Automatic rollovers make retirement plan administration easier when companies file bankruptcy

By Terry Dunne

Whenever a company files for bankruptcy protection, it is almost certain to set off a chain of short- or long-term problems for both retirement plan administrators and participants. The ultimate severity of these problems may be dictated by how quickly and in what manner they are addressed.

Concerns and issues will develop for retirement plans the moment a company announces it is planning to reorganize under Chapter 11. These announcements are often accompanied by the news that significant layoffs, perhaps numbering in the thousands, are forthcoming as a cost-saving measure.

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Even before these terminations take place, many employees participating in the plan will decide to leave of their own volition to seek other employment. These voluntary resignations will continue even as the promised layoffs are implemented.

Filing bankruptcy does not reduce the company's responsibility to provide the dollars and manpower necessary to administer all its retirement plan accounts, including those owned by hundreds or thousands of ex-employees. To add salt to the wounds, some of the human resources staff most familiar with the company's plan may be among those laid off or leaving. This can complicate matters even more.

What happens to all the ex-employee participants and their retirement plan balances? Some of them will find jobs with other companies and may want to transfer their funds to their new employers' retirement plans.

Others may join a company that does not offer a plan. Many may not find work. Some participants will decide to roll over their funds into their own individual retirement accounts, and many will elect a cash distribution, which will create tax consequences. A large number will do nothing.

To put this into perspective, a Charles Schwab survey conducted in spring 2009 noted that for plan participants who were terminated from their jobs one year earlier, 43 percent of the 401(k) assets were still sitting in their former employers' plans.

If all participants diligently informed the company of their whereabouts and confirmed what they want the plan administrator to do with their retirement funds, it would be an immense help. But, this is seldom the case, and a lack of instruction is only the tip of the iceberg.

Some of them actually may disappear as they move or travel to other parts of the country and leave without a forwarding address. The company has no way to contact them for plan communications, but is obligated to continue to try to do so. Others will not disappear at all. They will receive company information about their retirement accounts but, for whatever reason, fail to respond.

THE MISSING AND NONRESPONSIVE EX-EMPLOYEE PROBLEM

Companies filing bankruptcy now and in the future will probably have more missing or nonresponsive retirement plan participants than in years past because more workers are enrolled in their plans. The Pension Protection Act of 2006 encourages companies to automatically enroll employees in retirement plans and many companies are doing just that. A very high percentage of these participants, especially lower-paid employees with smaller retirement plan balances, remain in the plan after leaving the company.

A recent survey by Vanguard Group Inc. showed that automatic enrollment increased plan participation significantly for key groups of employees. Participation increased from 44 percent to 80 percent for employees earning less than $30,000 and rose from 56 percent to 86 percent for those between 25 and 34 years of age. Such workers often make up the majority of those laid off during a bankruptcy.

In addition to the layoffs or resignations related to the bankruptcy filing, many companies have probably been managing the retirement plans for participants who departed throughout the previous decades.

This can be a costly situation for companies that are in bankruptcy and trying to conserve cash, and even more costly if they decide to ignore the problem. It is estimated that companies are absorbing the time and expense to manage plans for about 150,000 newly "missing" ex-employees each year, with a collective retirement plan balance of about $375 million.

The U.S. Department of Labor recently reported that employee retirement and savings plans are now costing employers an average of $1.29 for every hour worked by every employee. Managing ex-employee balances contributes a good portion to this cost.

Improper compliance with plan fiduciary responsibilities, even for ex-employees' plan accounts, carries legal and financial risk.

Cases like *LaRue v. DeWolff, Boberg & Associates,* 552 U.S. 248 (U.S. 2008), established the right for plan participants to sue plan sponsors if they think their retirement account has been mismanaged. Therefore, companies must diligently follow ERISA requirements, even for ex-employees' balances.

Meeting the obligations of ERISA is obviously difficult under bankruptcy conditions when plan participants cannot be located or when they ignore company communication efforts.

They must conduct due-diligence searches, maintain proper communications of required information with all plan participants, ensure a valid investment election is on file and in effect, and manage appropriate death benefit distributions to beneficiaries. Failure to do so can lead to fines, penalties and/or lawsuits.

Meeting these obligations obviously is very difficult under bankruptcy conditions when plan participants cannot be located or when they ignore company communication efforts.

Many companies using Chapter 11 as a means of reorganizing and staying in business might elect to keep their retirement plans active during the entire bankruptcy period. Still, they are under significant pressure to reduce costs including the administering of dozens, hundreds or thousands of accounts for ex-employees.

However, there are other scenarios. While in Chapter 11, a company may just decide to terminate the plan to reduce overall expenses. In this case, it must follow required procedures to notify current and ex-participants and distribute their funds based on their instructions. But, again, what can it do about the problem of nonresponsive or missing ex-employees?

What if another company with its own plan purchases a bankrupt company and wants to terminate the plan of the failed firm and transfer its newly obtained employees to its plan? This would be no different than if the original company terminated it except for the fact that now a new administrative team must address the issues of former and current employee participants.

AUTOMATIC ROLLOVERS

One solution to the problem of missing or nonresponsive ex-employees is to implement an automatic IRA rollover process. This has significant financial benefits for the company and is also a very effective means of reuniting these individuals with their retirement funds and providing them with the potential to continue to build their accounts on a tax-deferred basis. (Automatic rollovers are available for most defined-contribution and defined-benefit retirement plans, but terminating and abandoned defined-benefit plans should be handled in connection with the Pension Benefit Guaranty Corp.).

Automatic rollover IRAs were created by the Economic Growth and Tax Relief Reconciliation Act of 2001, Pub. L. No. 107-16, 115 Stat. 38 (2001). It allows companies, including those in bankruptcy, to roll over the funds in their retirement plans for missing and nonresponsive participants to a custodian that will create and administer an IRA in each individual's name.

The custodian will also attempt to locate and communicate with those individuals. The company can implement this process only after it has made a concerted effort to contact and communicate with these ex-employees.

Automatic rollovers are being used more frequently by financially healthy companies to move ex-employees' plan accounts out of their own retirement plan, thus reducing administrative time and expenses. However, these companies can only roll over accounts with an asset value of $5,000 or less. Rollovers for missing or nonresponsive employees of companies that are terminating their plans have no account value limits.

When these ex-workers' retirement plan balances are automatically rolled over to IRAs, they are no longer considered participants in their companies' plans. Assuming the companies have followed all the requirements stipulated in the Reconciliation Act, they are deemed to have satisfied their fiduciary duties and no longer are responsible for the new IRAs or to monitor the actions of the custodians.

There are specific steps a company must take prior to adopting an automatic rollover. First, automatic rollovers must be permitted in the retirement plan documents. Many companies include such a provision when the plan documents were first created. Companies that have not done so must amend their plan documents and notify all participants, including ex-employees, before embarking on the automatic rollovers.

The Labor Department has laid out specific procedures for bankruptcy trustees to follow when attempting to reach missing or nonresponsive participants of plans slated for termination.

The trustees must follow four steps:

- A certified letter should be sent to their last known address.
- If that brings no response, an attempt should be made to review plans and employer and administrator records to find information that would help in the search.
- Then the beneficiaries listed for their account should be contacted.
- If this provides no information, letter-forwarding services offered by the Internal Revenue Service and Social Security Administration must be utilized.

Depending on the number of participants and the dollar value of the funds in question, the use of Internet tools, commercial locator services and credit reporting agencies are recommended.

The preferred method of distributing the assets of missing or nonresponsive participants after all reasonable location attempts have failed is the use of automatic rollovers.

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THE AUTOMATIC ROLLOVER PROCESS

The automatic rollover process begins when the plan sponsor or plan fiduciary enters into a written, automatic-rollover agreement with an IRA custodian. This agreement must stipulate the initial investment to be used for the transferred funds, services to be provided to the company and the IRA account holders by the custodian, plus all related fees and expenses to be paid by the plan or charged to account holders.

The initial investment must minimize risk, preserve principal, provide a reasonable rate of return and maintain liquidity. Examples include money market funds, interest-bearing savings accounts, certificates of deposit and stable value products. No fee or expense can exceed those charged by the selected IRA custodian for its other comparable IRAs.

In most cases, regardless of the number of accounts involved, the automatic-rollover process can be completed quickly after the agreement is signed.

First, the plan sponsor, third-party adviser or record-keeper must provide key information to the custodian, including each participant's name, last known address, Social Security number, birth date and account balance. This should be done as a secure electronic transfer to protect the confidentiality of the participant's information.

Next, the funding must be sent to the IRA custodian. Preferably, this is in the form of a single check or wire transfer equal to the collective value of the account balances. The IRA custodian then allocates the appropriate amount to each individual, opens up IRA accounts for each one in their name and notifies the company that the IRA rollovers have been completed.

WHAT ABOUT ABANDONED PLANS?

Several thousand retirement plans are considered abandoned each year. Many are abandoned by companies filing for Chapter 7 bankruptcy protection. Abandonment is a specific legal status that is declared when there have been no deposits to or distributions from the plan during 12 consecutive months, and the plan sponsor cannot be found or is unable to administer the plan.

When a retirement plan is abandoned, it puts all ex-employee participants in limbo. The retirement funds in their accounts remain theirs, but they have no access to them. The financial institution with custody of the plan assets does not have the authority to distribute the funds until a formal abandonment-resolution process has been initiated.

This process typically requires about six months. The assets of the plan must be held by or transferred to the control of a custodian such as a bank or trust company designated by the Labor Department as a qualified termination administrator. The QTA must then follow a carefully defined procedure to wind down the plan and to enable the participants to determine what they want to do with the retirement balances they have in the abandoned plan.

First, the QTA is appointed as custodian of all the individual accounts in the plan. If the QTA is not the current custodian of the funds, the funds are transferred to the control of a QTA. At the same time, the QTA must locate and take possession of all plan records.

Next, the QTA deposits these funds into a single, non-interest-bearing account and sends notice to the plan sponsor declaring its intent to terminate the plan. The plan sponsor has 30 days to object. If it does not, the QTA officially declares the plan abandoned, notifies the Labor Department and indicates it will serve as QTA for the assets. At this point, it also calculates the value of the assets at that time and assesses administration fees.

All participants are then notified that an IRA will be established in their name after 30 days if they provide no other instructions. After the 30-day period, funds are distributed to those requesting them, while IRAs are established for missing and nonresponsive participants.

EVALUATING AUTOMATIC-ROLLOVER FIRMS

Fortunately for administrators and company management or the bankruptcy trustees, there are several firms that can provide appropriate IRA rollover services. Candidates for such assignments can be identified by contacting pension, employee benefit and retirement associations such as the American Society of Pension Professionals & Actuaries, the International Foundation of Employee Benefits Plans, the National Institute of Pension Administrators and the Profit Sharing/401k Council of America.

Searching the online archives of trade magazines and professional journals covering financial and bankruptcy topics is another method. It also pays to review the agendas of upcoming trade shows and conferences in a company's own industry as well as in the financial service industry as IRA automatic rollover firms may be exhibiting or conducting workshops.

Not all IRA custodians will go about the rollover process in the same way. Companies or trustees responsible for evaluating candidates should be certain to as specific questions that may relate to their own circumstances. Among those questions are:

- Is there a minimum-sized account they will accept? Some will only accept accounts of $1,000 or more. There may be missing or nonresponsive ex-employees in bankruptcy situations with smaller balances that must be included in a rollover.
- How many rollover accounts can they accommodate? Bankruptcies may result in large numbers of accounts that must be rolled over, but not all custodians have the capability to efficiently open and administer a large number of accounts at one time, and thereafter initiate the process to find missing participants.
- How do they go about finding missing plan participants? The approaches for locating individuals can vary by custodian. Some have relationships with search organizations that specialize in sophisticated searches.
- Will the custodian offer rollovers from Roth 401(k) plans into Roth IRAs or allow for conversions from IRAs to Roth IRAs? The IRS allows IRA account holders to convert their traditional pre-tax IRA balances into Roth IRAs and therefore allow their investments to grow tax-free until and at distribution.
- What transfer and administration technology does the custodian have? The transfer of information about ex-employees participants and their balances, as well as the transfer of the funds in those accounts, should be accomplished quickly, accurately, seamlessly and securely.
- What is the custodian's experience with automatic IRA rollovers? This

includes the number of years providing the service and the number of rollovers completed. It also relates to the size and experience of its client service team, the accounting and record-keeping capabilities, and the reporting system it utilizes.

Predictions on the specific number of business bankruptcies for 2010 and beyond vary, but there seems to be unanimous certainty that they will continue at a strong pace. As a result, more retirement plan administrators and participants should be able to benefit from the automatic rollover process. WJ

Terry Dunne is senior vice president for automatic rollovers at **Millennium Trust Co**. in Oak Brook, Ill. The company works with numerous record-keepers and TPAs to provide automatic rollover services to their plan sponsor clients and as of May has agreements with about 5,500 plan sponsors to provide automatic rollover services. He can be reached at (630) 368-5675 or tdunne@mtrustcompany.com.

Defunct banking

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> The policy proceeds are not the property of Downey Financial's bankruptcy estate, and even if they were, the officers can claim their share, Bankruptcy Judge Christopher S. Sontchi ruled.

In re Downey Financial Corp., No. 09-13041, 2010 WL 1838565 (Bankr. D. Del. May 7, 2010).

U.S. Bankruptcy Judge Christopher S. Sontchi found that the policy proceeds (the funds available to pay claims) are not the property of the estate of the debtor company, and even if they were, the officers can claim their share of them since they were covered under the policy.

The District of Delaware judge addressed a controversial overlap of bankruptcy and insurance law concerning whether a bankrupt company or its officers and directors are first in line for what is often one of the firm's last remaining assets: its insurance policies.

That question has split federal appeals courts, but the answer was more simple than usual here, Judge Sontchi said. The corporate entity is not named in the case against the executives and therefore does not need the money to defend itself, he said, so the officers and directors should have access to it.

In the underlying actions, Downey shareholders said they lost their total investments because the company's executives did not disclose that the bank consistently made subprime loans to borrowers who lacked the ability to repay the debts.

They also said they were not informed about the extent of Downey's issuance of "option ARMs," exotic adjustable-rate mortgages that allow subprime borrowers to pay as much as they want during the initial term, with the unpaid amounts added to the loan balance. These loans often end up in default.

The shareholder suits, filed in May and June 2008, made state law breach-of-duty and federal securities law charges, but both types of suits centered on allegations that Downey had more than $12 billion worth of option ARMs on its books and that the executives knew these loans were risky.

The securities fraud charges were dismissed, but the derivative state law claims have now been taken over by the bankruptcy trustee, who is pursuing them against the officers and directors in the name of the company's estate.

At issue is the $10 million available under an insurance policy written for Downey by National Union Fire Insurance Co. The policy covers both the corporate entity and the directors and officers.

The executives have asked Judge Sontchi to let them tap the policy proceeds, but the trustee opposes that move, arguing that the policy belongs to the debtor.

The judge said the guiding principle in this type of case is that if the officers and directors can use the policy proceeds without diminishing the money that the company itself might need, they should have access to it.

Since Downey itself is not a defendant in the derivative action, it does not need the money and loses nothing when the directors and officers get a benefit they were promised when they signed on, Judge Sontchi said. WJ

Related Court Document:
Opinion: 2010 WL 1838565