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AN INTRODUCTION TO EMPLOYEE BENEFITS ISSUES CONFRONTED BY FINANCIALLY DISTRESSED COMPANIES

By: Jeffrey M. Sklarz, Zeisler & Zeisler, P.C.[1]

I. INTRODUCTION

The current state of the American economy is fragile. Energy prices have increased dramatically in the past year, consumer spending is waning, health insurance premiums, again, are rising at double digit rates, real estate prices have collapsed at a time when personal income has remained stagnant and savings rates continue to decrease. Consequently, businesses in every sector and of all sizes, are faced with financial problems. Combined with several years of stagnant or negative growth, numerous businesses and industries in general are barely surviving and have been forced to more extreme options for continued operations and a return to profitability. What does this mean?

In order to survive in an ever more competitive business climate financially distressed companies must confront the awkward and counterintuitive business strategy of accomplishing a successful reorganization. Part of orchestrating a successful restructuring (either inside or outside of bankruptcy) is identifying the legal issues involved with executing a business plan. Often, one of the largest expenses of a company are the costs associated with employee compensation. Compensation includes not only wages, but every fringe benefit and in-kind distribution to which an employee may be entitled, including health insurance, defined benefit pensions, matching contributions for defined contribution plans, car allowance, bonuses, etc. Further, corporate overhead increases on account of the cost of administering benefit programs. In executing a plan of reorganization, reducing or reconfiguring employee compensation and the more drastic option of downsizing must often be considered. However, many businessmen are

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unaware of the array of laws governing the methods by which reorganization of a company's work force and/or the work force's compensation structure are governed.

First and foremost, laws relating to workforce downsizing/reorganization are generally designed to protect compensation which employees became entitled to prior to a decision to reorganize. For example, if an employee has accrued 401(k) benefits, a reorganization resulting in termination of the 401(k) plan could not typically strip the employee of his accrued benefits. Second, the laws require employers to provide notice to employees so that employees can plan for the unfortunate event.

Some issues which, as summarized below, frequently come into play when companies downsize are: (1) the Worker Adjustment Retraining Notification Act (the "WARN Act"), (2) liability for contributions to defined contribution plans and plan termination, (3) the affect of bankruptcy on COBRA rights and (4) the Pension Benefit Guaranty Corporation (the "PBGC"). Identifying the effect of compensation issues on a company's financial restructuring strategy is essential to successful implementation of the plan.

II. THE WARN ACT

A. The Statutory Requirements

The WARN Act's purpose is, not surprisingly, to warn employees and the surrounding community about the shut down of a large business or mass layoff of employees. The WARN Act requires 60 days notice be given to employees and 60 day severance pay be provided for "mass layoffs" or "plant closings". Failure to give WARN Act notice will, unless an exception applies, trigger the requirement for the employer to pay up to 60 days of severance pay to affected employees. Where an employer violates the WARN Act, it is liable for the employee's salary for the next 60 days (or until the appropriate notification was given), less compensation

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paid by the employer to, or on behalf of, the employee. The employer is also liable for the cost of benefits that would have been provided during the period.[2] The employee is also entitled to prejudgment interest.

When considering restructuring options, if the WARN Act applies, the severance payments required should be factored into the company's restructuring budget. There are exceptions to WARN Act compliance, which will be discussed below, which, if applicable, can reduce or eliminate liability under the WARN Act.

The WARN Act only applies to employers with (1) 100 or more full time employees or (2) 100 or more employees who, in the aggregate, work more than 4000 hours per week (exclusive of overtime).[3] Workers on temporary layoff who will likely be recalled should be included in the calculation.[4] Employees within the same business line but located at different plants and sites are also counted.[5] For example, if a holding company has two subsidiaries each with 50 employees, the shut down of one subsidiary would not typically cause a WARN Act event since the employer is not over the 100 employee threshold.

The WARN Act also applies when a "plant closing" or "mass layoff occurs". A "plant closing" occurs when there is a permanent or temporary shutdown of a facility or facilities involving the layoff of at least 50 employees during any 30 day period.[6] A "mass layoff" occurs when a downsizing, not part of a plant closing occurs and results in employment loss at a single site of employment of at least (a) 500 full time workers or (b) 33% of the full time workforce (with a minimum of 50 layoff).[7] A frequent issue of WARN Act litigation concerns what constitutes a single site of employment.

WARN Act notice must be given to affected employees individually or to their union representation. The notice must inform employees of bumping rights, if available. Notice must

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also be given to the state dislocated worker office or the governor if no such office exists. Finally, notice must be given to the chief elected official of the local government unit to which the employer pays the most taxes.[8]

There are several exceptions to WARN Act compliance. Meeting an exception means that the 60 days notice/severance period does not apply. The Faltering Company Exception applies when: (1) the company was actively seeking capital or financing which, if it had come through, would have eliminated the need for WARN Act notice and (2) the employer believed that giving WARN notice would have detrimentally affected the raising of the capital or procuring the financing. Nevertheless, the employer must still provide as much notice as possible once the financing falls through.

The Unforeseen Business Circumstances Exception applies when events that are not reasonably foreseeable arise. This does not include a slow and steady decline in business. It does include loss of a major client without prior notice or a strike. Again, the employer must provide as much notice as possible to employees.

The WARN Act does apply where employees are retained for a specific project with a definitive start and end point. Notice is not required if the downsizing is precipitated by a natural disaster.

A prevailing plaintiff is entitled to attorneys' fees in civil litigation under the WARN Act.[9] Like other federal fee-shifting statutes, the plaintiff's attorneys' fee is calculated pursuant to the lodestar analysis. That is, the reasonable hourly rate of the plaintiff's attorney (determined by taking into account the prevailing rates in the market place, expertise of the plaintiff's lawyers and quality of the representation provided) is multiplied by the hours the plaintiff's attorney spent working on the case. Accordingly, in individual WARN Act cases, it is not atypical for the

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attorneys fee of a prevailing plaintiff to exceed the actual damage award. Accordingly, when deciding whether to contest a WARN Act claim, the attorneys fee of the successful plaintiff must also be considered. [10]

The WARN Act is a federal law that applies in all states. It is important to remember that each state may have a similar law (Connecticut has its own version). The state laws typically have requirements that are in addition to the federal dictates.

B. Application in Reorganizations

When undertaking a corporate reorganization, whether inside or outside of bankruptcy, that contemplates dissociation of employees, application of the WARN Act must be analyzed. If the Act applies then the cost of compliance must be built into the budget. Often a company may seek to use one of the exceptions to avoid the Act's effect. Relying on an exception can be tricky due to the fact intensive nature of the inquiry into its application. For example, many companies seek to use the faltering company or unforeseen business circumstances exceptions to avoid WARN liability. However, both of these exceptions require truly exceptional circumstance (i.e. unexpectedly losing seeking financing tied to certain employment or productivity levels or losing a major customer, etc.). In reality, most companies faced with potential WARN Act issues can reasonably foresee these events and they would not actually represent good cause to avoid application of the Act.

The use of an exception does not obviate the need to afford notice to employees of a mass layoff or plant closure. Rather, the employer must still provide as much notice as possible before the event or, at a minimum, give employees notice that there was no time or ability to comply with the WARN Act requirements. Accordingly, restructurings that will result in the need for WARN Act compliance should be carefully planned to provide the requisite notice.

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III. DEFINED CONTRIBUTION PLAN ISSUES

A. Employee Contributions

A "401(k) plan" is a type of defined contribution plan derived from the Internal Revenue Code provision, 26 U.S.C. § 401(k). The employer has no funding obligation to the extent the employer elects not to contribute to the 401(k). However, employers do have an obligation to remit employee contributions to the 401(k) trust as soon as reasonably practicable or no later than the 15th day of the month following receipt of the contribution by the employee.[11] Thus, when handling employee's money (i.e. through a payroll deduction earmarked for the 401(k)) the employer must take great care in placing the deducted amount into the 401(k) trust as soon as possible or face civil and potentially criminal liability.

With respect to civil liability, assuming the employer has discretion to administer and invest plan assets, the employer is a fiduciary. Thus, decisions on how to handle and invest plan assets must be made in the best interest of the plan participants and beneficiaries. Failure to administer the plan in accordance with the employer's fiduciary duty may subject the employer to liability for mismanagement of the 401(k) plan. For example, if the employer invests 401(k) plan assets imprudently, the employer can be held liable to participants and beneficiaries for the improper investments.

Further, intentional acts to deprive employees of their 401(k) plan contributions can be sanctioned criminally. Pursuant to 18 U.S.C. § 664: "Any person who embezzles, steals, or unlawfully and willfully abstracts or converts to his own use or to the use of another, any of the moneys, funds, securities, premiums, credits, property, or other assets of any employee welfare benefit plan or employee pension benefit plan, or of any fund connected therewith, shall be fined under this title, or imprisoned not more than five years, or both. As used in this section, the term

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'any employee welfare benefit plan or employee pension benefit plan' means any employee benefit plan subject to any provision of title I of the Employee Retirement Income Security Act of 1974." Thus, where employee contributions are not properly remitted to a 401(k) trust, criminal liability may also attach.

However, 18 U.S.C. §664 is a specific intent crime requiring proof of "willfulness" on the part of the defendant: "acting [willfully] with 'specific intent' means acting with intent to deprive the retirement plan of its funds or with reckless disregard for the interests of the retirement plan."[12]

The conclusion to be drawn from the law is simple, yet very serious. When a company, or company representative, is handling its employee contributions – the personal funds of the employees – failure to remit them to the 401(k) trust can be disastrous. Purposefully diverting money to allow the company to stay in business may be sufficient to impose criminal liability. Rather than get into trouble, a company experiencing an inability to manage a 401(k), or similar plan is well advised to suspend and/or terminate the plan.

Often a first step a company may take as part of a reorganization is to suspend employer contributions to the plan. The plan may not need be immediately terminated because the employer intends to make future contributions once the company is on better financial footing. Suspension of contributions does not eliminate an employers obligations to pay for the administrative costs associated with the plan. Where the administrative burden of having a benefit plan is too high, plan termination must be considered.

B. Plan Termination

Pursuant to Treasury Regulations, 401(k) plans can be terminated intentionally or by application of law. A 401(k) plan is purposefully terminated when an employer/sponsor seeks

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termination of the plan under the applicable Treasury Regulations. Typically, prior to termination of a plan, the plan is suspended by the employer. In other words, no further contributions are permitted by employees or are made by employers if the plan is contributory. Plan termination is particularly appropriate when the administrative burden of maintaining the 401(k) plan is too great for the company to sustain.

Termination or partial termination can also occur when plan participants are laid off in sufficient number to meet numerical benchmarks established by Treasury Regulation. When partial termination occurs, employees who request distributions of their benefits are entitled to payment of all accrued benefits.[13] What this means is that the employees are entitled to (a) any employee contributions they have made to the 401(k) plan and (b) any employer contributions "accrued to the date of the such termination or partial termination…."[14] Accrued benefits include unvested contributions that have been earmarked for an employee's individual account. Thus, upon partial (or total) termination of a 401(k) plan, employees become vested in everything credited to their individual account.

In the context of plan termination, it is essential to ensure that the plan is fully funded, otherwise employees may have claims against the company. The company will generally be held liable upon termination for a request for distribution from a 401(k) plan for unfunded employer contributions.

In bankruptcy, certain claims related to contributions to employee benefit plans have a fourth priority amongst other unsecured pre-petition claims. Obviously, with respect to employee contributions, plan fiduciaries have personal civil and criminal liability for breach of fiduciary responsibility with respect to unfunded obligations (Remember: under ERISA the definition of fiduciary – a person with discretionary authority with respect to a plan – is

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functional. Thus, if the CFO of a company has discretionary authority but is not a named fiduciary, the authority is what is important, not his title.)

As with WARN Act considerations, termination of a 401(k) plan, or any other employee benefit plan, will increase costs associated with employee compensation. However, due to the administrative burden of terminating a plan (professional fees, establishing roll over accounts, etc.) it is important that these collateral expenses be properly budgeted. Thus, the costs of plan termination, as well as the future cost savings, should be included in the restructuring budget and projections. While the legal requirements concerning plan termination should not be the driving force behind whether to terminate the plan, the strictures need to be followed to ensure compliance with lending and creditor requirements.

IV. COBRA ISSUES IN BANKRUPTCY

In a Chapter 11 reorganization, employees who are laid off are generally entitled to COBRA elections, assuming they are otherwise eligible under COBRA. Where an employer discontinues all health plans, shuts down or is a debtor in a Chapter 7 case or under state liquidation law, COBRA coverage is not available to employees as there has to be some remaining plan under which the employee could obtain continuation coverage. However, employees may be entitled to special enrollment in their spouse's plan or qualification as an "eligible individual" who would be entitled to access to individual insurance on the same terms as under a COBRA election.

If the health plan is a self-funded plan (i.e. the plan sponsor is also the insurer), claims for reimbursement of health care expenses incurred prior to a bankruptcy filing constitute claims against the bankrupt entity. To the extent court approval is not obtained for the company, acting

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as debtor-in-possession, to certain pay pre-petition health care claims, claims for reimbursement would be unsecured claims against the debtor/company, with an argument for priority status under 11 U.S.C. §§ 507(a)(3) (relating to payment of pre-petition wages and salary) or 507(a)(4) (relating to contributions to employee benefit plans).

In bankruptcy, unpaid self-insured claims become a particular concern. If the company does not pay the bill, the provider will eventually look to the employee for payment. Obviously this will place even greater strain on employees who are likely already hard pressed by their employer's bankruptcy filing, which may likely include a pay cut or job loss and other benefit cuts. Once again, the best way to address this problem is by proper pre-petition budgeting. First, payment of all claims should be made as quickly as possible prior to the petition date. Second, the motion to pay prepetition benefits should ensure that all benefit payments can be paid up to the priority amounts. While these efforts may not prove perfectly successful, the goal is to reduce the effect of the bankruptcy filing on the employees, who are already being asked to sacrifice.

V. THE PBGC – DEFINED BENEFIT PLANS

The PBGC was established under ERISA to insure and regulate defined benefit plans. ERISA also established minimum funding requirements for defined benefits plans, which, if not met, subjects sponsors to PBGC regulatory action. When a plan does meet the minimum funding requirements it is "underfunded". Upon request, the PBGC will waive minimum funding requirements for good cause shown, such as financial difficulty. As evidenced by the recent wave of airline bankruptcies, years of waivers on minimum funding requirements have increased the amount of the outstanding pension liability for which the public may ultimately be liable.[15]

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When a plan is terminated, either by the sponsor or PBGC, known as a "distress termination", the PBGC becomes liable for the full amount of the employees' expected benefits. This means that the PBGC will cover the full amount of the underfunding. However, benefits are disbursed by regulation, not by the terms of the plan. Upon termination of an underfunded defined benefit plan, the sponsor becomes liable to the PBGC for the underfunded amount. In the bankruptcy context, the PBGC's claim is viewed by a majority of the Circuit Court's of Appeals as a pre-petition claim.[16] A more vexing problem is the priority to which a PBGC claim in bankruptcy is entitled. Under certain circumstances, the PBGC may be entitled to a first priority administrative expense, fourth priority benefit claim, an eighth priority tax claim or no priority.

Historically the steel industry, and today, the airlines, have used the PBGC termination process to transfer the enormous costs associated with their retirement plans to the public.[17] Indeed bankruptcy has been used strategically to reduce the pension liability for companies that are languishing under legacy costs. Additionally, PBGC takeover of a pension plan can often dramatically reduce the benefits paid to retired employees.

Given the reduction of benefits to workers, officers and directors of companies involved in a defined benefit plan termination must consider the possibility of facing personal lawsuits by both the PBGC for the underfunded liability and from plan participants and beneficiaries for financial mismanagement under ERISA. As demonstrated by the airline bankruptcies, lawyers should begin discussions with the PBGC early in the process to ensure a smooth termination of the plan and to establish a level of trust so as to leverage the best possible resolution for the company involved. To do this, all of the various parties-in-interest to a plan termination must be consulted, including unions, corporate officers and directors, and insurers that may ultimately be

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liable for any judgments. It is self-evident that reaching a resolution with the PBGC will greatly enhance the ability of the debtor to restructure its pension obligations through bankruptcy.

VI. CONCLUSION

Financially distressed companies tend to face more pension and employee benefit issues than healthy companies due to the often high percentage of cost associated with salary and benefits. In undertaking a financial restructuring, whether inside or outside of bankruptcy, it is important for decision makers to remember that employment issues are subject to federal and state regulation. Often, dealing with the employee compensation issues of a distressed business can be resolved by careful budgeting and early discussions with lending and capital sources to ensure that a restructuring budget is properly financed on the first try. Indeed, there is nothing financing sources like less that unexpected cash needs to resolve an emergency situation which, with a little preplanning, could have been budgeted or avoided altogether.

From a lawyers perspective, successfully reorganizing a financially distress company is as much about trust among the various parties-in-interest as it is about understanding the applicable law. Proactively applying a comprehensive knowledge of the regulatory framework is essential to establish the rapport necessary to avoid preventable liability, engender confidence and accomplish a successful revitalization so that the company can sustain and benefit its employees and shareholders in the future.

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[1] Jeffrey M. Sklarz is a partner with Zeisler & Zeisler, P.C. in Bridgeport, Connecticut where he focuses his practice on representing businesses and individuals in financial reorganizations, bankruptcy, pension and employee benefit, tax and commercial litigation.
[2] 29 U.S.C. § 2104.
[3] 29 U.S.C. § 2101(a)(1).
[4] 20 C.F.R. § 639.3(a)(1).
[5] 20 C.F.R. § 639.3(a)(4).
[6] 29 U.S.C. § 2101(a)(2) and 20 C.F.R. § 639.3(b).
[7] 29 U.S.C. § 2101(a)(3) and 20 C.F.R. § 639.3(c).
[8] 29 U.S.C. §2102(a) and 20 C.F.R. § 639.6.
[9] 29 U.S.C. § 2104(a)(6).

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[10] See, Childress v. Darby Lumber, Inc., 357 F.3d 1000, 1011 (9th Cir. 2004) (affirming district court award based on lodestar analysis of twice the actual damage award in a WARN Act case).
[11] 29 C.F. R. §§ 2510.3-102(a) and (b).
[12] U.S. v. Krimsky, 230 F.3d 855, 860-61 (6th Cir. 2000)(affirming conviction of company president and trustee of pension trust under 18 U.S.C. § 664 for using pension trust funds to secure loans that were prohibited transactions under ERISA); U.S. v. Grizzle, 933 F.2d 943 (11th Cir. 1991)(conviction of company officers affirmed where they failed to remit payroll pension withholdings to a vacation fund); U.S. v. Santiago, 528 F.2d 1130, 1133 (2nd Cir. 1976)(Second Circuit affirmed conviction of union president who diverted employee contributions to a union pension fund to the union's general fund: "Diversion of Welfare Fund assets into the union's general fund was a conversion for the benefit of the membership as a whole and differed only in degree from a diversion of such funds into the hands of a smaller group or an individual union member. The legislative history of § 664 clearly indicates that its intended purpose was to preserve welfare funds for the protection of those entitled to their benefits.")
[13] See, 29 C.F.R. § 1.411(d)-2(a).
[14] 29 C.F.R. § 1.411(d)-2(a).
[15] Although the PBGC stresses that it receives no funds from Congress and is funded by the premiums on insured defined benefit plans, the PBGC acknowledged in its 2004 annual report: "It is important to stress that, despite the financial pressures facing PBGC, the Corporation's more than $39 billion in assets enable it to continue paying participants their guaranteed benefits for a number of years. However, with more than $62 billion in liabilities, it is clear that the Corporation does not have sufficient resources to meet all of its long-term obligations. This affects not only the more than 1 million Americans who are now directly dependent on PBGC for their pension income, but the 44 million Americans whose pensions PBGC insures." 2004 PBGC Annual Report at 1. Given the political repercussions of allowing the PBGC to stop paying retiree benefits, it is unlikely that Congress will permit the PBGC to simply go out of business.
[16] See, PBGC v. LTV Corp., 875 F.2d 1008 (2nd Cir. 1989), rev'd on other grounds, 496 U.S. 633 (1990).
[17] See, E.g., Ass'n of Flight Attendants-CWA, AFL-CIO v. United Air Lines, Inc., 2005 U.S. Dist. LEXIS 16292 (N.D. Ill. July 21, 2005) (affirming bankruptcy approval of settlement between debtor and PBGC, over and above union's objection, concerning pension plan termination and barring future use of pension plans by debtor).

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