Employee Benefits and Executive Compensation in Corporate Bankruptcy

The following material is excerpted from the Collier monograph EMPLOYEE BENEFITS AND EXECUTIVE COMPENSATION IN CORPORATE BANKRUPTCY, *written by John R. Cornell, Daniel C, Hagen, Lisa Rothman Jesner and Tricia Eschbach-Hall.*

There are unique issues that arise with respect to employee benefits and executive compensation when a business entity, typically a corporation, files for bankruptcy.

Employees of a company that enters bankruptcy are likely to be concerned about their livelihood and may seek more secure employment opportunities. Executives of the company may have personal interests very different from the interests of the debtor, and unless those interests are balanced, they may have difficulty envisioning the proper course for the reorganization and negotiating with creditors. Handling executive compensation issues can thereby become a challenge much larger than protecting the financial wellbeing of individual employees.

Unions generally present significant issues in a bankruptcy case where employee benefits of the debtor are collectively bargained. Labor laws are complex and negotiations are difficult outside of bankruptcy. The Bankruptcy Code imposes even more legal hurdles on modifying labor contracts, and the interests of labor unions (who may have a seat on the creditors' committee) result in more challenging negotiations. At the same time, the escalating cost of union benefits, including retiree medical and retirement plans, may be a substantial contributing factor in the decision to file.

Debtors need to consider compensation and benefits issues carefully during the prepetition period, and will address these issues at the outset of the case, in

first-day motions. Once in bankruptcy, the debtor will determine which benefits can be paid, and which benefits will remain as claims on the estate. Benefits that are claims will have differing levels of priority under the Bankruptcy Code, and will receive differing treatment. For benefits that the debtor wishes to establish during the course of the case, restrictions often apply, and negotiations with creditors may be necessary, as well as approval by the bankruptcy court.

The recently published *Collier* monograph *Employee Benefits and Executive Compensation in Corporate Bankruptcy* presents a complete discussion of the intersection of bankruptcy and employee benefits law. It walks through the prepetition period to first-day motions and actions, discusses the priority of compensation and benefit claims and treatment of compensation and benefits in bankruptcy, including challenges to benefit plan contributions, and then turns to specific areas of concern. These areas include defined benefit pension plans, executive compensation, retiree benefits, voluntary employees' beneficiary associations, and the group health plan continuation of coverage requirements of the COBRA.[1] Finally, the monograph discusses recent changes to the Bankruptcy Code affecting benefits and compensation.

This Expert Commentary provides brief excerpts from the monograph on (1) the treatment of defined benefit plans and interactions with the Pension Benefit Guaranty Corporation, (2) executive compensation and claims related to non-qualified retirement benefits and (3) modification of retiree welfare benefits under section 1114 of the Bankruptcy Code.

Treatment of Defined Benefit Plans and Interactions with the Pension Benefit Guaranty Corporation. Underfunded defined benefit pension plans often play a major role in bankruptcy, particularly in traditionally unionized industries, such as steel and other primary metals, rubber, airlines and

[1] Consolidated Omnibus Budget Reconciliation Act of 1985, Pub .L. No. 99-272 § 10002(a), 100 Stat. 227 (codified at 29 U.S.C. §§ 1161-1168).

automotive. In some cases, serious underfunding may be one driving factor in a debtor's decision to restructure.

Liability for both pension funding obligations and defined benefit plan termination underfunding extends to controlled group members. For companies not protected by the automatic stay in bankruptcy, a lien may arise for termination liability (essentially, underfunding at time of termination) and for missed minimum required contributions in excess of $1 million.[2] As a result, at the outset of the case, and at such time as the debtor does not make minimum required contributions during the case, underfunded defined benefit pension plans may impact whether subsidiaries, including foreign subsidiaries, decide to file for chapter 11 protection so that the automatic stay will protect against the imposition of liens. Once the debtor is in bankruptcy, the PBGC will file contingent claims for underfunding and for contributions and premiums, and as a result, may play an important role on the creditors' committee. If the PBGC is concerned about plan funding, it may threaten termination. If the debtor wants to terminate and the PBGC does not agree to the terms, it may threaten plan restoration. As a result, the PBGC can plan a major role in the course of the bankruptcy case.

Termination Premium. As part of the Deficit Reduction Act of 2005 ("DRA"), ERISA was amended to include a "termination premium," also known as an "exit premium" for companies that undergo a distress termination or involuntary termination in or out of bankruptcy. The premium is $1,250 per participant for three years and is payable by the debtor *after* emergence from bankruptcy.[3] For debtors that elect special airline funding rules, this premium may be greater.

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[2] I.R.C. § 430(k); ERISA §§ 303(k), 4068, 29 U.S.C. § 1083(k), 1368.

[3] ERISA § 4006(a)(7), 29 U.S.C. § 1306(a)(7), as amended by the Deficit Reduction Act of 2005 § 8101(b), Pub. L. No. 109-171.

While the DRA provision had a sunset date of 2010, the Pension Protection Act made this provision permanent.[4]

The federal district court for the Southern District of New York recently held that the obligation to pay the premium was unenforceable following emergence, as the obligation was a prepetition claim under the Bankruptcy Code. Defining a claim as including "a right to payment that is 'contingent' and 'unmatured,'" the court concluded that the premium was a contingent claim in bankruptcy that was discharged at the time of confirmation of the plan of reorganization. If a debtor was permitted to contract with a private party for a payment to be made after confirmation of the plan of reorganization, it would essentially be a preference created by the parties, rather than by the Bankruptcy Code. The court refused to allow such a preference to arise in favor of the PBGC, as it was not clear that an explicit amendment of the Bankruptcy Code was intended by the DRA. Based on the specific facts of the case, where the DRA was in effect at the time of filing, and a plan termination was contemplated prior to bankruptcy (debtor and PBGC had two prepetition meetings), the court found that the exit premium was a prepetition claim.[5]

Executive Compensation. Under the Bankruptcy Code there are several options for the treatment of employment agreements and other executive agreements after filing. Under certain circumstances, it is possible to assume or reject existing contracts with the approval of the bankruptcy court. In addition, it may be possible to modify contracts in the ordinary course of business. Similarly, if a debtor wishes to put in place a new employment or other executive agreement, court approval is necessary, unless it is in the ordinary course of business. The court is constrained by provisions of the Bankruptcy Abuse

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[4] ERISA § 4006(a)(7), 29 U.S.C. § 1306(a)(7).

[5] Oneida Ltd. v. PBGC (*In re* Oneida Ltd.), 383 B.R. 29 (Bankr. S.D.N.Y. 2008).

Prevention and Consumer Protection Act of 2005 ("2005 Act") that severely restrict retention and severance payments for insiders.

In addition to the legal requirements regarding such arrangements, more practical concerns govern. Executive compensation in bankruptcy typically involves intense negotiations with stakeholders, including creditors and unions. If creditors consent, it is more likely that the bankruptcy court will approve the compensation arrangement; on the other hand, the bankruptcy court is less likely to approve compensation over the objections of creditors.

There is often pressure to cut back preexisting employment arrangements with executives to show creditors that the executives are making sacrifices along with the creditors and other employees.[6]

Non-Qualified Retirement Benefits—Claims. Non-qualified plan benefits that vest prior to the bankruptcy filing are an unsecured prepetition claim on the estate.[7] Treatment of the portions of non-qualified benefits that vest during the course of the bankruptcy case is less clear. Caselaw does not establish whether priority depends on whether an award (or part of an award) vested prepetition or postpetition. However, it is possible that a court would analyze the arrangement to determine which portion relates to postpetition service, and might use vesting as a guide. It is often difficult to determine an individual's accrued benefit under a non-qualified plan at any particular point in time, and therefore it is difficult to establish which portion of the benefit is vested at the time of filing, and also to

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[6] Allison K. Verderber Harriott, *Comment: Toward an Understanding of the Dialetical Tensions Inherent in CEO and Key Employee Retention Plans During Bankruptcy*, 98 Nw. U. L. Rev. 579, 593-94 (2004).

[7] *In re* Merry-Go-Round Enterprises, Inc., 1999 WL 33457180, at *4 (Bankr. D. Md. Dec. 21, 1999) (holding that "[b]ecause the Executives were fully vested prior to the petition, their postpetition employment with the Debtor did not entitle them to have these claims treated as an administrative expense."); Kucin v. Devan, 251 B.R. 269, 272 (D. Md. 2000) ("[t]he court found that the agreement was properly characterized as a nonexecutory contract since the retirement agreement had already vested," quoting *In re* Stewart Foods, Inc. 64 F.3d 141, 145 n.2 (4th Cir. 1995)); *see also In re* Bethlehem Steel Corp., 479 F.3d 167 (2d Cir. 2007) (treating prepetition accruals as unsecured claims on the estate).

establish the amount of the claim for any benefits determined to be prepetition claims. For example, some non-qualified plans provide benefits that cannot be provided under qualified benefit plans due to limits under IRC section 401(a)(17) (limit on compensation that may be taken into account under a qualified plan) or IRC section 415 (limit on annual benefits payable to a retiree).[8] Decreases in compensation can cause the IRC section 401(a)(17) limits to have less of an impact in one year than it had in an earlier year, thus decreasing benefits payable under the non-qualified plan. Also, the limit under section 415 is generally reduced (and thus non-qualified plan benefits increase) if an employee retires before age 65. Therefore, non-qualified plan benefits depend to some extent on unknown future events.

A debtor may choose to reject its non-qualified benefit plans. Upon rejection, all claims for accrued benefits under the plans might be treated as prepetition unsecured claims. Alternatively, claims for benefits might be allocated between prepetition unsecured claims and postpetition administrative expenses, depending on when the benefits accrued. A debtor that rejects its non-qualified benefit plans may face employee morale problems, especially since the plans often cover executives critical to the success of the reorganization.

The debtor may request bankruptcy court approval for payment of prepetition non-qualified plan benefits (in either the first-day motions or at some subsequent date). For benefits that are payable to former employees, such approval is unlikely to be granted since the terminated employees are not providing any value to the estate of the debtor. More often, non-qualified benefits payable to terminated employees that accrued prepetition are simply treated as general

[8] I.R.C. § 401(a)(17).

unsecured claims of the debtor. Bankruptcy law does not typically allow rejection of a plan for former employees and assumption for current employees.[9]

With respect to arrangements that cover only active employees who continue to be covered by the non-qualified plans and who terminate employment after the filing date, a debtor may request bankruptcy court approval to pay the prepetition benefits for these employees. Depending on the amount involved, a court may agree to such payments (and the creditors will not object to such payments) in order to help employee morale. Due to the controversy likely to surround such a request (*i.e.*, the amounts involved and the fact that the benefits are only paid to highly compensated employees), this request is almost never included in the first-day motion. If made, it generally occurs sometime later during the administration of the case.

If (a) an executive's employment contract specifically provides for payment of non-qualified plan benefits and (b) the debtor assumes the employment contract, a court could provide for the full payment of the benefits by treating the executive's employment contract as an executory contract.[10] Accordingly, if the

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[9] Section 365(f) requires a debtor to assume a contract subject to the benefits and burdens thereunder. *In re* ANC Rental Corp., 277 B.R. 226, 238 (Bankr. D. Del. 2002) (quoting *In re* Italian Cook Oil Corp., 190 F.2d 994, 997 (3d Cir. 1951): "The [debtor] ... may not blow hot and cold. If he accepts the contract he accepts it cum onere. If he receives the benefits he must adopt the burdens. He cannot accept one and reject the other."). The *cum onere* rule "prevents the [bankruptcy] estate from avoiding obligations that are an integral part of an assumed agreement." United Air Lines, Inc v. U.S. Bank Trust Nat'l Ass'n (*In re* UAL Corp.), 346 B.R. 456, 468 n.11 (Bankr. N.D.Ill.2006), *quoted in In re* Fleming Companies, Inc., 499 F.3d 300, 308 (3d Cir. 2007); *see also* N.L.R.B. v. Bildisco, 465 U.S. 513, 104 S. Ct. 1188, 79 L. Ed. 2d 482 (1984); *In re* Italian Cook Oil Corp., 190 F.2d 994, 997 (3d Cir. 1951).

[10] The Bankruptcy Code provides that subject to court approval, the debtor may assume or reject any executory contract or lease. *See* 11 U.S.C. § 365. For a general discussion of a debtor's right to assume or reject executory contracts or leases, *see* 3 Collier on Bankruptcy, ¶ 365.03.

Any decision by a debtor to assume an executory contract will be governed by the business judgment test. The business judgment test consists of analyzing whether assuming the contract would be a good business decision using the type of judgment a business person would exercise. *See* Orion Pictures v. Showtime Networks, Inc. (*In re* Orion Pictures Corp.), 4 F.3d 1095, 1099, 29 C.B.C.2d 1341 (2d Cir. 1993); *see also* 3 Collier on Bankruptcy, ¶ 365.03[2]. Furthermore, in order to assume an executory contract, the debtor must cure, or provide adequate assurance that the debtor will promptly cure any default in the contract that may exist at the time of assumption. *See* 11 U.S.C. § 365(b)(1)(A); *see also* 3 Collier on Bankruptcy, ¶ 365.

executive's employment contract is assumed, the debtor would have to cure any default in the contract, which, if the contract specifically requires payment of the non-qualified plan benefits, would include paying any claim for damages arising from the loss of those benefits. Payments would be treated as a second priority administrative claim.[11] If the benefit is a vested prepetition, however, the benefit will likely be classified as non-executory, and therefore it may not be assumed.[12]

Following the amendments to the Bankruptcy Code in the 2005 Act,[13] approval to pay prepetition non-qualified plan benefits for insiders[14] may be more difficult to obtain. Payments made to induce insiders to remain in the employ of the debtor may not receive administrative priority unless it is proven that the insider has a bone fide job offer for the same or greater compensation, and only where employment of that insider is essential to the "survival of the business." Even when this standard is met, payment must be less than 10 times the incentive payments provided to non-management employees in that year, or, if no incentive payments have been made in that year, no greater than 25 percent of the amount of any similar payment made to that insider in the previous year. [15]

Prior to the 2005 amendments, a debtor could argue that assumption of the non-qualified plan benefit was required to retain executives critical to the success of the restructuring. Today, with respect to an insider, the principal purpose of the assumption can no longer be retention.[16]

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[11] 11 U.S.C. § 507(a)(2).

[12] *Kucin*, 251 B.R. 269, 271-72 (D. Md. 2000).

[13] Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Pub. L. No. 109-8, 119 Stat. 23 (2005).

[14] For definition of "insider," *see* 11 U.S.C. § 101(31); *see also* 2 Collier on Bankruptcy, ¶ 101.31.

[15] 11 U.S.C. § 503(c)(1), as amended by Pub. L. No. 109-8, § 331 (2005).

[16] *Id.*

In one case, a bankruptcy court approved assumption (and therefore payment as an administrative priority claim) of a non-qualified pension benefit to a CEO (with respect to 60 percent of his prepetition benefit) and three senior management employees (with respect to the entire benefit) on the condition that all prepetition accruals would revert to prepetition unsecured claims in the event of a termination of the debtor's defined benefit plan. All postpetition accruals were granted administrative priority.[17]

Modification of Retiree Welfare Benefits under Section 1114 of the Bankruptcy Code. Retiree welfare benefits are given special protection in an employer's chapter 11 bankruptcy case. Section 1114 of the Bankruptcy Code ensures that a chapter 11 debtor continues to pay certain retiree benefits postpetition and that the debtor's plan of reorganization adequately provides for the claims of retired employees. Section 1114 provides generally that a chapter 11 debtor "shall timely pay and shall not modify any retiree benefits."[18] Modification (including termination) of retiree benefits is permitted if the debtor and the retirees' authorized representative agree to the modification or if a court orders the modification pursuant to statutory procedures.[19] Section 1114(a) defines retiree benefits as:

> payments to any entity or person for the purpose 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

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[17] *In re* Dana Corp., 358 B.R. 567 (Bankr. S.D.N.Y. 2006).

[18] 11 U.S.C. § 1114(e)(1). For a complete discussion of section 1114, *see* 7 Collier on Bankruptcy, ch. 1114.

[19] *Id*.; 11 U.S.C. § 1114(g). The requirements of section 1114 may not need to be followed if the retirees do not have a vested contractual right to the applicable benefits.

> 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.[20]

The definition of "retiree benefits" therefore includes retiree health and life insurance premiums, contributions to multi-employer welfare funds on behalf of retirees and payments made directly to retirees under self-insured plans. Section 1114 does not apply to "any retiree, or the spouse or dependents of such retiree, if such retiree's gross income for the twelve months preceding the filing of the bankruptcy petition equals or exceeds $250,000" unless the retiree is able to demonstrate that he or she is unable to obtain comparable coverage to that provided prepetition, elsewhere.[21]

A debtor is permitted to modify its retiree benefit plans subject to the procedures set forth in section 1114. These procedures: (a) provide for the appointment of an "authorized representative"[22] for retirees (a union or a committee of retirees appointed by the U.S. trustee) for negotiation purposes;[23] (b) require the debtor to make a proposal for modification to the authorized representative based upon certain relevant information and to confer in good faith with the authorized representative and provide it with relevant information regarding the debtor's proposal;[24] (c) permit the authorized representative to approve or reject such proposal;[25] (d) in the case of rejection, require the court to hold a prompt hearing on the proposal;[26] and (e) set forth certain standards by which the court

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[20] 11 U.S.C. § 1114(a).

[21] 11 U.S.C. § 1114(m).

[22] 11 U.S.C. § 1114(b)(1).

[23] 11 U.S.C. § 1114(c), (d).

[24] 11 U.S.C. § 1114(f)(1)(A), (B).

[25] 11 U.S.C. § 1114(g)(2).

[26] 11 U.S.C. § 1114(k)(1).

may approve the rejected proposal for modification.[27] Section 1114 was modeled after Section 1113 of the Bankruptcy Code, which governs the debtor's ability to assume or reject a collective bargaining agreement. As a result, the procedural requirements of Section 1114 are nearly identical to those under Section 1113.[28]

Retiree benefits that were modified during the 180-day period prior to filing may be subject to reinstatement. Reinstatement may occur if the employer was insolvent at the time of the modification, unless a court determines that the balance of the equities favors the modification.[29]

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[27] 11 U.S.C. § 1114(g)(3).

[28] Soon after section 1113 was added to the Bankruptcy Code, courts distilled these statutory procedural requirements into nine requirements that must be satisfied for court approval of rejection of a collective bargaining agreement.

[29] 11 U.S.C. § 1114(l).

He is also involved in designing and implementing compensation and retention programs covering key executives and other senior management of companies in financial distress. He has been and is involved in the negotiation, establishment and funding of voluntary employees' beneficiary associations (VEBAs) for union represented retirees and nonrepresented retirees for the provision of health, disability and life insurance benefits. These VEBAs involve legacy liabilities in the automotive, steel, aluminum and rubber industries. Mr. Cornell has lectured on ERISA fiduciary issues and pension, welfare, and bankruptcy compensation issues, and has written on ERISA litigation and fiduciary issues and benefits in bankruptcy proceedings. Mr. Cornell is admitted in New York and Maine. He received bachelors and masters (hon.) degrees from Colby College in 1965 and 1997, respectively. He graduated from Georgetown University Law Center in 1968, where he was an Executive Editor of the *Law Journal*, and he received an L.L.M. in Taxation from New York University in 1972.

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