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Orderly Dissolution: Best Practices for Bankruptcy Plan Terminations

Retail bankruptcies and corporate debt are on the rise, and economic contraction is inevitable after an unusually long bull market. With that in mind, retirement plan administrators should be mindful of procedures related to the orderly dissolution of their retirement plan in the event of a bankruptcy proceeding.

BY TERRY DUNNE

Terry Dunne is senior vice president and managing director of Retirement Services at Millennium Trust Company, LLC. Mr. Dunne has over 35 years of extensive consulting experience in the financial services industry. Millennium Trust Company performs the duties of a directed custodian, and as such does not sell investments or provide investment, legal, or tax advice.

In 2017, retail bankruptcies reached a six-year high. {Tonya Garcia, "Retail bankruptcies hit highest number since 2011: S&P Global," MarketWatch, *https://www.marketwatch.com/story/retail-bankruptcies-hit-highest-number-since-2011-sp-global-2017-12-19*" (2017)} The reasons were straightforward: Shopping habits have changed, and many traditional retailers have been unsuccessful adapting to a new business model.

As the Federal Reserve pushes interest rates higher, other market sectors may see corporate bankruptcies as well. Many non-financial companies, in the United States and elsewhere, have been unable to resist the lure of persistently low interest rates and unusually high investor risk tolerance. {McKinsey&Company, "Rising Corporate Debt: Peril or Promise," McKinsey Global Institute, *https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/rising-corporate-debt-peril-or-promise*" (2018)}

Since 2008, corporate capital structures have become more highly leveraged. Low interest rates have made debt financing less expensive than equity financing, and many companies have chosen to issue lower-rated investment grade bonds to fund expansions, purchase inventory, buy back shares, and complete other transactions. As a result, the average credit quality of investment grade bonds has fallen, and levels of leverage have increased. McKinsey explained the shift:

> In the United States, almost 40 percent of all nonfinancial corporate bonds are now rated BBB, just a few steps above noninvestment grade, up from 22 percent in 1990 and 31 percent in 2000, according to Morgan Stanley. Overall, BBB-rated US nonfinancial corporate bonds outstanding total $1.9 trillion—almost twice the size of the high-yield bond market. Issuers are also more heavily indebted than before. The net leverage ratio for BBB issuers rose from 1.7 in 2000 to 2.9 in 2017, according to PIMCO.

{McKinsey&Company, "Rising Corporate Debt: Peril or Promise," McKinsey Global Institute, *https://www.mckinsey.com/business-functions/strategy-and-corporate-finance/our-insights/rising-corporate-debt-peril-or-promise*" (2018)}

Pacific Investment Management Company (PIMCO) defines net leverage this way: (total debt – cash – short term investment) / EBITDA (i.e., earnings before interest, taxes, depreciation and amortization).

Broad net leverage ratios do not tell the whole story, though. When the current recovery began, just 6.6 percent of non-financial, investment grade debt had net leverage that exceeded four times assets. In 2017, 19 percent did. In addition, in 2010, more than one-half (55 percent) of outstanding non-financial, investment grade debt was leveraged less than two times assets. In 2017, about one-fourth had leverage levels that low. {Jelle Brons & Lillian Lin, PIMCO, *https://www.pimco.com/en-us/insights/viewpoints/investment-grade-credit-be-actively-aware-of-bbb-bonds*" (2018)}

Last June, when Federal Reserve Chair Jerome Powell was asked whether the United States was experiencing a credit bubble, he responded that households were in reasonably good shape; however, corporate balance sheets could be vulnerable. {Federal Reserve, Transcript of Chairman Powell's Press Conference, June 13, 2018, *https://www.federalreserve.gov/mediacenter/files/FOMCpresconf20180613.pdf?mod=article_inline*" (2018)} As interest rates continue to rise and the U.S. economy matures—cycling out of expansion and into contraction—the less attractive side of debt financing may become apparent. Companies with high levels of leverage are vulnerable during periods of rising rates and economic downturn. High levels of debt financing increase companies' risk of bankruptcy. {Zacks Equity Research, "Bet on These 5 Low Leverage Stocks Amid Uncertainties", *https://www.zacks.com/stock/news/322234/bet-on-these-5-low-leverage-stocks-amid-uncertainties*" (2018)}

While it is possible that American companies will emerge relatively unscathed despite vulnerabilities in corporate capital structures, it is a good time to review best practices for plan terminations for companies that may be headed into Chapter 11 reorganization or Chapter 7 bankruptcy.

Completing Plan Terminations During and After Bankruptcy

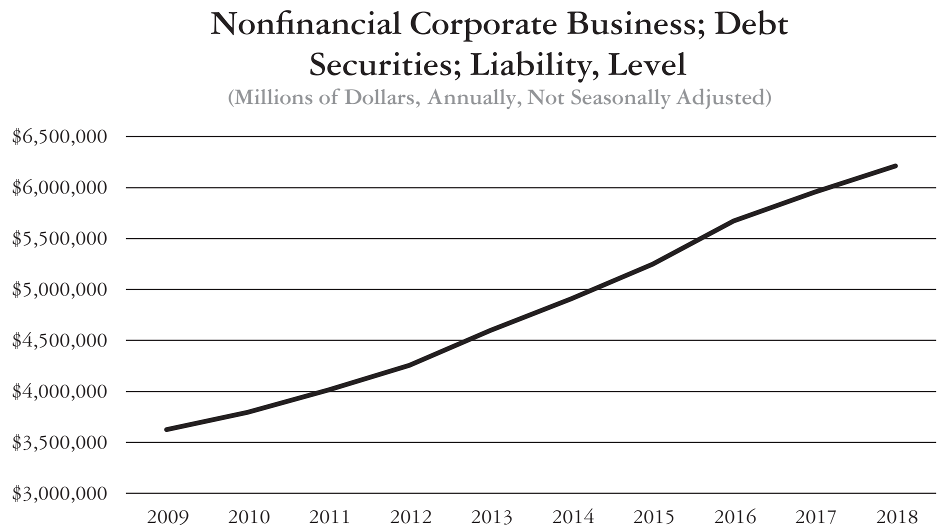
Pre-bankruptcy terminations are not common practice, especially in the case of a Chapter 7 filing, according to Stephen Sokolic, an ERISA attorney with experience in bankruptcy plan terminations. "In my experience, retirement plans are the last thing on the minds of executives at companies that are experiencing bankruptcy," he said.

Often, plan termination is overlooked or delayed until bankruptcy proceedings have begun or have been completed. In either of these circumstances, bankruptcy trustees, who often are not ERISA experts, become plan administrators and fiduciaries. They are responsible for complying with ERISA. They also are subject to Department of Labor enforcement proceedings. {Kenneth Kirschenbaum & Steven Sheinwald, "What's All the Fuss About Between DOL and Bankruptcy Trustees," ASPPA, *https://www.asppa.org/Resources/Publications/Plan-Consultant-Online/PC-Mag-Article/ArticleID/5158*" (2015)}

Sokolic advises that bankruptcy trustees should take immediate action with regard to plan termination rather than delaying the process. There are many reasons for this, including the possibility that a plan participant will file a complaint with the Department of Labor and the possibility that plan service providers may be less responsive if they are uncertain that they will be compensated for work completed.

In fact, it is not unusual for service providers to require the payment of all owed and anticipated future fees up front. DWC ERISA Consultants explained, "If some or all of those fees are to be paid from plan assets, it is important to take care of that as quickly as possible before distributions start—usually concurrent with the effective date of the termination. Otherwise, you could end up with only a handful of

Exhibit 1



[Federal Reserve Bank of St. Louis, "Nonfinancial Corporate Business; debt securities; liability, level", *https://fred.stlouisfed.org/series/NCBDBIQ027S*" (2018)]

participants left to shoulder the fees for the entire plan, and they are not likely to be pleased with that outcome." ["Retirement Plan Termination: Are There Special Rules for Paying Out Account Balances?," DWC The 401k Experts, "*https://www.dwc401k.com/blog/retirement-plan-termination-special-rules-for-paying-out-account-balances*" (2017)] In some cases, bankruptcy trustees will hire ERISA attorneys to facilitate the plan termination process. Having experts who are knowledgeable about the intricacies of ERISA law becomes especially important if a plan has been put on the back burner while the company tries to stay in business and normal plan operations may have been neglected.

The bankruptcy trustee or its consultant may have to complete significant research on the state of the company's retirement plan, or plans, before the plan termination process can begin.

If the employees have been let go, the party responsible for termination may need to locate former plan administrators and/or review previous Form 5500 filings to gather enough information to:

- Identify plan service providers,
- Determine outstanding compliance issues,
- Update plan documents,
- File any required reports,
- Find missing participants, and
- Complete a variety of other activities.

Since plan termination cannot be completed without the full distribution of assets, safe harbor IRAs (automatic rollover IRAs for participants with vested account balances less than $5,000) often are an essential tool. If the plan document allows it, plan sponsors and/or bankruptcy trustees have the ability to automatically roll over the assets of missing and/or unresponsive participants into safe harbor IRAs.

Retirement Plan Termination in the Event of Bankruptcy

In an ideal world, plan sponsors would treat the plan, or plans, as though the company were not going bankrupt and follow established processes for plan termination. However, as mentioned by Sokolic above, it is not common practice, particularly in a Chapter 7 liquidation scenario.

It is sensible for plan sponsors to familiarize themselves with the established process and take action to prepare for such a possibility. Typically, this process includes:

1. **Amending the plan document**. Among other things, plan amendments should establish a termination date, update the plan for all changes in the law or plan qualification requirements as of the termination date, end contributions, fully vest all participants, authorize the distribution of assets,

simplify distribution options (if possible), and, if not already included, add automatic rollover provisions.

2. **Issuing required notices to plan participants and beneficiaries**. The bankruptcy trustee will be required to give all required notices to participants in connection with the termination, such as freeze notifications, notice of intent to terminate, and notice of plan benefits, to the extent applicable. If participants or beneficiaries are missing or unresponsive, ERISA-governed plans are required to conduct a diligent search. The Department of Labor and Pension Benefit Guaranty Corporation have provided some guidance on the steps required [“Missing Participants Program for PBCG-insured Single Employer Plans” Pension Benefit Guaranty Corporation, *https://www.pbgc.gov/prac/missing-p-single-employer* (last visited Nov. 26, 2018); Department of Labor Field Assistance Bulletin 2014-01, *Https:/www./dol.gov/agencies/ebsa/employers-and-advisers/guidance/field-assistance-bulletins/2014-01*], and industry groups continue to press for more detailed and more consistent guidance from the agencies.
3. **Providing a distribution election and rollover notice**. Participants must be offered all distribution options available under the plan; the termination does not allow employers to ignore required distribution options. Generally, the distribution forms should include a notice that explains rollover rules, describes rollover options available, and discusses the potential impact of each option. The notice also should describe the consequences of choosing not to roll over a plan distribution, including penalties and automatic withholding. The Internal Revenue Service (IRS) offers sample notices explaining the rollover rules. [“Retirement Plan Participant Notices – Distributions,” Internal Revenue Service, *https://www.irs.gov/retirement-plans/retirement-plan-participant-notices-distributions*” (Dec. 2017)]
4. **Plan to pay any required contributions**. All outstanding contributions—employer and employee—should be deposited and allocated. It is very common for employee contributions just prior to bankruptcy to be missing from the plan. These should be deposited with interest, and bankruptcy trustees should anticipate correspondence from the Department of Labor to confirm that this issue has been examined and remedied. In addition, any forfeitures remaining after fees and other expenses should be allocated (in a bankruptcy, generally to pay expenses of the plan termination if permitted). [“Retirement Plan Termination: Are There Special Rules for Paying Out Account Balances?”, DWC The 401k Experts, “*https://www.dwc401k.com/blog/retirement-plan-termination-special-rules-for-paying-out-account-balances*” (2017)] When a defined benefit plan is involved, the bankruptcy trustee should expect to hear from the Pension Benefit Guaranty Corporation (PBGC) and follow the PBGC termination procedures and, if the plan is underfunded, determine the priority of any claim from PBGC.
5. **Request the recordkeeper update vesting for all participants**. Any employee or former employee with an account balance (or accrued benefit) on the termination date must be 100 percent vested.
6. **Distribute all plan assets as soon as possible, administratively**. The IRS has suggested that assets, generally, should be distributed within 12 months of the termination date. Small account balances may be distributed to safe harbor IRAs. Account balances belonging to missing or unresponsive participants generally may be paid to the PBGC and, in some cases, rolled over into safe harbor IRAs.
7. **File any applicable Forms 5500**. Keep in mind that the last 5500 may be due prior to the ordinary filing date for the plan if the plan is not terminated on the last day of the plan year. Bankruptcy trustees may find it particularly difficult to complete the Forms 5500 for plans with more than 100 participants because the audit requirement might be particularly difficult to complete.
8. **Request an IRS determination letter (optional)**. This can add cost and time to the plan termination process. Generally, if a letter is requested, it is better to delay distributions until after the letter has been received, because an adjustment may be required, said Sokolic. However, the delay in distributions may not be advisable in a bankruptcy setting, where delay could result in additional expenses in the form of fees and audits, which must be borne by fewer and fewer participants.

As with many processes related to retirement plans, these steps are the tip of the iceberg. It is likely that additional actions will need to be performed in order to complete each step of the process. In some cases, bankruptcy trustees will be required to make difficult decisions without established guidance.

Summary

It is possible the United States may experience additional corporate bankruptcies as interest rates rise and the business cycle matures. Plan sponsors who know their companies are facing bankruptcy should follow best practices and terminate workplace retirement plans prior to bankruptcy, if possible.

When plan sponsors are unable to complete plan terminations before bankruptcy proceedings are initiated, bankruptcy trustees are responsible for the orderly dissolution of workplace retirement plans. Unless the trustee is familiar with ERISA-governed plans, it is a sound idea to work with an ERISA attorney to make sure the bankruptcy trustee's fiduciary responsibilities are satisfied. ■