



The Bankrupt's Guide to Employee Benefits: What to Do When Your Company Is in Financial Straits

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When facing the “worst-case scenario”—insolvency, bankruptcy, or the complete failure of the business—a company’s leaders need to review the organization’s employee benefits programs to determine what can be done to help the company and what must be done to avoid plunging the business and its leaders into legal trouble.

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Do not read this article if you are faint of heart.

Do not read this article if you seek something hopeful and uplifting to read in these dark and dire economic times. If you like to read happy stories about hard-working employees who earn wonderful benefits, you will be disappointed. In this article, we will discuss how a financially troubled company (the Company) that faces possible or pending insolvency or bankruptcy (the Worst-Case Scenario), but that has not actually filed a petition with the bankruptcy court, should deal with its employee benefits programs. We will also lay out the tough choices to be made by the Company’s leaders—the board members, executives, human resources staff, and employee benefits specialists (Leaders)—and provide advice on how to make those decisions as the Leaders strive to bring the Company back from the brink. Although Leaders’ goals will vary, depending upon the Company’s size, ownership structure, and financial situation, we will assume their primary goal is to keep the Company afloat and in business.

Thus, the majority of this article will discuss benefits that the Leaders can cut easiest and quickest, how to plan ahead before making cuts in benefits so that no laws are broken and no plan rules are violated, and what benefits the Company must keep to retain those indispensable employees the Company needs to survive.

Although this article is billed as a “Bankrupt’s Guide,” it will actually be most helpful to farsighted Leaders of a solvent Company who want to be prepared for the Worst-Case Scenario, even if they do not actually expect to reach such financial straits. As this article will point out many times, it takes considerable time to analyze benefit plans to determine which plans and programs that, if cut, will save the Company the most money and to complete the formal processes required to eliminate the targeted plans or benefits. Therefore, this article will be of greatest assistance to those Leaders who still have time to carefully consider the tough choices they face (or could potentially face) and to put a strategy in place in case the worst happens. So this article may have been more appropriately titled “The Barely Solvent (But Planning for Disaster) Company’s Guide,” but the Hollywood moguls who purchased the movie rights demanded a catchier title. Leaders of an *insolvent* Company may have already determined what benefit programs must go, but they may find this article useful to identify the typical, yet avoidable, pitfalls they will encounter when terminating plans and cutting other benefits. The final section regarding how

Leaders should protect themselves is particularly apropos in such circumstances.

Save the Company

When the Company is in dire straits, Leaders must cut costs. Unfortunately, that cost cutting must include reducing or eliminating various employee benefits. When a Company is healthy, benefits professionals focus on maximizing the benefits with the dollars available, preventing health costs from spiraling out of control, helping employees set aside adequate amounts for their retirement, and using the Company's benefits portfolio to attract new talent and retain the best performers. When a Company struggles to remain solvent, employee jobs and paychecks take precedence over perquisites. Leaders must make the tough call to decide what benefits can be cut, begin making cuts, and communicate those cuts to the workforce.

Three Rules for Survival

First Rule: Be a Boy Scout, Not a Member of the Optimist Club

Entrepreneurs and executives achieve success by seeing opportunity where others do not. In the Company's start-up and initial growth phases, hope and optimism were essential, but there is no place for rose-colored glasses when the Company runs onto the rocks. Bankruptcy practitioners can tell endless stories of successful chief executive officers and entrepreneurs who waited too long to admit the Company was in trouble because those business leaders could not change their mindset, accept realities, and plan for the Worst-Case Scenario. By refusing to consider and plan for the possibility of failure, they ensured it. By the time these captains of industry admit they need help and file for bankruptcy, too often, the assets have dwindled too far to keep the Company running and the hopes of a successful Chapter 11 reorganization drown in a Chapter 7 liquidation. Adopt the First Rule for Survival: Don't be an optimist.

Second Rule: Act Like a Boy Scout—Be Prepared

Cutting employee benefits can be a lengthy process. In some cases, benefits eliminated prior to the Company's bankruptcy filing can be reinstated by a bankruptcy judge. (For any Leaders who do not expect the Company to actually file for bankruptcy, please refer to the First Rule for Survival.) You need to give

yourself time to act. Rule Two for Survival is the Boy Scout Motto: Be Prepared. Leaders should determine as soon as possible how the Company will handle the Worst-Case Scenario, which includes the need to file for bankruptcy protection and all the preparations that it entails.

Third Rule: Act Promptly

Cut benefits now, not later. As long as an employee benefits plan or program remains in place, employees can earn additional benefits. Generally, once an employee has accrued a right, it is his to keep and the Company must provide the benefit. Each benefit plan and each benefit has different triggers for when an employee accrues rights under the plan: certain thresholds for hours worked in a year, an employee's anniversary date, the end of the calendar year or the plan year, the date the Company declares the amount of an award, and set dates specified in the plan document, just to name a few.

Until the Company conducts a survey of all its benefits and all the accrual triggers for each benefit, the Leaders will not know when employees could be accruing nonforfeitable benefits and how much those additional benefits will cost the Company. The safest measure is to eliminate those benefits that will save the Company the most money, that can be cut immediately, and that will allow the Company to retain and keep productive those employees needed to keep the Company running. Obey the Third Rule of Survival: Make cuts now to ensure there will be a later.

Preparatory Steps

Determine What Benefits Can Be Cut

As soon as Leaders see financial trouble on the horizon, they should consult with their benefit plan service providers, outside benefits advisers, and benefits counsel to consider how benefits costs might be trimmed. Leaders should ask which benefits cost the Company the most money, which benefits can most quickly be eliminated, and how much notice they must give participants or service providers under the service contracts before the Company can eliminate a benefit, reduce the number of covered participants, or change to a lower-priced benefit option. Leaders should also ask the plan service providers and other benefits vendors to offer benefits alternatives to keep or obtain the Company's business, including lower prices for current benefits packages, cheaper

alternatives, and waivers of contract notice requirements, termination periods, and automatic renewal provisions.

Leaders also need to identify the benefits that the Company's indispensable employees cannot live without. Most employees insist on basic health insurance coverage for themselves and their families. Employees who cannot retain basic health coverage for their families may be forced to quit and find a job where they can obtain such coverage. Other benefits may be equally as vital to employees, depending upon the Company's industry, location, and workforce. For example, workers in dangerous manufacturing and mining jobs may demand short-term and long-term disability insurance; whereas, clerical staff may consider such benefits to be optional. Meanwhile, employees in high-rent urban areas may consider essential programs to include Company assistance purchasing homes, locating rental properties, paying commuting costs, and providing telecommuting alternatives. Before making drastic cuts that will be difficult and expensive to undo, Leaders should conduct some research to ensure that they are not eliminating any benefits that employees cannot work without and, if possible, the first programs cut are those employees value least.

Always Keep the Bankruptcy Windows in Mind

Not only can the bankruptcy court dictate what a Company in bankruptcy can and cannot do, the judge can also reverse certain actions Leaders took in the months leading up to the filing for bankruptcy protection. In the case of retiree health, death, and disability benefits, the judge can reinstate benefits that were eliminated as far back as six months in advance of the filing [11 U.S.C. § 1114(l)]. The length of the period the judge can look back and take action depends upon when the Company became insolvent, as that term is defined in the bankruptcy rules—i.e., when the Company's liabilities exceed its assets. However, the assets and liabilities used in that calculation do not match those most Companies track, so it will be almost impossible for Leaders to ascertain all the variables and estimate when the Company may become "insolvent" under the bankruptcy rules. It is also difficult to predict as far as six months out whether the Company will file for bankruptcy and to pinpoint the date of such filing. So Leaders will never know for certain at the time they are cutting benefits programs whether the bankruptcy court will honor those decisions or not. For these reasons, if Leaders

can foresee the need to reduce or eliminate retiree health benefits, they should act quickly to minimize the chances, if a bankruptcy filing becomes necessary, that a bankruptcy judge would reinstate such benefits.

Cutting Retirement Benefits

Defined Benefit Plans

Defined benefit plans usually cost more to maintain and require larger contributions from Companies than defined contribution plans. Furthermore, they are harder to terminate than defined contribution plans. As a result, Leaders reviewing their retirement plan costs and obligations should start with the Company's defined benefit plans. Current employees whose Companies terminate their defined benefit plans must then prepare for retirement knowing that the full benefits under those plans will not be available.

Leaders can offer current employees participation in a 401(k) plan as an alternative to participation in the defined benefit plan. This allows employees to save for their own retirement without burdening the Company with any fixed costs other than plan administration. Because 401(k) plans often cost less to administer than defined benefit plans, Companies also save on administrative costs when switching from defined benefit to defined contribution plans (although the short-term fees for terminating a defined benefit plan and establishing a replacement 401(k) plan will generally be high). Only people actually in retirement or near retirement have a short-term need for retirement benefits and, unless the defined benefit plan is underfunded, the Company already made contributions on behalf of those employees and former employees in years past and the funds are available in the plan's trust to pay their accrued benefits.

However, Companies cannot simply stop contributing to a defined benefit plan on a whim; certain formalities must be observed. A defined benefit plan must be amended to "freeze" future benefit accruals, and this may require that all employees be fully vested in the benefits they have already earned to date. [See I.R.C. § 411(d)(3)(A).] In the short run, freezing benefit accruals stops the heaviest flow of cash out of the Company that is caused by these plans. Be aware that the Company may not experience significant cost savings by freezing the plan if the benefits that employees have already earned under the plan cannot be met by the funds in the plan, either

because the Company failed to properly fund the plan or because the plan's assets lost value due to market declines or investment decisions. However, even in this case, freezing the plan to prevent new benefit accruals will stem the bleeding.

As long as a defined benefit plan exists, however, the Company must continue to administer the plan, pay out benefits to retirees and beneficiaries, update the plan for changes in the law (some mandatory changes generally are required every few years), pay for annual actuarial evaluations, file annual reports with the federal government, and send various notices to participants. Therefore, if Leaders know that they will not want to continue a defined benefit plan even when the Company returns to sound financial footing and if earned benefits are properly funded, then the Company should terminate the plan.

If the plan is fully funded, the termination process will not be too difficult, although the Company will require the additional assistance of the actuaries and outside benefits counsel and advisers. Terminating an underfunded plan requires the Company to fully fund the plan immediately or to engage in a special termination process for insolvent or bankrupt Companies. The Pension Benefit Guarantee Corporation (PBGC) may also obtain a lien on the Company's assets for the amount of any unfunded benefits. Therefore, many Leaders will prefer to wait until the Company's financial crisis has passed before initiating a plan termination.

Be aware that if the Company eliminates benefits for only a portion of the employees eligible under the plan, the employees who lose eligibility may become entitled to be fully vested in their benefits. If 20 percent or more of the participants lose the right to continue participating in the plan because either the plan is amended to make them ineligible or because they lose their jobs, then the IRS will presume that there has been a "partial termination" of the plan and will require the plan to fully vest those participants in their plan benefits [Rev. Rul. 2007-43, 2007-28 I.R.B. 45, Rev. Rul. 2003-65, 2003-25 I.R.B. 1035]. The Company should consult its employee benefits counsel or advisers in any case where a significant number of employees will lose eligibility under the plan or will be terminated (and that includes a series of related terminations spanning more than a year).

The Company must provide a notice to all affected employees when it stops the accrual of new benefits under a defined benefit plan [I.R.C. § 4980F(e), ERISA § 204(h)], and if the number of participants in

the plan falls by 20 percent during the plan year (or by 25 percent from the beginning of the prior plan year) or if there is a partial termination of the plan, the Company must notify the PBGC [ERISA § 4043(c)]. (PBGC coverage does not apply to plans covering only owners, professional corporations with fewer than 25 participants, governmental plans, and church plans, among others.)

Defined Contribution Plans

If the Company sponsors one or more profit-sharing plans, 401(k) plans, or other defined contribution plans, the Company can cut costs by eliminating the Company's contributions. If the plan provides for mandatory profit-sharing contributions—those the Company must make each year—the plan should be amended to make those contributions optional at the Company's discretion. Such an amendment can be made quickly, is easy and inexpensive to make, and gives the Leaders the flexibility to cut off contributions in the short-run, to offer such benefits again in the future, or to never offer such benefits again, all without requiring future amendments to the plan.

If the plan provides for matching contributions, Leaders should likewise ensure that the plan allows the Company the discretion to decide whether a matching contribution will be made for any pay period, the amount of the match, and the level of deferrals that will be matched. Furthermore, the plan should give the Company discretion to decide when the matching contribution will be made, up to the legal due date for deductibility of the contribution. For example, the plan should permit the 2009 matching contribution to be made any time before the Company's tax filing deadline for 2009 (March 15, 2010, for corporations with a calendar year tax year, or August 15, 2010, if the filing deadline for the return is extended). However, once employees have met any eligibility requirements to receive matching contributions and met any current-year participation requirements (e.g., worked for 1,000 hours in the plan year or remained employed on the last day of the year), the Company cannot change any plan-guaranteed contribution or allocation rules for the matching contribution for that year.

The Company's benefits staff should check the plan to determine whether highly compensated employees (HCEs) made salary deferrals to the plan that exceeded the amount permitted by the nondiscrimination testing. If the Company has typically corrected this problem by making additional contributions into the plan

to the accounts of nonhighly compensated employees (NHCEs), the Company can save money by forgoing those additional contributions and distributing excess contributions back out to the HCEs.

In a profit-sharing or 401(k) plan, if the Company permanently discontinues contributions to the plan, the plan must fully vest participants in their accounts. As with a defined benefit plan, Leaders could also unintentionally create a “partial termination” of a defined contribution plan if they amend the plan to prevent some current participants from accruing future benefits, such as matching contributions or profit-sharing contributions, or from vesting in those benefits, or if some employees lose their right to participate in the plan because their employment is terminated. If 20 percent or more of the participants lose their right to participate (for reasons other than death, disability, or retirement), the IRS will presume a partial termination has occurred. [See Rev. Rul. 2007-43, 2007-28 I.R.B. 45, Rev. Rul. 2003-65, 2003-25 I.R.B. 1035.] Again, Leaders should consult with employee benefits counsel before amending the plan to change eligibility or before any significant numbers of employees are terminated.

Health and Welfare Benefits

Leaders will find cutting health and welfare benefits much easier, at least procedurally, than retirement benefit plans. First, Companies can generally terminate these benefits programs at will. Second, in most cases, health and welfare benefits never vest. Therefore, most of the attendant costs stop immediately upon termination of the plan. The main exceptions exist in group health plans, which may be required to administer COBRA continuation coverage for some time after termination and which usually process and pay run-out claims for some period after benefit coverage ends.

Retiree Benefits

Leaders should begin their cost-reduction analysis with retiree health benefits. First, because of the bankruptcy judge’s special power to reinstate certain retiree welfare benefits, as discussed above in “Always Keep the Bankruptcy Windows in Mind,” Leaders should cut these programs as quickly as possible to prevent a bankruptcy judge from reinstating these benefits. Second, employees can continue to work without these benefits. Health benefits for retirees do not keep current employees healthy and productive. (And if the Company does go out of business, these

benefits will not help retirees, either, because (unless provided through a funded trust) there will be no one to continue to pay the health benefits or the insurance premiums.) Third, because these benefits are not retirement benefits, they can be eliminated much more quickly and easily and result in immediate savings.

Leave and Severance Benefits

Some generous Companies allow employees to donate the cash equivalent of their unused vacation, personal leave, or other paid leave time to other employees who have been victims of natural disasters, such as Hurricane Katrina. Some Companies even allow employees to donate unused leave to help non-employees. These benefits can be cut without reducing worker productivity. Paid holidays, paid sick leave, and special purpose leaves of absence, such as for birthdays, work anniversaries, personal days, jury duty, and bereavement also do not directly contribute to higher employee productivity or the bottom line. Of course, before cutting holidays and leaves of absence, the Company should determine how much these cuts will save (at least in the short run) and how much additional revenue will be generated by any additional productivity the Company will gain by having employees work more days. Leaders should not eliminate such benefits and further damage employee morale if the Company cannot reduce its overall payroll cost or convert additional days at work into additional revenue.

Finally, severance benefits do not directly contribute to employee productivity or the bottom line, so they are worth considering as a source of savings. However, Companies that become insolvent or enter bankruptcy reorganization may need to retain such benefits if employees will only continue working through such a period in exchange for a financial safety net when employment ends.

Health Benefits to Current Employees

Private U.S. employers pay more for health care than any other employee benefit, and among all of employers’ employee-related costs, health care ranks second only to wages and salaries. According to the U.S. Bureau of Labor Statistics, health insurance comprised 7.9 percent of employee benefits provided by private sector employers in September 2008, the most recently available figures. [Economic News Release, U.S. Bureau of Labor Statistics, “Company Costs for Employee Compensation Summary,” Table 1. Civilian Workers, by Major Occupational and Industry Group,

available at <http://www.bls.gov/news.release/ecec.t01.htm> (last modified date: Dec. 10, 2008).] (Salaries and wages represented 70 percent of total compensation, and all other benefits represented 30 percent of compensation. [*Id.*]) Companies can often save significant amounts by eliminating or reducing health benefits.

A Company needs to maintain any benefits that would cause essential employees to leave the Company, and basic health insurance is usually one such benefit. However, Companies often offer a range of additional health-related benefits that employees may be willing to forgo, especially if the Company's competitors are not hiring, or employees may be willing to shoulder a larger part of the cost of such benefits in a tough economic environment. Examples of such benefits include spouse and dependent health insurance coverage; vision and dental coverage; short-term and long-term disability coverage; and life insurance. If the Company fully pays for any of these benefits, it can still offer such benefits to employees on a voluntary basis—that is, the Company may shift the cost to an employee who is willing to pay for the benefit in order to retain it. If the Company subsidizes the cost of such benefits, the Company can drop the subsidy and pass along the additional cost to employees who are willing to pay the full price of such benefits. If employees already pay the full cost of their own benefits, the Company only bears the cost of administering the program, which is usually so small as to make eliminating it unnecessary. However, if employees do not take advantage of a voluntary benefit, or if they refuse to continue a subsidized benefit on a voluntary basis, then there is no need to pay administration costs for an unused benefit option.

Health Benefits Worth Retaining

Companies may find it in their own best interests to maintain basic health insurance and certain other health-related benefits. Basic health insurance allows sick and injured employees to get the medical assistance they need, and generally this means the employees get well sooner and return more quickly to full productivity. For some Companies, employee productivity and effectiveness may also see the same boons from dental and vision screening/treatment benefits. Leaders must weigh the costs and advantages of such programs and must determine whether employees can be made to bear some or all of the cost of such programs.

There may also be other health-related benefit programs that help reduce the Company's health care

insurance costs. Leaders should carefully compare the costs of these programs and the savings they produce before putting these programs on the chopping block. For example, successful programs that help employees lose weight, reduce cholesterol levels, or stop smoking may save the Company more on health insurance expenses than such programs cost. Leaders should also factor into their considerations whether such programs improve attendance and productivity and how those improvements affect the bottom line.

Certain health-related incentive programs may yield benefits that exceed any cost. For example, if a Company offers a \$200 reward to employees who successfully quit smoking for one year, and if the Company knows that every nonsmoker saves the Company \$500 in annual health insurance premiums, then the Company should certainly continue the program. If an employee quits smoking for six months and starts smoking again, the Company pays nothing and it may still see some health improvements in the employee (and dependent) population. If the employee succeeds in quitting for a year, the Company has already saved \$500, netting a \$300 benefit after paying the \$200 reward. The Company likely will save another \$500 in health care costs the following year, at no additional cost, because the employee's chances of remaining a nonsmoker are high after such a long period of abstinence.

Programs that may save the Company more on health care costs or reduced employee absenteeism than they cost to provide include weight loss and diet assistance programs, smoking cessation programs, wellness-promotion programs, gym memberships, on-site health facilities, on-site medical and health-screening facilities, and employee assistance programs. (Employee assistance programs—which vary widely in the services they offer—may provide employees with discounts for initial visits with medical and mental health providers. These programs may also provide referrals for all types of services useful to employees—medical help, child care, legal assistance, home repair, tax-preparation services—so that employees do not spend work time taking care of personal health or other family responsibilities.)

Subsidized Fringe Benefits

Companies may find that other fringe benefits, usually not as vital to employees as health care coverage, are unnecessary to retain employees in a poor economic market. Companies paying for or subsidizing such benefits should consider whether significant cost

savings could be obtained by eliminating or lowering the subsidized portion of the cost. These types of benefits include: paid parking, commuting assistance (train and bus passes and incentives for ride-sharing), legal assistance, adoption assistance, child and dependent care, and tuition reimbursement.

What Benefits Cannot Be Cut?

Before cutting any benefits policies or plans, Leaders should check with their benefits counsel and advisers. Most benefits can be reduced or eliminated in one way or another. Certain payroll policies, including certain types of vacation and holiday pay, can be eliminated altogether without notice to employees and without formal plan amendments. However, nothing can prevent a disgruntled employee or former employee from suing, even if the suit is frivolous. Therefore, even with simple benefits, Leaders should consult with benefits advisers before making any cuts to take steps such as those outlined below. This will ensure the legal formalities are followed and that communications with employees minimize employee frustration.

1. Determine if any employees have accrued a benefit under the rules of the policy or plan,
2. Provide employees with notice of all changes in their benefits,
3. Provide as much advance notice as possible so employees do not make decisions in reliance on the promise of benefits that will be reduced or cut, and
4. Document the change in a signed and dated writing so that any disputes or claims of inconsistent treatment among employees can be either avoided or quickly resolved.

As discussed above in “Always Keep the Bankruptcy Windows in Mind,” a Company may reduce or eliminate retiree health benefits, but under certain circumstances, a bankruptcy court can unravel that Company decision and require the Company to provide all the benefits the retirees lost extending back to the day the change was made. That exception occurs only in a bankruptcy setting, but there are other, more common limitations, such as collective bargaining agreements and business contracts that can also prevent Leaders from cutting back benefits at their discretion.

Collective Bargaining Agreements

If the Company has a collective bargaining agreement (Agreement) with a union local or another

collective bargaining unit, Leaders cannot simply drop the benefits the Company committed to provide in the Agreement. Unions can sue a Company in federal court to enforce the terms of the Agreement. When a Company wants to change the benefits of members of a collective bargaining unit, Leaders should first consult the Agreement to see whether the document promises the benefit and, if it does, whether there are any circumstances in which the benefit can be reduced or eliminated. The Agreement may also provide rules regarding the circumstances in which the Company can renegotiate the benefit or renegotiate the entire Agreement. The Agreement may prevent the Company from trying to renegotiate certain provisions or promised benefits, and Leaders should know these before contacting the union or collective bargaining unit to avoid any violations of the Agreement. Of course, Leaders should always consult with legal counsel to make sure their reading of the Agreement is correct (and that no opportunities have been missed).

If a Company provides any benefits under a collective bargaining agreement, Leaders should contact the collective bargaining unit as soon as possible so the bargaining unit will understand the need for concessions and a rapid beginning to the negotiation process. When planning for the Worst-Case Scenario, the Company should allow time for possibly protracted negotiations with any collective bargaining unit.

Contractual Obligations

During mergers and acquisitions, the acquiring company may agree in the merger or purchase document, or in a side agreement with certain parties, to continue to provide certain benefits. These agreements often apply to certain employees or former employees and extend for a set period of time, commonly one year but sometimes longer. If a Company has recently acquired another business or was involved in a merger of two or more entities, the Company may be contractually bound to continue certain benefits plans and programs for employees of the acquired business or to provide a certain level of insurance coverage or retirement contributions on behalf of those employees.

Before any cessation or reduction in benefits occurs, Leaders should consult the purchase agreements, related agreements, and transfer documents and consult with benefits counsel to determine whether any obligations to maintain benefits exist and whether any exceptions may apply. Purchase agreements containing provisions for the continuation of certain

benefits often will have an escape clause that permits the Company to discontinue such promised benefits in cases of extreme economic duress. If Leaders decide to rely upon such an escape clause, they should document their decision to reduce or eliminate the benefits, note the provision in the agreement allowing for an exception, and document the considerations undertaken by the board of directors (or other authorized parties) to establish that the conditions for the exception were met.

Accrued Benefits

Both retirement and health and welfare benefits can provide for the accrual of employee benefits in such a way that the Company is bound to pay for a benefit once the accrual occurs. Leaders should be most concerned about those benefits for which the Company has not yet paid money into a plan, trust, or insurance provider, but which the employee has accrued or may accrue a right to sometime in the near future. Under a traditional defined benefit pension plan, until the Company freezes or terminates the plan and provides proper notice to employees, they will continue to accrue benefits under the plan's benefit formula. Once the period for accrual passes, the Company must provide at least the accrued benefit and may not reduce that benefit. [See I.R.C. § 411(d)(6).]

Under a defined contribution plan, such as a 401(k) plan, an employee can accrue rights to a promised matching contribution as frequently as every payroll period or on an annual basis. If the plan provides for a profit-sharing contribution, employees usually earn the rights to a share of such contribution either at some point during the year—such as after the completion of a given hours requirement—or at the end of the year—if the trigger to qualify for the benefit is that the participant is employed with the Company on the last day of the year. Plans can also provide for combinations of qualification requirements that may make it difficult to assess when employees are accruing rights to such benefits.

Once employees meet all the requirements to accrue a benefit, the Company generally becomes bound to pay for the benefit, even if the payment occurs sometime later in the plan year or shortly after the end of the plan year. However, if the plan gives the Company complete discretion to determine the amount of the benefit awarded, such as in a profit-sharing plan, the employees may have accrued only a right to a share of whatever award the Leaders name. In that case, Leaders

may decide to award no benefit and to make no contribution without violating any rules.

Although Companies can, in general, eliminate employees' rights to most health and welfare benefits at any time, when employees accrue certain benefits under these plans immediately before the benefit is terminated, the Company must still pay for the accrued benefits. In general, an employee accrues a benefit when he has a matured claim for the benefit under the existing formula. For example, suppose the Company has a severance pay plan that provides a two-week severance payment upon termination of employment. If Leaders fire an employee on January 30 and then, on January 31, terminate the severance pay plan, they terminate the plan too late to avoid paying the severance benefit to that employee. The Company must pay the two-week severance to the employee who earned that right before the plan amendment.

The more costly and unexpected benefits that employees may accrue under health and welfare plans are medical claims. If an employee or his dependent incurs an expensive course of treatment covered by the Company's health care insurance before the Company terminates the health plan, the Company (or insurance provider) must still pay that claim, even if the claim is not submitted until the end of the claims run-out window provided for under the health policy. If the Company purchased the group health policy from an insurance company, the Company should not incur any additional costs above its normal premiums. If the Company self-insures its health plan, the Company is contractually bound to pay the claim and will incur the additional cost directly.

In Summary...

To avoid expensive surprises, Leaders need to take the following steps as soon as possible:

1. Assess what benefits employees potentially could accrue under all Company plans.
2. Determine which plans the Company will potentially terminate.
3. Analyze with the Company's benefits counsel and advisers and with any relevant plan service providers if measures should be taken to suspend accruals and how long such measures will take.

Protect Plan Funds

When Leaders finish making all the cuts to the Company benefits programs that can be made, they

must turn to other responsibilities in the employee benefits arena. If a potential bankruptcy filing lies in the offing, Leaders will want to do everything possible to protect employees and the remaining plans by protecting the plan funds.

Retirement Plans

Funds in qualified plans are already protected. By law, such funds must be placed in trust and used only for the exclusive benefit of employees or their beneficiaries [I.R.C. § 401(a)(2)]. Neither the Company nor its creditors has any claim to the funds in the plan. (If the Company terminates the plan and excess funds remain after the claims of all the participants and beneficiaries have been met, the remaining funds could revert to the Company, if the plan so provides. At that point, after the participants have received all the benefits due to them, it is possible the Company's creditors might be able to reach any funds that revert to the Company.)

Even the funds a Company withholds from an employee's wages to make employee contributions into a qualified retirement plan (or Section 403(b) plan) but that have not yet been contributed to the plan or placed in the plan trust are protected from creditors in a bankruptcy case. [See 11 U.S.C. § 541(b)(7) (excluding such amounts from the debtor's bankruptcy estate).] However, this bankruptcy provision for funds still in transit does not apply to retirement plans that cover only Company owners or Company owners and their spouses and it does not apply to IRAs. [See 11 U.S.C. § 541(b)(7) (not excluding from the debtor's bankruptcy estate amounts to be contributed to a nonERISA plan sponsored by a private, for-profit business); Labor Reg. § 2510.3-3 (excluding from coverage under Title I of ERISA plans that do not cover any non-owner employees); Labor Reg. § 2510.3-2 (excluding IRAs from coverage under Title I of ERISA).]

Of greatest concern is the money Leaders intend to use to make the Company's contributions to the plan but that remains in the Company's general assets. As long as those funds remain in the Company's control, they remain vulnerable to creditors, whether the Company is in bankruptcy or merely insolvent. A bankruptcy trustee may recover from third parties amounts paid or transferred by a Company that is a debtor in bankruptcy during periods of up to two years before the Company filed for bankruptcy [11 U.S.C. § 548(a)]. The bankruptcy trustee can reach back as far as two years if the payment or transfer was

made for the purpose of preventing other creditors from being paid or if the Company was insolvent at the time of the transfer. [*Id.*] The bankruptcy courts have held that a Company's payments of its own contributions to a plan that were made to plan administrators, service providers, and similar parties could be recovered from those parties if not deposited into the plan. [See, e.g., *Golden v. Guardian (In re Lenox Healthcare, Inc.)*, 343 B.R. 96 (Bankr. D. Del. 2006) (finding that a debtor-company's contributions to a health plan could be part of the debtor's estate and a bankruptcy trustee could potentially avoid the transfer or recover the payment under 11 U.S.C. §§ 547, 548, 549, or 550).]

Therefore, if Leaders want to better fund an underfunded defined benefit pension plan, they should contribute the funds to the plan as soon as possible. Leaders should also confirm that the contributed funds actually have been deposited in the plan's trust and are not being otherwise held by an administrator or trustee.

For defined contribution plans, such as a 401(k) plan, the Company should make matching contributions, profit-sharing contributions, and nonelective contributions as soon as possible after the right to such contributions has accrued and the Company has funds available. The Code and DOL rules both require a Company to contribute employees' elective deferrals as soon as possible after they are withheld from employees' wages [Labor Reg. § 2510.3-102], and a Company cannot "pre-fund" an employee's elective deferrals or related matching contributions before the compensation being deferred is either earned or otherwise payable as compensation [Treas. Reg. §§ 1.401(k)-1(a)(3)(iii)(B), 1.401(m)-1(a)(2)(iii)(A)]. Companies also cannot "pre-fund" matching contributions by putting the money in the plan before the employee earns the wages and contributes the deferred portion into the plan that the Company is matching.

Health and Welfare Plans

When Companies make premium payments for fully insured plans as they become due, those payments are not likely to be undone by a bankruptcy trustee because the trustee's powers to undo a transaction do not extend to circumstances when a Company pays for some new product or service of value (i.e., not to pay old debts). [See 11 U.S.C. 547(b) (preventing the trustee from avoiding a transfer that is intended by the debtor and creditor to be, and in actuality is, a "contemporaneous exchange for new value given to the debtor").] When a Company makes a contribution to

the trust of a health or welfare plan, the funds in the trust are typically protected from creditors, because the Company has no claim to funds in the trust. Also, as with similar contributions to retirement plans, funds a Company withholds from an employee's wages to make employee contributions into a health or welfare plan but that have not yet been contributed to the plan or placed in the plan trust are protected from creditors in a bankruptcy case, provided the plan is subject to Title I of ERISA. [See 11 U.S.C. § 541(b)(7) (excluding such amounts from the debtor's bankruptcy estate).]

Self-Insured Health Plans—Company funds that Leaders intend to use to pay for benefits under a self-insured health plan remain subject to the claims of creditors, can become part of any potential bankruptcy estate, and can be recovered by a bankruptcy trustee, unless and until the Company actually segregates those funds from the Company's assets. If the plan has a trust that is exempt from the claims of creditors, such as a voluntary employees' beneficiary association (VEBA), the Leaders can protect funds to be used for health benefits by contributing those funds as rapidly as possible into the trust and ensuring that the plan administrator and any service provider handling such funds actually contribute the funds to the trust in a timely manner. If the self-insured plan is not a funded plan, meaning the Company pays the claims as they become due from its general assets, then all the Leaders can do to protect participants is to encourage them to timely file their claims and to pay those claims as rapidly as possible.

Protect Yourself

No matter how dire the business situation, Leaders need to keep in mind that even a complete and total business failure is just that: a business failure. Notwithstanding the current financial climate, executives and staff alike will eventually find new jobs. Commerce will continue, customers will continue to need products and services, and suppliers will continue to seek out buyers for their goods. With time and effort, even fortunes can be rebuilt.

What almost no Leader can recover from is a criminal conviction. Almost equally difficult to surmount is a heavy debt to the IRS for unpaid Company taxes and penalties. If a Leader ever faces the choice between losing the Company and losing his reputation and personal freedom, he needs to let the Company go.

What Not to Do

Leaders of troubled businesses, especially small businesses with cash flow problems, all too often fall

into the trap of using funds in the Company's possession, but that do not belong to the Company, for Company purposes. Do not make this mistake, and heed the following rules:

- Never use withholdings from employee wages for any Company purpose.
- Never delay transferring withholdings to the proper place, whether it is to the IRS, state tax authorities, retirement plans, health plans, or any other parties to be paid with those funds.

Any officer or employee responsible for handling those funds or directing their proper payment can be held personally liable for the Company's failure to timely pay or deposit those funds. For example, each person in a Company responsible for some part of the collection, accounting, and payment of federal income taxes and Social Security taxes from employees' wages can be personally responsible for paying 100 percent of the amount not properly paid to the U.S. government [I.R.C. § 6672]. Any responsible person who fails to timely deposit federal taxes—such as tax withholding—can face penalties ranging from two percent for a deposit that is less than five days late to 15 percent for payments not made within 10 days after the IRS issues a delinquency notice [I.R.C. § 6656].

Anyone handling or directing the handling of the assets of the plan, whether those funds were supposed to be deposited into the plan or were funds already in a plan trust, will be responsible as a plan fiduciary for the handling of those funds. Company owners, officers, and fiduciaries can be personally liable for the improper use of plan funds, including the use of those funds for some purpose benefitting the Company. An officer, employee, or director using plan funds for his or her own personal use or benefit or for the use or benefit of the Company can be held personally liable for such funds, plus a penalty tax equal to 15 percent of such funds [I.R.C. § 4975(a)]. If the Company does not correct the abuse before the IRS issues a notice of deficiency, each responsible person, including the Company, can be held liable for a penalty tax equal to 100 percent of the amount involved [I.R.C. § 4975(b)]. Improper uses can include making transfers of plan funds to a person's or the Company's account, making transfers of plan funds to another party on behalf of a person or the Company (such as a lender), or making a loan to a person or the Company from plan funds [I.R.C. § 4975(c)].

What a Company Must Do

Unless an employee benefit plan has been terminated and all the assets of the plan have been distributed to participants and their beneficiaries, federal laws require Companies to monitor the plans they sponsor and ensure such plans remain in compliance with the multitude of requirements in the Internal Revenue Code and ERISA. These responsibilities toward the plan continue even if the Company goes out of business. Leaders should consult with their employee benefits staff, service providers, and benefits advisers throughout the year to ensure Company plans are in compliance. The following list provides just an overview of the Company's ongoing responsibilities:

- Monitor distributions to participants and beneficiaries to ensure they are receiving the correct payments in a timely manner;
- Ensure all required notices and distribution election materials are provided on a timely basis to employees who terminate employment or otherwise become entitled to a distribution under the terms of the plan and that beneficiaries receive such materials after an employee's death;
- Monitor the ages and retirement dates of participants to ensure that mandatory distributions required under the plan's terms and under the Internal Revenue Code are made on a timely basis;
- Ensure that annual nondiscrimination, coverage, and other required testing is performed each year and that suitable corrections are performed as needed;
- Monitor the transfer of funds from the Company and participants into plans to ensure funds are being transferred to the plan on a timely basis;
- Monitor plan investments at least annually and evaluate whether such investments are suitable for the plan;
- Review agreements with plan service providers to ensure services are adequate and costs paid by the plan are reasonable for the services provided;
- Monitor plan expenses to ensure that only expenses authorized in the plan document are paid and that the appropriate amounts are being paid;
- Monitor the use of plan funds to ensure that no funds are being used by or for the benefit of any parties other than plan participants and their beneficiaries and that no prohibited transactions (as provided under the Internal Revenue Code and ERISA) have occurred;
- Ensure a fidelity bond is maintained to cover plan losses through mishandling of funds by employees;
- Provide each participant with a current summary plan description;
- Provide participants with updates on changes to the plan in the form of summaries of material modifications;
- Provide participants with annual summary financial reports;
- File with the federal government the required annual reports and any reports required under special circumstances (such as notice to the PBGC when a defined benefit plan becomes underfunded); and
- Maintain copies of plan documents at the Company's offices for review by participants who request to see them.

Conclusion

When a business encounters serious financial difficulty, the business's executives, human resources personnel, and benefits staff will struggle to meet the crush of urgent matters that demand their attention. They will strive to simultaneously grow revenue, cut costs, answer investors' and owners' questions, and maintain employee morale and productivity, and do it all with fewer resources and less staff. Under such circumstances, executives will spare little time or patience for the complex analysis and procedures required to make smart decisions to cut the cost of employee benefits. The human resources staff will be stretched thinner than ever, too. For these reasons, business leaders need to look far ahead and begin preparing their Plan B alternatives as soon as possible. If they prepare well, they will be ready to act quickly and decisively to cut costs that will contribute to the bottom line and they will avoid business blunders that send employees scurrying and legal blunders which could cost the business sorely-needed time and money.

When done right, careful pruning of employee benefits programs can save businesses substantial sums of money—money that can be used to improve cash flow or be reinvested in the company's revenue-generating operations. Employee benefits, particularly defined benefit plans and health care plans, siphon off a large portion of any company's ready cash. A careful analysis of the costs and benefits of such programs can yield great results at a time when great results are badly needed.

When eliminating programs and scaling back benefit levels, business leaders must ensure proper procedures are followed. Do not cut corners. Companies should save money by reducing the cost of benefits programs, not by trying to perform benefits compliance on the cheap. Companies must devote adequate staff and resources to handle the complex and time-intensive procedures involved in benefits projects and must pull in outside experts—benefits advisers and counsel—to provide any expertise not available within the company. Business leaders must also be more vigilant than ever to ensure employment taxes, wage withholdings, and plan contributions are timely transferred

to the proper parties. Failure to meet compliance procedures can result in hefty taxes, fees, and correction costs, and failure to comply with tax and withholding rules can result in substantial penalties, personal civil liability, and criminal penalties.

Finally, when the business returns to profitability, do not forget about the company's employee benefits programs. The savvy selection of new employee benefits programs will inspire employees to new levels of productivity and will attract the new talent needed for future growth. More importantly, awarding new benefits to employees feels so much better than cutting benefits. ■