was filed. (See 11 U.S.C. § 704(a)(11).)

This same duty is also imposed on Trustees and Debtors-in-Possession in Chapter 11 cases. (See 11 U.S.C. § 1106(a)(1).)

II. Employee Compensation Issues.

A. Priority Claims for Wages, Salaries and Benefit Plan Contributions

Current law provides that wages, salaries and commissions (including vacation, severance and sick leave pay) earned within 90 days of the bankruptcy petition are entitled to priority treatment up to $4,925 per individual. (A "priority claim" is one that must be paid ahead of the pre-bankruptcy trade and other general unsecured debt.) The new law increases the look-back period to 180 days and increases the limit per individual employee to $10,000. (See 11 U.S.C. § 507(a)(4).)

The practical impact of this amendment will be to increase the amount of employee benefit plan contribution claims entitled to priority. Holders of employee benefit plan contribution claims can assert priority claims for contributions related to services rendered during the 180 days before bankruptcy, up to the aggregate unused amount the individual wage priority—that is, the aggregate amount wage cap remaining after payment of priority wage claims. Because many employees do not have priority wage claims that exceed the $4,925 limit under current law, the new law may effectively more than double priority benefit plan contribution claims entitled to priority. (See 11 U.S.C. § 507(a)(4).)

(This amendment is effective upon enactment and applies with respect to cases filed on or after the date of enactment. See Act, § 1404(b).)

B. Administrative Priority for Certain Back Pay Awards

The new law provides for administrative expense priority treatment of awards of back pay attributable to any post-bankruptcy time period (regardless of the time of the occurrence that is the basis for the award) if the Bankruptcy Court determines that administrative priority treatment "will not substantially increase the probability of layoff or termination of current employees, or of nonpayment of domestic support obligations." Administrative expense priority claims are entitled to payment ahead of all other unsecured claims. (See 11 U.S.C. § 503(b)(1)(A)(ii).)

C. Reinstatement of Pre-Bankruptcy Retiree Benefit Modifications

The Bankruptcy Court is now required to reinstate retiree benefits modified during the 180-day period prior to bankruptcy while the debtor company was insolvent unless the court makes a finding that "the balance of the equities clearly favors such modification." (See 11 U.S.C. § 1114(l).)

(This amendment is effective upon enactment and applies with respect to cases filed on or after the date of enactment. See Act, § 1404(b))

III. Management compensation issues.

Under existing law (not changed by the new law) an "insider" of a corporate debtor includes, among others, all its directors and officers, as well as any holder of 20 percent or more of its stock. A number of changes impose limits on compensation agreements made with insiders.

A. Avoidance of Employment Contracts

Obligations incurred, or transfers made, to or for the benefit of an "insider" under employment contracts within 2 years of a bankruptcy can be set aside or recovered under the new law if they were for less than reasonably equivalent value and not in the ordinary course of business. (See 11 U.S.C. §548(a)(1)(B)(IV).)

(This amendment is effective upon enactment and applies with respect to cases filed on or after the date of enactment. The extension of the current 1-year reach back period to 2 years, however, is effective only with respect to cases filed 1 year after the date of enactment. See Act, § 1404(b))

B. Limitations on Post-Bankruptcy Payment of Severance

The post-bankruptcy payment of severance to "insiders" is prohibited under the new law unless:

(1) the payment is part of a severance program that is generally applicable to all full-time employees, and

(2) the severance payment is not more than 10 times greater than the mean severance pay given to nonmanagement employees during the calendar year in which the payment is made.

This new limitation appears to apply equally to payments under both pre-bankruptcy and post-bankruptcy severance agreements. (See 11 U.S.C. § 503(c)(2).)

C. Limitations on Post-Bankruptcy Payment of Retention Compensation

The post-bankruptcy payment of retention bonuses or compensation to "insiders" is prohibited under the new law unless the Bankruptcy Court makes a finding at an evidentiary hearing that:

(1) the payment is essential for retention of the person because he or she has a "bona fide job offer from another business at the same or greater rate of compensation,"

(2) the services of that person are "essential to the survival of the business," and

(3) the retention compensation is not more than 10 times greater than the mean amount of similar compensation given to nonmanagement employees during the calendar year in which the payment is made.

This new limitation appears to apply equally to payments under both pre-bankruptcy and post-bankruptcy retention compensation agreements. (See 11 U.S.C. § 503(c)(1).)

D. Justification of Post-Bankruptcy Employment Agreements

Under the new law, any transfer made to or obligation incurred for the benefit of an officer, manager or consultant hired post-bankruptcy is prohibited if it is outside the ordinary course of business and "not justified by the facts and circumstances of the case." (See 11 U.S.C. § 507(c)(3).)

IV. Effective Date (Generally).

Unless otherwise indicated above, the amendments made by the new law take effect on October 17, 2005, and they apply to bankruptcy cases filed on or after that date.

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