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Bankruptcy Issues for Self-Insured Plans in the Age of COVID-19

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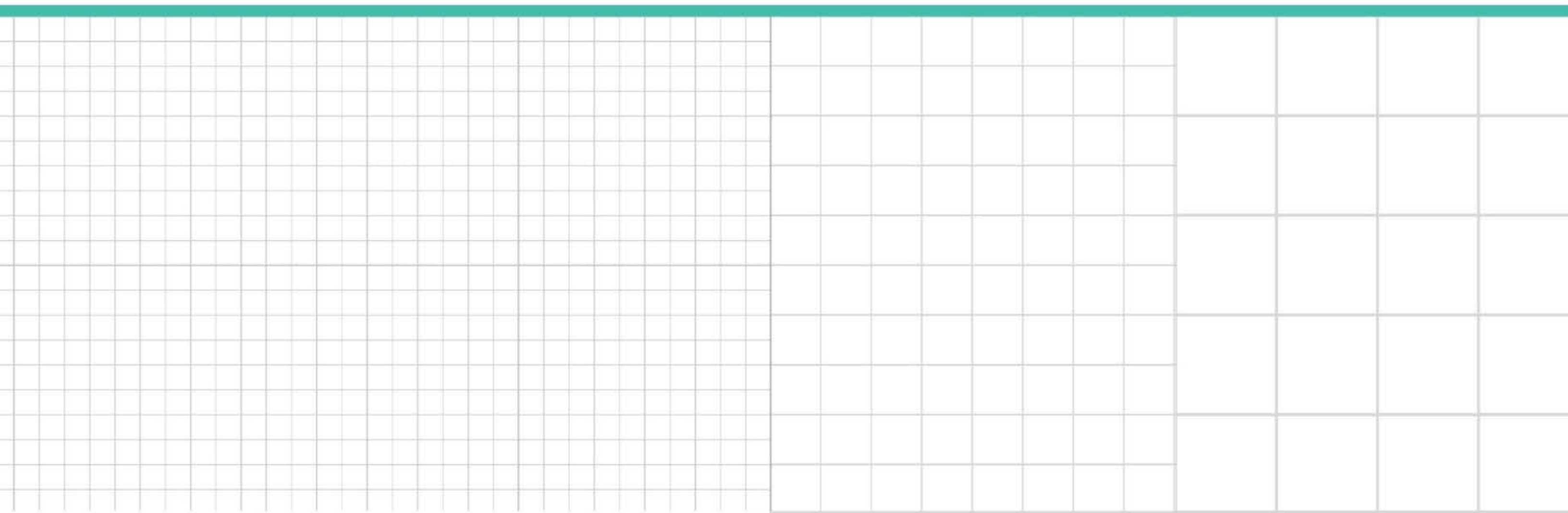

Bankruptcy Issues for Self-Insured Plans in the Age of COVID-19

Contributed by Michael Cooley, Reed Smith LLP

The basic premise of self-insurance is simple enough: rather than pay fixed premiums to an insurer in exchange for a pre-negotiated level of health or other insurance benefits for its employees, an employer agrees to fund the reimbursable medical claims of its employees directly. The claims themselves are administered by a third party administrator for a fee according to a set of rights, responsibilities, and procedures set forth between employer and administrator in the terms of an Administrative Services Agreement (ASA).

Employers often view self-funded insurance plans as a means to reduce costs. According to the Employee Benefit Research Institute, as of 2018, 38.7% of employers reported self-insuring at least one of their health plans, including 79% of employers with 500 or more employees. For the insurer, acting solely as an administrator of the claims submitted under the plan provides a revenue stream without—at least in theory—the risk that claims paid exceed premiums collected.

But insurance is in some ways a bet on the future, and with the nation in the grip of both a novel coronavirus pandemic and the accompanying economic downturn, critical variables may be shifting rapidly for both insurers and employers alike as medical claims increase just as business revenues shrink to previously unimaginable levels. Companies that cannot consistently cover their ordinary monthly operating expenses find themselves in an ever-deepening hole as they are forced to defer (and frustrate) vendors, cannibalize assets to raise cash, or draw existing credit lines further to stay afloat. At the same time, plan administrators must guard against becoming overextended to the extent they advance payments for health claims for financially distressed employers.

Set Your Baseline. Even before getting to the question of whether any particular employer's business is in distress, the first thing to do is the simplest: *read your contracts*. Administrators and employers alike should take the opportunity now to refamiliarize themselves with precisely what rights and obligations are set forth in their ASAs and other agreements.

Administrators and employers often get into a rhythm of performance based on mutual convenience (or unconscious neglect) that may not be entirely consistent with what the contract requires or permits. Having reviewed the ASA's terms, consider the parties' behavior relative to the contract. If the ASA defines "timely" payment to mean ten days after notification to the employer of amounts due the administrator, is the employer consistently "timely"? If not, is there a reason? If the ASA conditions the administrator's duty to pay claims upon the employer having made all payments due to the administrator, has the employer done so? If an employer is running a claims fund deficit, the administrator's attention will necessarily go to risk mitigation. Some of that mitigation can be achieved by completing the contract review described above and ensuring that employers are properly and *timely* fulfilling their respective payment and other contract obligations. Fund deficits—where the administrator has advanced more to pay claims than the employer has paid in—create risks for administrators and employers alike. For the administrator, it creates a financial exposure. For the employer, the fund deficit is a liability with the potential to impact continuity of employee health plan benefits when they may be needed most.

Where an employer is fully and timely remitting its claims reimbursements and administrative fees, little more may need to be done. In these troubled economic times, however, at least some employers will inevitably show signs of distress. If the employer is delinquent in its payment obligations or has accrued a claims fund deficit, in many cases the administrator may have only limited means to better secure its position. An employer in financial distress may have no ability to suddenly catch up a past-due balance or provide additional payments in form of a security deposit or advance payment against future claims. If it is, such an acceleration in payments may invite later scrutiny for their avoidability as possible "preferential transfers" in a subsequent bankruptcy, and some administrators will conclude that's an acceptable risk according to the particular circumstances.

Some ASAs also contain provisions allowing for the creation of a dedicated account from which the administrator will pay approved claims only upon the deposit of sufficient funding. If feasible, arrangements like this can reduce the risk to the administrator of soliciting reimbursement for approved claims from the employer only after those claims have been paid by the administrator.

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Barring such options as may exist in the terms of the ASA, in many cases the administrator's only meaningful leverage may be to terminate (or threaten to terminate) the contract. Under many ASAs this triggers a run-off period during which the administrator continues to process claims for services rendered prior to termination, and so this may not immediately solve the administrator's problem where it is facing a mounting delinquency in reimbursement from the employer. However, even the threat of termination may be sufficient in many instances to impel a substantive response from the employer, who may be equally loath to disrupt its employees' benefits at the same time the employer is struggling with other financial or operational difficulties. If a bankruptcy filing by the employer is imminent, termination of the ASA *prior* to the bankruptcy filing may also lend the administrator some added leverage when it comes to the assumption or rejection of the ASA later in the bankruptcy case.

"First" Things First. If a self-insured employer does file for bankruptcy relief, the administrator can and should take steps to protect its rights at the start of the case by establishing the priority payment of outstanding amounts due under the ASA in connection with the debtor-employer's "first day" orders. Upon entering chapter 11, operating businesses commonly seek bankruptcy court approval of a variety of substantive and procedural "first day" motions at the outset of the case to smooth the transition to operating in the bankruptcy environment. One of the most important of these seeks authority for the debtor to continue the uninterrupted payment of employee wages and benefits notwithstanding the bankruptcy filing (which would otherwise bar payment of such prebankruptcy claims). As a business depends on its employees, so those employees—many of whom among the rank-and-file may live paycheck-to-paycheck—depend upon the predictability of their payroll to minimize the disruption to their lives.

As a general matter, the Bankruptcy Code awards priority status to certain categories of unpaid prepetition claims. Among these are claims for unpaid wages, salaries, and commissions of employees, as well as "contributions to an employee benefit plan" arising from services rendered within 180 days before the bankruptcy filing or the shutdown of the debtor's business, if earlier. 11 U.S.C. § 507(a)(4), (5). The amount entitled to priority is limited by statute to $13,650 per covered employee less any amounts paid to employees as priority wage claims. 11 U.S.C. § 507(a)(5)(B). After learning that an employer has sought bankruptcy relief, administrators should therefore be ready to communicate immediately with the employer to ensure that outstanding amounts due under the ASA are included in—and expected to be paid currently under—the proposed "wages and benefits order." If not, the administrator may file a motion requesting allowance and payment of amounts entitled to priority under § 507(a)(5). At the same time, both employer and administrator should confirm that the employer's budget for anticipated bankruptcy expenses includes these amounts.

Importantly, the priority status reserved for employee benefit plan contributions holds equally in chapter 7 as in chapter 11. The critical difference in chapter 7, however, is that a chapter 7 trustee typically lacks the authority to operate the business and may therefore move promptly at the outset of the filing to terminate employees and employee benefits programs not needed for an orderly wind-down of the business. 11 U.S.C. § 721. In chapter 7 cases, therefore, the administrator will not expect to see a "wages and benefits order" of the sort common in chapter 11 cases, and will instead move promptly to seek allowance and payment of amounts entitled to priority under § 507(a)(5).

ASAs as Executory Contracts. The administrator should also review the ASA to evaluate whether it may be treated as an executory contract and discuss with the employer whether (and on what terms) the employer may intend to assume or reject that contract. The subject of much scholarly and judicial contemplation since the Bankruptcy Code was first enacted, a contract is executory if sufficient performance remains due by both parties that the failure to perform would constitute a material breach. In this particular context, although an independent determination should be made as to the "executoriness" of any given contract, bankruptcy courts regularly treat ASAs as executory contracts that may be assumed or rejected in accordance with Bankruptcy Code § 365. The decision to assume or reject any given contract is generally left to the discretion of the debtor in the exercise of its reasonable business judgment, subject only to the requirements to cure outstanding defaults and provide adequate assurance of the future performance of the contract if it is to be assumed. The debtor-employer, therefore, can exercise broad discretion in its decision to assume or reject an ASA. The administrator's focus, therefore, will typically be centered on the impact of the debtor's election rather than the election itself.

If the debtor-employer elects to *reject* the ASA, it is important to recognize that rejection does not equate to termination or rescission of the contract; rather, it is treated as a *breach* of the contract occurring immediately before the filing of the bankruptcy case. 11 U.S.C. § 365(g). As it would outside bankruptcy, the administrator is then entitled to assert (by the filing

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of a proof of claim) a claim for any damages arising under the ASA as the result of that breach, and to seek priority status for any portion of that claim entitled to priority under § 507.

The rejection of an ASA may invite some complications for both sides, however, since ASAs commonly provide for the continuing administration of claims for pre-termination services during the "run-off" period following termination. Ordinarily, the rejection of an executory contract excuses the non-debtor party from any further performance under the contract, but the outcome is less clear where the contract expressly requires some element of performance to occur or continue after its termination (noncompete agreements are another example). Following the rejection of an ASA, a debtor-employer might very well look to the administrator to continue to process claims during the run-off period. In that event, the administrator should look closely to whether arrangements are in place for the prompt payment of the debtor-employer's obligations relating to those run-off claims, including both the claim payments themselves and the administrator's fees.

The reimbursement of advances made by the administrator for run-off claims may fall under the category of "actual, necessary costs and expenses of preserving the estate" entitled to administrative priority under the Bankruptcy Code. 11 U.S.C. § 503(b)(1)(A). They might alternatively be viewed as postpetition advances of credit entitled to administrative priority in same way that ordinary vendors are protected to the extent they offer a debtor ordinary trade terms. 11 U.S.C. § 364(a). On the other side of the ledger, however, the debtor-employer may contend that any estate obligation to reimburse the administrator for the payment of run-off claims is added to the administrator's rejection damages claim and treated as an ordinary, nonpriority unsecured claim. Either way, the precise wording of the parties' respective rights and obligations under the ASA will be key to the resolution of this issue.

Conversely, should the debtor-employer seek to assume the ASA or assume and assign it to a third party (e.g., as part of an acquisition of the business through a § 363 sale), the Bankruptcy Code requires the debtor-employer to cure all outstanding monetary defaults under the ASA as a condition to assumption. Procedurally, the debtor-employer will typically accomplish this by filing a schedule with the bankruptcy court detailing the cure amount proposed to be paid in connection with the assumption of each executory contract, and administrators should review that schedule carefully to ensure it includes all amounts then due and owing under the ASA. In addition, the debtor-employee (or the assignee, if the ASA is being assigned to a third party) must provide "adequate assurance" of its ability to perform under the ASA in the future. Again, in most cases this requirement can be satisfied through proactive dialogue between the administrator and the debtor-employer or its assignee.

Resorting to Termination. Once a company files for bankruptcy relief, the automatic stay prevents most commercial actions against it absent prior bankruptcy court approval, including contract terminations. However, if a contract is validly terminated prior to the bankruptcy filing subject to the expiration of a designated notice period, that termination *can* still become effective in the debtor's bankruptcy case notwithstanding the automatic stay. This is because a debtor's bankruptcy estate succeeds to neither more nor less than whatever property rights the debtor held at the time it entered bankruptcy, and the Bankruptcy Code offers no mechanism to extend or revive an executory contract that terminates of its own accord during the pendency of a debtor's case.

ASAs are commonly structured as open-ended agreements that may be terminated by either party without cause following a specified notice period. If an ASA is terminated prior to the employer's bankruptcy filing, therefore, the employer may be precluded entirely from assuming the ASA provided the termination is effective upon the expiration of the required notice period and without any further action by the parties. In some cases, even the threat of termination may be sufficient to "encourage" the employer's needed compliance; in others, prompt termination in appropriate circumstances may limit the administrator's later exposure if the employer does eventually seek bankruptcy relief. Either way, depending on the timing of termination in relation to a subsequent bankruptcy filing, the employer and administrator may still have to navigate any run-off obligations that persist after the filing.

A Word About Preference Exposure. As employers feel pressure to maintain self-insured plans for their employees and administrators focus greater attention on fund deficits and other delinquencies, some of the employers that eventually seek protection in bankruptcy court will inevitably have made "extra" payments to administrators in the weeks and months leading up to the filing. Those payments that were made in the 90 days prior to the bankruptcy filing and were not regularly scheduled payments may be scrutinized for their potential avoidability as preferential transfers, or "preference payments." 11 U.S.C. § 547(b). For employers, the added financial cost of such payments may be necessary to avoid termination of the ASA at a time when its employees can ill-afford any disruption in health benefits. Administrators for their part should

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evaluate payment histories to determine whether they may have exposure to potential claims to avoid and recover payments made in the 90 days prior to the bankruptcy filing as preferential transfers. (Whether it is advisable to accept a payment that might later be subject to scrutiny as a preferential transfer is another question, but in this author's experience the recipients of such payments more often than not will choose to roll the dice on a preference lawsuit than decline the payment altogether.)

If the ASA is *assumed* by the debtor-employer, the risk of potential exposure for the administrator is low, as case law generally bars the recovery of transfers as preferential if made under a contract that the debtor has assumed. *See*, *e.g.*, *In re Superior Toy & Mfg. Co.*, 78 F.3d 1169 (7th Cir. 1996). If the ASA is not assumed—whether because it was rejected by the debtor-employer or terminated by the administrator prior to the bankruptcy—payments made to the administrator in the 90 days before the bankruptcy may be scrutinized for their avoidability as preferential transfers. As a general rule, ordinary-course payments may be insulated from clawback by a debtor-employer's bankruptcy estate, but "catch-up" payments collected by an administrator in an effort to cure past delinquencies may be at risk.

Administrators may be able to claim a "mere conduit" in those cases where the terms of the ASA required the employer to establish an account from which the administrator could pay employee claims directly upon sufficient funding, instead of paying claims first and being reimbursed by the employer thereafter. *See*, *e.g.*, *Golden v. The Guardian (In re Lenox Healthcare, Inc.)*, 343 B.R. 96 (Bankr. D. Del. 2006). Related to this, administrators whose ASAs permit the former option may consider proactively requiring more financially-distressed employers to establish such an account as a defensive maneuver.

Conclusion. Nobody wants to be (or be perceived to be) responsible for exacerbating a company's liquidity crisis or laying the final straw that forces it to tumble into bankruptcy. Nevertheless, self-insured plan administrators have a responsibility to their own stakeholders, too, as well as to the many other self-insured employers who depend upon the administrator's own financial well-being to ensure the timely and competent administration of their own employees' health claims. As employers across the country struggle to outlast the current medical and economic crisis, these administrators can stay ahead of potential problems by taking a proactive approach to ensuring compliance with contract terms, corralling deficiencies before they worsen, and recognizing the challenges and opportunities when bankruptcy enters the picture.

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