Nonqualified deferred compensation plan benefits and employer bankruptcy

Nonqualified deferred compensation plans allow participants to defer current income into future tax years. In order to receive this special tax-deferred treatment, a deferred compensation plan must be an unfunded arrangement, meaning that assets are subject to the claims of the employer's general creditors.

Participants are merely unsecured general creditors of the employer, and participation is limited to a select group of management or highly compensated employees. Therefore, a nonqualified deferred compensation plan is a contractual arrangement between the employer and selected participants. In the event of an employer's bankruptcy, there's no guarantee that participants will receive benefits from the plan. It's important for participants to understand the risk of deferring current compensation, should the employer become insolvent and unable to pay benefits.

When thinking about how bankruptcy could impact an employer's nonqualified deferred compensation plan, it's important to remember the participant's account balance (e.g., the employer's liability) may be different than any employer-owned assets used to informally finance the plan.

In a defined contribution-style nonqualified plan (as participants defer their own income, or the employer makes contributions to the plan), a liability account for each participant is generated on the books of the employer. This liability will fluctuate in value due to market gains and losses. In a defined benefit-style nonqualified plan, the participant liability is determined based on employer defined formula. These amounts are ultimately what the employer owes the participant upon a qualifying distribution event.

Most employers will informally finance nonqualified deferred compensation plan liabilities by purchasing assets, such as corporate-owned life insurance (COLI) policies or mutual funds. These employer-owned assets *do not* formally fund the plan, even if the assets are held in a Rabbi Trust.[1] Rather, the assets are subject to the claims of the employer's creditors in the event of a bankruptcy. So, while a trust can provide participants some assurance that assets set aside may not be used for any other non-bankruptcy corporate purpose, the trust does not guarantee participant benefits. Therefore, participants are general unsecured creditors in the event of an employer bankruptcy.

Once a company declares bankruptcy, a court will determine the amount of nonqualified deferred compensation plan benefits the participants may receive, if any. A court might consider many factors, including:

- Source of funds (e.g., employee deferral or employer contribution),
- Individual participant demographics, such as age, employment status, and position, and
- Any other factors the court finds relevant.

Chapter 11 vs. Chapter 7 bankruptcy

An employer who files for bankruptcy generally chooses between a Chapter 11 and Chapter 7 bankruptcy. A Chapter 11 bankruptcy is a reorganization of the company's assets and liabilities, while a Chapter 7 bankruptcy is a liquidation of the company.

In a Chapter 11 reorganization bankruptcy filing, a bankruptcy administrator determines what debts may be forgiven, and the company continues business operations for the foreseeable future. The bankruptcy administrator will have discretion to determine if balances are maintained, reduced, or eliminated.

In a Chapter 7 liquidation bankruptcy filing, the employer and the company cease to exist. Assets of the company, including any corporate assets used to informally finance the nonqualified deferred compensation plan, are sold. Because nonqualified deferred compensation participants are general creditors of the company, the bankruptcy administrator will have discretion to determine which creditors get paid and how much.

Anytime a company files for bankruptcy, the circumstances can vary widely, and there are no guarantees participant balances will be distributed. In fact, companies may be prohibited from making benefit distributions when in financial distress. When the courts are making determinations regarding nonqualified deferred compensation balances, the company should work closely with counsel to determine what actions are permitted and what needs to be communicated to plan participants.

Eligible participants should always discuss their participation in nonqualified deferred compensation plans with their tax or legal advisors.

[1] For more information on a Rabbi Trust, see the Applied Knowledge article titled, "Employer Rabbi Trusts" (BB10136).

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