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New Law Exempts Plan Loans from Bankruptcy

The Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, which became effective on October 17, 2005, exempts loans to an employee from a tax-qualified retirement plan, such as a 401(k) plan, from the bankruptcy process. As a result, plan administrators who are notified that a participant has filed bankruptcy after October 17 are no longer required to stop payroll withholding in order to repay a plan loan, or to declare the plan loan in default.

The Bankruptcy Code includes a provision called the “automatic stay”, which provides that, as soon as an individual files for bankruptcy, all creditors are automatically prohibited from taking any further collection action on any debts owed by the individual, at the risk of being held in contempt of court. Although the issue was not entirely clear under the old law, the general consensus of practitioners was that the automatic stay prohibited plan sponsors from continuing to withhold from paychecks in order to repay plan loans. The new bankruptcy act makes it clear that repayment of plan loans is exempt from the automatic stay, so that paycheck withholding should continue even after receiving a notice of bankruptcy filing.

There was also confusion under the old law as to whether a plan loan survived a bankruptcy proceeding, and whether an employee could voluntarily agree to repay the loan to avoid adverse tax consequences even after filing bankruptcy. Under the new law, it is clear that a plan loan is not discharged, and that amounts withheld from an employee's paycheck and used to repay a plan loan (as well as 401(k) deferrals) are not assets of the bankruptcy estate subject to being used to repay other creditors. Unlike the old law, the same rules now apply in both Chapter 7 and Chapter 13 proceedings.

If you have any questions concerning the treatment of plan loans or contributions in bankruptcy, please contact the Seyfarth Shaw LLP attorney with whom you work or any employee benefits attorney on the website at www.seyfarth.com.