6 Strategies For Protecting Non-Qualified Plan Accounts From Bankruptcy Risk

By Jeff Roberts

2020 Bankruptcies

Will 2020 be the year of bankruptcy? Hertz, Nieman Marcus, J. C. Penney, J. Crew, Pier 1, Aldo Group, Diamond Offshore Drilling, Gold’s Gym, McClatchy, and Whiting Petroleum filed for Chapter 11 bankruptcy protection in early 2020, and more are likely later in 2020. Executives at these companies risk losing millions of dollars in retirement savings held in Non-Qualified (NQ) plans accumulated over a lifetime of hard work.

NQ Plans

Non-Qualified Deferred Compensation (NQDC) plans and Supplemental Executive Retirement Plans (SERPs) are popular tools for accumulating pre-tax retirement savings for executives who are restricted by IRS limits on their ability to benefit from qualified retirement plans like 401(k), 403(b) and traditional pension plans.

NQ plans allow for unlimited pre-tax savings and company contributions plus tax-deferred earnings. NQ plans are allowed to offer these benefits by demonstrating to the IRS that NQ plan participants do not have “constructive receipt” of their account balance. By making elections before income is earned and subjecting NQ plan account balances to bankruptcy risk, NQ plans are able to demonstrate to the IRS that plan participants do not have taxable constructive receipt until money is paid out of the NQ plan.

While money is held in the NQ plan, plan participants have the standing of a general, unsecured creditor of the plan sponsor. In some cases (e.g. Arch Coal, Chrysler, etc.), NQ plan participants lose their entire account balance following a bankruptcy filing. In other cases (e.g. Kodak), recovery can be as little as 4% to 5% of the NQ plan account balance. The U.S. Government Accountability Office (GAO) recently studied 30 bankruptcy cases and found that in 21 cases, NQ plan participants recovered less than 25% of their account balance.

GAO Review of Recovery Rates for NQ Plan Participants

Each bar represents loss and recovery estimates for 1 of 30 total bankruptcy cases

General unsecured creditors estimated to recover 100% of claims in 6 cases

General unsecured creditors estimated to lose more than 75% of claims in 21 cases

Estimated general unsecured creditor recovery for that case

Estimated general unsecured creditor loss for that case

SOURCE: GAO review analysis of corporate bankruptcy case data. I GAO-20-70
1 - Risk Pooling

In 2018, StockShield began offering a patented risk-pooling solution called the Deferred Compensation Protection Trust (DCPT). For executives with a significant portion of their wealth inside NQ plans, the DCPT provides protection against bankruptcy risk by gathering an industry-diverse group of say 20 people – with that group comprised of NQ plan participants who worked for, or retired from, companies that initially have similar credit ratings. The group’s cash contributions are held in a corporate trust account for 5 or 10 years.

There are essentially four potential scenarios (with the first and second far more likely):

1. In the event of zero (0) bankruptcies, each Investor will receive their pro rata share of the cash pool. For example, if 20 investors are each protecting a $5 million account balance and the cash pool totals $10.5 million at the end of the protection period, each investor will receive $525,000.

2. In the event of one (1) bankruptcy resulting in the total loss of an investor’s NQDC account balance, the impacted investor will receive $5 million of the cash pool. Each of the other 19 Investors will receive their pro rata share. For example, if the cash pool totals $10.5 million, $5 million first will be paid to the investor sustaining the total loss of their NQDC account balance while the remaining $5.5 million will be distributed equally to the other 19 Investors.

3. In the event of two (2) bankruptcies resulting in the total loss of these investors’ NQDC account balances, each of these two impacted Investors will receive $5 million of Series Pool Assets. The other 18 Investors will each receive their pro rata share of any remaining pool assets. For example, if the cash pool totals $10.5 million, $10 million first will be paid to the two investors sustaining the total loss of their NQDC account balances while $500,000 will be distributed equally to the other 18 Investors.

4. In the event of three (3) bankruptcies resulting in the total loss of these investors’ NQDC account balances, each of these three impacted investors will receive their pro rata share of cash pool. For example, if the cash pool totals $10.5 million, $3.5 million will be paid to each of the three investors sustaining the total loss of their NQDC account balances. The other 17 investors will lose their cash contribution but could receive a “tax asset” at tax time, as their cash contribution should be treated as a long-term capital loss which can be used to offset long-term capital gain elsewhere in the investor’s portfolio.

2 - Rabbi Trust

Some companies with NQ plans elect to set aside assets in a rabbi trust account. While the company remains solvent, funds held in the rabbi trust account only
can be used to pay benefits due under the NQ plan(s) plus expenses related to maintaining the NQ plan and the rabbi trust. In the event of corporate insolvency, payments from the rabbi trust to NQ plan participants are immediately halted, and the remaining balance in the rabbi trust account is available to all General Unsecured Creditors (GUC). If the rabbi trust properly includes special language from the 2003 Seventh Circuit Bank of America v. Moglia case, the funds held in the rabbi trust should not be available to secured creditors – only unsecured creditors. If your company has funds set aside in a rabbi trust, be sure the rabbi trust agreement includes this Moglia language. If your company does not yet have funds set aside in a rabbi trust account, you might encourage them to review the benefits of adopting a rabbi trust including change-in-control protection, limited preferential treatment in bankruptcy, and a liquid source of funds to pay NQ plan benefits.

3 - Laddering Strategy

Some NQ plans allow participants to make new payment elections every year during annual enrollment. In this scenario, you might choose to have your money remain in the NQ plan for a relatively short amount of time to minimize your bankruptcy risk. If your employer remains healthy, the NQ plan may allow you to re-defer the money before you receive a taxable payment. Typically, re-deferrals are allowed if the election is made at least 12 months before the originally scheduled payment date, and the new election delays payment by at least five years.

After using this laddering strategy for several years, you will have separate buckets of money in your NQ plan account scheduled for payment in each future year. As long as you remain satisfied with your employer’s financial health, you can continue to re-defer any payments scheduled for 13 months in the future. If at any time you start to have concerns about your employer’s financial health, you can simply allow the previously scheduled payments to occur which will draw down your balance in the NQ plan subject to bankruptcy risk.

For the laddering strategy to be successful, check your NQ plan document to confirm you can make separate payment elections each year, you are allowed to select payments on a future date when you expect to still be working (also known as in-service payments), and you are allowed to make unlimited changes to your payment elections (subject to the 12 month/5 year rules).

4 - Limit Exposure

When allocating your assets across various brokerage accounts, retirement plans, and other investments, consider strategies which limit your overall exposure to the bankruptcy risk in NQ plans. Some financial
advisors suggest a maximum of 10% of your overall portfolio should be held inside NQ plans. Some NQ plan sponsors restrict participation in the NQ plan when your account balance exceeds $1 million. Whatever percentage or dollar limitation makes sense for you and your risk tolerance, consider taking steps to limit your exposure to bankruptcy risk in NQ plans by limiting the portion of your overall investment portfolio held inside NQ plans.

5 - Investment Allocation

As you consider your investment allocation across your entire portfolio of investments, be sure to factor NQ plan bankruptcy risk into your model. For example, consider an investor who held relatively stable cash and bond investments inside their NQ plan account and held more aggressive domestic and international equity investments outside their NQ plan account. If economic conditions worsen, this investor could find their aggressive investments losing value at the same time as their NQ plan balance is at greater risk of loss due to corporate insolvency. For this reason, many NQ plan participants hold more aggressive investments inside their NQ plan account and keep their conservative investment holdings in other accounts not subject to their employer’s bankruptcy risk.

6 - NQ Plan Document

Finally, it is always a good idea to carefully review the NQ plan document(s) available from your employer. Some plan documents allow special “haircut” withdrawals for pre-2005 balances which may be helpful if you have concerns about corporate insolvency. Other plan documents allow for accelerated payments due to death, disability, change-in-control, plan termination or separation from service prior to retirement. Carefully review your employer’s NQ plan documents to determine if any of these features are available, and if they could be helpful as you consider your level of participation in the NQ plan. The rules which govern plan terminations and payments immediately prior to a bankruptcy filing are complex, and you should review the NQ plan document(s) with your legal advisor if you have any questions.

Summary

The best time to take advantage of the six strategies discussed above is well before there are any dark clouds on the horizon. Some of the strategies discussed in this article are no longer available after your employer’s credit rating begins to drop. For additional information about protecting your NQ plan account, please visit www.StockShield.com.
About the Author

Jeff serves as the national Business Development Director for StockShield. Jeff works with accredited investors, wealth management advisors, executive compensation and benefits consultants, broker/dealers, family offices, qualified and non-qualified retirement plan advisors and legal counsel to provide education and facilitate sales of StockShield’s patented risk-pooling products including the Stock Protection Trust, the Deferred Compensation Protection Trust and the ESOP Protection Trust.

Prior to joining StockShield, Jeff spent 21 years as the lead consultant for non-qualified plan record-keeping clients at a Fortune 500 financial services company.

Jeff graduated cum laude from Pacific Lutheran University with a Bachelor of Arts degree in Economics with a minor in Mathematics. Jeff is a Certified Pension Consultant (CPC) with the American Society of Pension Professionals & Actuaries (ASPPA). Jeff was a founding member of the ASPPA Benefits Council of the Northwest, and Jeff currently serves as the co-chair of the Spring Seminar Committee for the Seattle Chapter of the Western Pension & Benefits Conference. Jeff is a frequent speaker at national conferences including the PlanAdviser National Conference, PlanSponsor National Conference, myStockOptions.com Financial Planning Conference and the Texas Total Rewards Conference.

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4 https://www.gao.gov/products/GAO-20-70