Bankruptcy and Non-Qualified Deferred Compensation Plans

The Internal Revenue Code requires that a Non-Qualified Deferred Compensation Plan ("NQDCP") must be treated as an unsecured promise to pay future benefits such that participants can defer current income recognition.

Therefore, a NQDCP participant will have the status of a general unsecured creditor of the plan sponsor in bankruptcy with respect to his/her NQDCP benefits. Even amounts that are set aside in a Rabbi Trust to pay NQDCP liabilities are treated as general assets of the plan sponsor in bankruptcy and thus remain subject to the claims of the plan sponsor's general creditors.

Bankruptcy Process Overview

A bankruptcy is a public, judicial process during which a debtor corporation (or individual) and its creditors will resolve outstanding debts with certain protections afforded by the U.S. Bankruptcy Code. The fundamental goal of the U.S. Bankruptcy Code is to give debtors a financial "fresh start" from burdensome debts. The U.S. Supreme Court made this point about the purpose of the bankruptcy law in a 1934 decision Local Loan vs. Hunt:

"It gives to the honest but unfortunate debtor…a new opportunity in life and a clear field for future effort, unhampered by the pressure and discouragement of preexisting debt."

Businesses may file for bankruptcy under Chapter 7 (Liquidation) or Chapter 11 (Reorganization). In a Chapter 7 filing, a court-appointed trustee takes over the assets of the debtor's estate, reduces them to cash, and makes distributions to creditors (which may or may not include NQDCP participants depending on the level of assets held by the debtor). In a Chapter 11 filing, the debtor usually files a plan of reorganization whereupon NQDCP claims are typically resolved after the Petition Date, as part of a "second day order" (which typically occurs after the second day of the bankruptcy). An appointed unsecured creditors committee will generally have the most influence in determining the ultimate outcome of the pre-petition NQDCP accrued benefits.

Non-Qualified Deferred Compensation Impact

Upon the filing date of a bankruptcy petition ("Petition Date"), NQDCP payments are subject to an "automatic stay" in which payments are suspended for all participants. NQDCP participants who have accrued benefits before the bankruptcy filing (otherwise known as "pre-petition obligations") are permitted to file claims to the bankruptcy court to the extent that their claims are not accurately scheduled by the debtor in order to preserve their rights under a bankruptcy.

One essential factor for Rabbi Trust structure is demonstrated in The Seventh Circuit case of Bank of America, Inc. vs. Moglia. This case clarified that "general creditors" means only the unsecured creditors. As such, the court held that the Rabbi Trust assets were subject only to the claims of the unsecured creditors. If the trust had said that the trust assets were subject to the claims of all creditors of the company, then the secured creditors would have the valid claim. If Rabbi Trust assets are subject to the claims of the secured creditors, the NQDCP participants would have much less of a chance of recovering their deferred compensation benefits. From the point of view of protecting the interests of plan participants, this case shows the importance of preparing the Rabbi Trust language such that the assets are subject only to the unsecured general creditors of the company.

Several factors can determine whether, and to what extent, a participant will receive his/her NQDCP benefits, including but not limited to:

- Chapter 7 vs. Chapter 11 filing
- Current vs. former employees
- Breadth of employee participation in the plan
- Change in ownership or control of the plan sponsor
- Change in senior leadership of the plan sponsor

Generally speaking, if a company remains an ongoing concern post-bankruptcy, employee compensation and goodwill will be more likely considered to be critical factors post-bankruptcy and thus more likely to protect NQDCP benefits.

Note that any NQDCP accruals that are earned after the Petition Date are considered "post-petition obligations" and are not subject to the plan sponsor's general unsecured creditors. They are generally required to be paid if considered "administrative expenses" under bankruptcy law.

Please see Appendix for a summary of bankruptcy cases and their treatment of NQDCP plans therein, over the last two decades. However, please note that treatment under past bankruptcies does not guarantee similar treatment for future bankruptcies.

Appendix

Arch Coal

Arch Coal Inc., one of the largest coal producers in the United States, filed for Chapter 11 bankruptcy in January 2016. In subsequent communications to its employees, the company indicated that it expects "little or no recovery of funds contributed to the Deferred Compensation Plan prior to the Chapter 11 filing."

Armstrong World Industries

Armstrong World Industries, Inc. filed a voluntary petition for relief under Chapter 11 in order to use the bankruptcy reorganization process to achieve a resolution of its asbestos-related liability. In October 2006, the company emerged from Chapter 11 and in connection therewith, the Deferred Compensation Plan participants recovered their entire accrued benefits.

Bank of America/Outboard Marine

Outboard Marine Corp. had filed for Chapter 7 bankruptcy. It had contributed $14 million to a Rabbi Trust to fund its NQDC plan. The bankruptcy trustee claimed this amount was available to the unsecured creditors of Outboard Marine. Bank of America, the agent for the secured creditors, said that the secured creditors had a claim to this money because the security agreement that Bank of America relied on covered "general intangibles" and described Rabbi Trust assets. The Rabbi Trust, however, said that the trust assets belonged only to "general creditors" of the company. The Seventh Circuit, in the case of Bank of America, Inc. vs. Moglia, explained that "general creditors" means only the unsecured creditors. If the trust had said that the trust assets were subject to the claims of all creditors of the company, then the secured creditors would have a valid claim. As such, the court held that the Rabbi Trust assets were subject only to the claims of the unsecured creditors.

Caesars Entertainment

Caesars Entertainment, the largest casino chain in the U.S., filed for Chapter 11 bankruptcy in January 2015 upon which time payments from its five deferred compensation plans were suspended. As of May 2015, payments from two of the plans were resumed because the US Attorney's office was investigating whether the plan liabilities were illegally transferred to the bankrupt entity prior to the bankruptcy filing. In October 2016, Caesars Entertainment agreed to fully assume responsibility for all five deferred compensation plans totaling $90 million as part of a settlement with the casino company's bankrupt operating unit. The settlement, approved by a bankruptcy judge, resolved a lingering dispute between Caesars Entertainment and its subsidiary Caesars Entertainment Operating Co., now in Chapter 11, over which entity is responsible for making continued payments to employees under the plans.

Appendix

CIT Group

CIT Group declared Chapter 11 bankruptcy on November 1, 2009, and with the consent of its bondholders, proposed to quickly emerge from bankruptcy court proceedings. On December 10, 2009, CIT satisfied all of the conditions required to consummate the prepackaged Plan of Reorganization (the "Plan"). The distribution of CIT's new debt and equity securities took place in accordance with the company's confirmed Plan and the new common stock commenced trading on the New York Stock Exchange (NYSE) under the symbol "CIT." All previously issued and outstanding common stock and preferred stock was cancelled. As CIT was to remain an ongoing entity, executive benefits including deferred compensation plans and its liabilities survived intact.

Eastman Kodak

Eastman Kodak filed for bankruptcy in January 2012. Kodak's Plan of Reorganization (Aug. 20, 2013) stipulated that the Executive Deferred Compensation Plan (EDCP) participants, with total balances equaling $15 million, would receive only 4%–5% of their deferred salaries and incentive awards. Delivery was not to be in cash but in common shares of the new Kodak to be issued upon the company's emergence from Chapter 11. Taxation upon grant to the creditors (including participants in the Kodak EDCP), was as ordinary income based on the value at grant. No deductions would be permitted for amounts lost. Recovery of the $15 million in salary and bonuses owed to former Kodak managers was to be treated under the plan of reorganization in the same way as the other $2.8 billion in unsecured debt, including unfunded pensions, accounts payable, customer rebates, royalties, shippers/warehouses, and litigation. Only the former EDCP participants forfeited a large portion of their deferred compensation.

Enron

CEO Kenneth Lay, along with several other executives, cashed out of their deferred compensation plans (with assets held in a Rabbi Trust) just prior to official bankruptcy. A U.S. bankruptcy judge authorized Enron to pursue $53 million in accelerated deferred compensation paid by the company shortly before its bankruptcy filing. Enron sent letters to the recipients of such accelerated deferred compensation, demanding the return of between 40% – 90% of the money. Those who remained with the company were asked to repay less because they were perceived to have provided a post-bankruptcy benefit to Enron's creditors. As of May 2006, settlements were reached with 104 individuals for a net benefit to Enron’s estate of more than $36 million.

Section 409A of the Internal Revenue Code was enacted, in part, in response to the practice of Enron executives accelerating the payments under their deferred compensation plans in order to access the money before the company went bankrupt, and also in part, in response to a history of perceived tax-timing abuse due to limited enforcement of the constructive receipt tax doctrine.

General Motors (GM)

GM filed for Chapter 11 reorganization in the New York federal bankruptcy court on June 1, 2009. Under the bankruptcy, participants in GM’s deferred compensation plan received a two-thirds (2/3) “haircut” of any benefits in excess of an annual distribution of $100,000.

Appendix

Lyondell/Arco Chemical

The bankruptcy occurred in 2010. Lyondell had an active deferred compensation plan while the Arco Chemical plan was terminated with participants in payout status. In both cases, a Rabbi Trust was in place with less than 100% funding. Participants in both plans received a pro-rata share of the funding, i.e. if the trust was 80% funded, they received 80% of what they were owed, even if other general creditors received a lesser amount.

Nortel Networks

On January 14, 2009, Nortel filed for bankruptcy protection from its creditors in the United States, Canada, and the United Kingdom, in order to restructure its debt and financial obligations. In June 2009, the company announced it would cease operations and sell off all of its business units. The period of bankruptcy protection was extended to February 2, 2013. As part of the bankruptcy proceedings in the United States, Nortel reportedly reached a settlement with former executives who were entitled to receive $31 million in the aggregate for a recovery of 97% of the funds that were in their deferred compensation accounts on the day Nortel filed for bankruptcy.

Pacific Gas & Electric (PG&E)

In April 2001, PG&E filed a voluntary petition for relief under Chapter 11 of the U.S. Bankruptcy Code. As the company remained a going concern post-bankruptcy, the deferred compensation plan's funding remained intact post-bankruptcy, and annuities that were purchased to replace a significant portion of the unfunded plan benefits for certain officers were not liquidated.

Pilgrim's Pride

Pilgrim's Pride Corp., a large poultry producer, lost $1 billion in 2008 as higher grain prices, an oversaturated chicken market and looming debts, forced the Texas-based company into bankruptcy protection. However, since the company was to remain a going concern post-bankruptcy, the deferred compensation plans were assumed and executives survived with 100% of their benefits intact.

Washington Mutual (WAMU)

The former parent of the thrift bank that went into bankruptcy, Washington Mutual Bank (WAMU) allowed its senior executives to pull millions out of its deferred compensation plan trust before it filed for bankruptcy.

However, WAMU claimed $69 million in deferred compensation plan assets of its acquired subsidiary, Home Savings of America (HSA). Ultimately, WAMU prevailed and the deferred compensation assets of HSA remained with the estate of WAMU for distribution to its creditors.

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