

Protecting Retirement Plans

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An ounce of prevention is worth a pound of cure. That this cliché contains a measure of truth is demonstrated by the value of prebankruptcy planning. Proper use of asset protection promotes the Bankruptcy Code's⁽¹⁾ goal of providing the "honest but unfortunate debtor" with a "fresh start" by maximizing the benefit of either excluding or exempting certain assets from the claims of creditors. To be sure, the advantages of asset protection are not limited to the bankruptcy context; many such devices are just as effective in thwarting attempts by creditors to reach assets outside of bankruptcy.⁽²⁾

Nevertheless, the best litmus test for the validity of an asset protection device is a bankruptcy proceeding. The ability of a debtor to retain an asset by either excluding or exempting⁽³⁾ it from "property of the bankruptcy estate" will typically be tested by a trustee, who is specifically charged with the duty of enlarging the pool of assets available for distribution to unsecured creditors.⁽⁴⁾ To accomplish this goal, the Bankruptcy Code endows trustees with myriad powers under federal and state law for attacking such protections.

This article focuses on employee retirement benefits, particularly pension plans and individual retirement accounts (IRAs), and the extent to which they are insulated from the claims of creditors. Such protections owe their existence to a public policy goal of ensuring pension benefits to retirees and their dependents, thereby preventing them from becoming a burden to society. Not surprisingly, the protection of such assets depends on the particular state or federal law at issue. Although the differences in state law that inevitably arise in a federal system will yield differences in result, the Bankruptcy Code provides a uniform framework for analyzing recent issues concerning the validity of these particular devices.

Exclusion of ERISA-Qualified Pension Plans

Under Section 541(a) of the Bankruptcy Code, upon the filing of a bankruptcy petition, an estate is automatically created that is composed of all of the debtor's "legal and equitable interests in property" as of the time of the filing of the petition. As this definition indicates, the bankruptcy "estate" is quite inclusive. However, Section 541(c)(2) states that there is a specific exclusion from the bankruptcy estate for property that is subject to a "restriction on the transfer of a beneficial interest of the debtor in a trust that is enforceable under applicable nonbankruptcy law."

The Supreme Court had an opportunity to consider the tension between these provisions in *Patterson v. Shumate*.⁽⁵⁾ In that case, it was faced with a dispute between a debtor and trustee in a Chapter 7 proceeding over entitlement to the debtor's interest in a pension plan, established pursuant to the provisions of the Employee Retirement Income Security Act (ERISA).⁽⁶⁾ The pension plan had an antialienation provision, as required by ERISA. The Supreme Court held that this antialienation provision was a restriction on transfer for purposes of Section 541(c)(2).

The primary legal issue addressed by the Supreme Court was whether the term "applicable nonbankruptcy law" of Section 541(c)(2) was limited to traditional spendthrift trusts under state law or included other federal law. The Court granted certiorari to resolve a conflict among the courts of appeals on this issue. The majority view, before the Supreme Court's decision in *Patterson*, was that a pension plan did not qualify as a spendthrift trust under state law if the participant had the right to exercise direct or indirect control over the plan.⁽⁷⁾ Relying on the plain language of the term "applicable nonbankruptcy law" as containing no limitation to state law, the Court held that this language also encompassed federal laws, such as ERISA, and that Section 541(c)(2) applied equally to the antialienation provision in the pension plan at issue.

In concluding that the pension plan was excluded from the bankruptcy estate, the Court rejected the trustee's argument that its holding would undermine the Bankruptcy Code's policy of ensuring a broad inclusion of assets. The Court reasoned:

Our holding gives full and appropriate effect to ERISA's goal of protecting pension benefits. See 29 U.S.C. §§1001(b) and (c). This Court has described that goal as one of ensuring that "if a worker has been promised a defined pension benefit upon retirement--and if he has fulfilled whatever conditions are required to obtain a vested benefit--he actually will receive it.

[O]ur holding furthers another important policy underlying ERISA: uniform national treatment of pension benefits. [citation omitted]. Construing "applicable nonbankruptcy law" to include federal law ensures that the security of a debtor's pension benefits will be governed by ERISA, not left to the vagaries of state spendthrift trust law.⁽⁸⁾

The breadth of the Supreme Court's holding in *Patterson* is underscored by its reliance on its earlier decision in *Guidry v. Sheet Metal Workers Pension Plan*.⁽⁹⁾ In *Guidry*, a labor union attempted to impose a constructive trust on funds held in a pension plan of a union official who breached his fiduciary duty and embezzled union funds. In rejecting the union's equitable arguments to the contrary, the Supreme Court stated that ERISA "reflects a considered congressional policy choice, a decision to safeguard a stream of income for pensioners (and their dependents, who may be and perhaps usually are, blameless), even if that decision prevents others from securing relief for the wrongs done them."⁽¹⁰⁾ Thus, the exclusion of Section 541(c)(2) applies with equal force to the honest as well as dishonest debtor.

Defining an ERISA-Qualified Plan

Notwithstanding the Supreme Court's strong endorsement of the use of pension plans in *Patterson*, some retirement plans are more protected than others. For one, practitioners should anticipate that trustees and creditors will focus their attacks on the formal requirements of ERISA pension plans. If a particular pension plan fails to satisfy the statutory requirements, the plan may lose its protected status and result in a windfall to the bankruptcy estate.

The case law has been slow to develop in this area largely because of the complexity of the laws involved. Most of the reported decisions involving ERISA and bankruptcy issues have failed to clearly articulate what is exactly required to establish a valid ERISA pension plan. Many simply accept the Internal Revenue Service's (IRS) determination that a plan is "qualified" or "nonqualified" and begin their analysis from that point.⁽¹¹⁾

One important exception to the dearth of case law is the opinion in *In re Hall*.⁽¹²⁾ In that case, the debtor was the president and sole shareholder of a printing company. The corporation established a pension plan, which at the time of its inception was qualified under the Internal Revenue Code (IRC) and ERISA and contained an anti-alienation provision. Because of the corporation's financial difficulties, payments on behalf of the corporation's employees were suspended five years before the commencement of the debtor's bankruptcy case and were never reinstated.

In analyzing whether the pension plan was qualified at the time that the debtor filed his bankruptcy petition, the court began by noting that even though the Supreme Court conclusively decided that an "ERISA-qualified" plan was not part of the bankruptcy estate, it did not address what is or is not an ERISA-qualified plan. Relying on the Sixth Circuit's decision in *In re Lucas*,⁽¹³⁾ which predated but was consistent with the *Patterson* opinion, the court held that an ERISA-qualified plan must be (1) subject to ERISA; (2) tax-qualified under Section 401 of the IRC; and (3) include an anti-alienation provision.⁽¹⁴⁾

Coverage by ERISA

In discussing the first element, the court noted that a pension plan subject to ERISA is, by definition, a plan that (1) provides retirement income to employees; or (2) results in a deferral of income by employees for periods extending to the termination of covered employment or beyond. Pursuant to rule-making authority the Secretary of Labor narrowed the definition of "employee" to exclude an individual and his or her spouse who wholly owns a trade or business, whether incorporated or unincorporated. Relying on the decision in *In re Witwer*,⁽¹⁵⁾ which had substantially similar facts, the court held that the debtor and his spouse, the only participants in the plan, were not employees and, thus, the plan was not ERISA-qualified. As a result, it held that the pension plan was not excluded from the bankruptcy estate pursuant to Section 541(c)(2).

Tax-Qualified Under IRC Section 401. Given its decision on the question of whether the plan was subject to ERISA, the *Hall* court next focused its discussion on the plan's tax qualification under Section 401(a) of the IRC, which it characterized as a "legal mountain." Such legal complexities often contain cracks that can cause the entire structure to collapse on the unwary. Such was the case for the debtor in *Hall*.⁽¹⁶⁾

Because the plan only benefited two out of six present and former employees, the court concluded that the plan did not satisfy the minimum participation rule and was not tax-qualified. Therefore, it was not exemptable under

Section 522(d)(10)(E) either.

As the opinion in *Hall* demonstrates, there are numerous legal requirements under ERISA and the IRC that pension plans must satisfy in order to qualify for the exclusion of Section 541(c)(2). Not all courts agree that such avenues of attack should be available. For example, in *In re Youngblood*,⁽¹⁷⁾ a husband and wife filed a Chapter 7 petition and claimed as exempt the proceeds of their ERISA-qualified plan that had been rolled over into an IRA. A creditor objected to the exemption on the grounds that the funds were not "qualified" under the IRC and, therefore, were not exempt under the particular state statute.

When the husband's corporation established the pension plan, the IRS issued a favorable determination letter, ruling that the plan was "qualified" under Section 401 of the IRC. More than 10 years later, it issued another favorable determination letter based on proposed amendments to the plan. Just prior to the termination of the plan shortly thereafter, the IRS audited the plan and assessed penalties in the form of taxes but did not revoke its earlier determination that the plan was qualified. When the plan was subsequently terminated, the husband "rolled over" his distribution into an IRA.

In support of its objection, the creditor argued that the plan was, in fact, not qualified. It claimed that the plan was used to, among other things, provide working capital for the husband's corporation and to make business loans to the debtor. It also claimed, and the bankruptcy court agreed, that the bankruptcy court had the authority to make its own determination as to whether the plan was qualified. It then determined that the plan was not qualified and denied the exemption. The district court affirmed this decision.

On appeal, the Fifth Circuit reversed. In deciding whether the bankruptcy court had the authority to determine whether the plan was qualified, the court stated:

We answer this question in the negative. We are persuaded that the legislature intended for its own state courts (or bankruptcy courts applying Texas law) to defer to the IRS in determining whether a retirement plan is "qualified" under the Internal Revenue Code. We see no reason that the legislature would want its courts, which are inexperienced in federal tax matters, to second-guess the IRS in such a complex, specialized area. We find it much more reasonable to assume that the legislature contemplated creating an exemption from seizure for a debtor's retirement funds that could be simply and readily determined by deferring to the federal tax treatment of those funds. Moreover, we do not believe that the legislature wanted to adopt a scheme that invites frequent, unseemly, conflicting decisions between the state court or bankruptcy court, and the IRS, such as occurred in this case.⁽¹⁸⁾

While the decision in *Youngblood* involved a state law exemption, the Fifth Circuit went out of its way in the quoted passage to point out that not only state courts but also bankruptcy courts must defer to determinations of the IRS as to whether a particular plan is or is not a qualified plan. The import of the *Youngblood* holding is that once the IRS has made the determination that a plan is qualified, that decision is final unless it is revoked by the IRS. While this approach has the benefit of giving debtors the comfort of being able to rely on the IRS's determinations, other courts, such as those in *Hall* and *Lane*,⁽¹⁹⁾ will be more inclined to scrutinize a debtor's compliance with the legal formalities of such plans, particularly if there is a perception that the plan at issue is being used in an abusive manner.

Inclusion of Antialienation Provisions

With respect to the third requirement concerning antialienation provisions, the reasoning of *In re Witwer* is instructive. On similar facts and analysis as in *Hall* the *Witwer* court concluded that the debtor's pension plan was not subject to ERISA. Nonetheless, the debtor claimed that it had an antialienation provision consistent with Section 401(a)(13). The debtor argued that Section 401(a)(13) was "the coordinate section" of Section 1056(d) of ERISA and constituted "applicable non-bankruptcy law" under Section 541(c)(2), as interpreted by the Supreme Court in *Patterson*. In rejecting the debtor's argument, the court reasoned:

The Debtor correctly states that under *Patterson*, § 541(c)(2) encompasses any relevant nonbankruptcy law so long as the transfer restrictions are "enforceable". [*Patterson*, 112 S. Ct. at 2247.] Under ERISA a plan participant, beneficiary, or fiduciary, or the Secretary of Labor may file a civil action to "enjoin any act or practice" which violates ERISA or the terms of the plan. 29 U.S.C. §§ 1132(a)(3), (a)(5). The "coordinate section" of the I.R.C., however, does not provide for a similar remedy.

The provisions of I.R.C. § 401(a) relate solely to the criteria for tax qualification under the Internal Revenue Code. Although a transfer in violation of the required antialienation provision could result in adverse tax consequences I.R.C. §401(a) does not appear to create any substantive rights that a beneficiary or participant of a qualified retirement trust can enforce.⁽²⁰⁾

Thus, in order to obtain the protection afforded pension plans under *Patterson*, planners should ensure that the plan is subject to ERISA, tax-qualified under the IRC, and contains an enforceable antialienation provision.

Other Vulnerable Aspects

Even if these requirements are met, some debtors' plans may still be vulnerable. One area of concern is attachment of federal tax liens. In *United States v. Sawaf*⁽²¹⁾ the IRS secured a judgment against the defendants for the amount of their assessed tax deficiency. In order to enforce that judgment, the IRS proceeded under the Federal Debt Collection Procedure Act (FDCPA). Section 3205(a) of that act allows the government to collect a judgment owed to it by garnishing property ". . . in which the debtor has a substantial nonexempt interest and which is in the possession, custody or control of a person other than the debtor."

Citing Section 1056(d) of ERISA and *Patterson*, the defendants claimed that the pension plan was exempt. In rejecting the defendants' argument, the court noted that the only express statutory exception from the antialienation provision of ERISA was for qualified domestic relations orders. However, the court relied on IRS Regulation Section 1.401(a)-13(b)(2), which provides that an antialienation provision pursuant to Section 401(a) (13) of the IRC does not preclude (1) the enforcement of a federal tax levy made pursuant to Section 6331 or (2) the collection by the United States on a judgment resulting from an unpaid tax assessment. The court went on to explain that its holding was consistent with ERISA, the IRC, and the FDCPA.⁽²²⁾

Unlike a federal tax levy however, a state tax agency may not levy on an ERISA plan, because ERISA preempts state tax law. As discussed subsequently, if the plan is not an ERISA plan, the state exemption statute will apply.

As noted, the only statutory exception to the protection afforded by an ERISA-qualified plan is with respect to court orders for spousal and child support. In order to create an exception to ERISA's antialienation rule, Congress created a statutory exception for Qualified Domestic Relations Orders (QDRO), which allows retirement plan balances to be assigned to either a spouse, child, or other dependent of the participant.⁽²³⁾

Distribution of Proceeds

Another concern relates to invasion of the corpus of the pension plan, as was the case in *Velis v. Kardanis*.⁽²⁴⁾ The debtor in that case had, among other property, approximately \$184,000 in an ERISA-qualified pension plan. Shortly after the filing of his Chapter 11 petition, the debtor "borrowed" substantial funds from his pension plan. The debtor claimed that the amounts that he borrowed retained their excluded status under Section 541(c)(2) notwithstanding such distribution. In concluding that such assets lost their protected status, the Third Circuit stated:

With respect to the pension plan and the Keogh plan, we conclude that, to the extent the assets in these plans have already been distributed to or for the benefit of the debtor, the debtor no longer has available the protections which might otherwise have been accorded under the ERISA statute. Section 541(c)(2) requires recognition of restrictions upon transfer which are enforceable by law; it does not operate to require non-recognition of transfers which have already occurred, nor does it apply to assets in the possession of the debtor without restrictions. Here, it is undisputed that, shortly after the bankruptcy petition was filed, the debtor withdrew substantially all of the funds in his pension plan, Keogh plan and the IRA, and used the money to purchase the cooperative apartment--not as pension plan assets, or as part of the debtor's estate, but for his own purposes. To that extent, there can be no doubt that these moneys came into the unrestricted possession of the debtor, and were no longer pension assets.⁽²⁵⁾

The decision in *Velis* was expanded upon in *Trucking Employees of North Jersey Welfare Fund, Inc. v. Colville*.⁽²⁶⁾ In *Colville*, a union employee received overpayments of \$44,000 for disability payments. When he refused to return the payments, the union fund filed suit and withheld his retirement benefits. The district court granted the union fund judgment for the amount of the overpayments, but refused to place a constructive trust on Colville's retirement funds and ordered the union fund to release them to him.

When Colville received the funds, he placed them in a personal bank account. The union fund then served a writ of execution on the account. However, relying on the *Patterson* decision, the district court refused to order turnover of the funds. On appeal, the Third Circuit reversed. Relying on 26 CFR § 1.401(a)-13(c)(1) and the Tenth Circuit's decision after remand in *Guidry v. Sheet Metal Workers Pension Plan*,⁽²⁷⁾ the court held that a plan's antialienation provision applies to future payments on the plan's corpus, but not to amounts paid out to the participant. As a result, Colville had to turn over the funds in his account to satisfy the union fund's judgment.⁽²⁸⁾ Even though ERISA does not protect plan distributions, state exemptions may provide some relief. Some states exempt IRA rollovers from qualified plans,⁽²⁹⁾ while others protect such proceeds provided distributions remain segregated from other funds.⁽³⁰⁾

Finally, a debtor should also be aware of transactions that may be subject to avoidance by a trustee. The court in *Velis* alluded to this possibility. In discussing the protection given to pension plans, it stated that

[w]e believe it reasonable to conclude that Congress intended to provide protection against the claims of creditors for a person's interest in pension plans, unless vulnerable to challenge as fraudulent conveyances or voidable preferences. Presumably substantial and unusual contributions to a self-settled pension trust made within the preference period, or with intent to defraud creditors, should receive no protection under either §541(c)(2) or 522(d)(10)(E).⁽³¹⁾

Exemptions Under the Bankruptcy Code

In addition to the exclusion set forth in Section 541(c)(2), Section 522 of the Bankruptcy Code allows a debtor to "exempt" certain property from the bankruptcy estate. Whereas excluded property never enters the bankruptcy estate, exempt property becomes part of the bankruptcy estate but is removed from the estate by the debtor declaring it as exempt. This distinction is more than just conceptual. The exclusion of Section 541(c)(2) operates as a matter of law without any affirmative act of the debtor. An exemption requires the debtor to declare the particular exemption and allows the trustee and creditors an opportunity to object.

Section 522(d) sets forth a list of 11 relatively standard exemptions. The type of exemptions range from a homestead and household belongings to tools of the trade to financial instruments to health aids. Most have limitations on the extent of the value of the asset that may be exempted. Although the exemptions set forth in Section 522(d) are clear, it is not certain that they will always apply.

Section 522(b) provides states with a significant amount of authority by allowing them to choose between different possible exemption schemes, of which Section 522(d) represents only one. Section 522(b)(1) essentially authorizes states to affirmatively "opt-out" of the federal exemption scheme of Section 522(d). By doing so, states are free to enact their own exemptions. Most states have done so but with varying degrees of substantive difference. Florida, for example, has opted out of the Bankruptcy Code exemptions only to reenact a portion of them by reference.⁽³²⁾ Other states, including California, have opted out and then enacted a list identical to the bankruptcy exemptions as well as a separate set of exemptions containing significant differences and allowing the debtor to choose between the two different lists.⁽³³⁾ As one court noted, considering the differences in approach, outcomes often hinge on the particular statute at issue.⁽³⁴⁾

State Exemption of Nonqualified Plans

State exemptions are significant because they provide a second line of defense for the protection of pension plans. To the extent that a pension plan is not qualified under ERISA or the IRC or does not contain an enforceable antialienation provision, a debtor may be able to exempt part or all of such an asset. In particular, state exemptions become important with respect to IRAs, SEPs (Simplified Employee Pensions), top hat plans, excess benefit plans, and those plans that cover only the owner and his or her spouse. Even though some of these plans may be subject to some ERISA requirements, they are not subject to the antialienation rule of Part 2 of Title I of ERISA and therefore are not excludable under Section 541 (c)(2).

In considering the protection of such exemptions, attention should be given to the question of whether the state statute in question is preempted by ERISA. Section 1144(a) of ERISA states that ERISA "shall supersede any and all State laws insofar as they may now or hereafter relate to any employee benefit plan." Some courts have held that state statutes authorizing pension plans were preempted by ERISA.⁽³⁵⁾ These decisions were based on an interpretation of the "relate to" language of Section 1144(a) as being sufficiently broad to preempt state

statutes that make specific reference to ERISA as well as those that deal with the subject matter covered by ERISA.

More recent opinions have reached different conclusions.⁽³⁶⁾ These decisions have focused on the savings provision of Section 1144(d), which provides that ERISA's preemption clause "shall not be construed to alter, amend, modify, invalidate, impair, or supersede any law of the United States." In *In re Schlein*, the Eleventh Circuit reasoned:

The Bankruptcy Code was enacted as a comprehensive scheme to regulate debtor-creditor relationships after the filing of a bankruptcy petition. As part of this scheme, responsibility for defining what property debtors will take out of bankruptcy is shared with the states. ERISA, on the other hand, is a comprehensive regulatory program that governs employer-employee relations in the area of private employee benefit plans. Congress made clear that it did not want the states to interfere in this area. But as the Supreme Court has taught us, this does not mean that Congress intended ERISA preemption to ride roughshod over other areas of federal legislation, whether it be Title VII, the Bankruptcy Code, or other comprehensive federal schemes. In relying on the approach adopted by the Ninth Circuit in the now-withdrawn *Pitrat* case, the district court fell into the same trap that Judge Sneed found the *Pitrat* majority had stumbled in the failure to accommodate or account for the policies and goals underlying the Bankruptcy Code.⁽³⁷⁾

Thus, the weight of recent authority supports the use of state exemption statutes to provide additional protection for pension plans that are not ERISA qualified. However, a state cannot make an exemption into an exclusion similar to Section 541(c)(2). Such purported exclusions are preempted by the Bankruptcy Code.⁽³⁸⁾

Exemption of IRAs

Even though IRAs are recognized as tax-qualified retirement plans under IRC Section 408, they are not ERISA-qualified plans.⁽³⁹⁾ State exemption statutes are far more important for their protection of individual retirement accounts than for pension plans. A growing number of states have enacted exemptions protecting IRAs. Although an IRA may not be specifically mentioned in the statute, states often employ certain language that is broad enough to encompass IRAs. A good example is the language in Section 522(d)(10)(E), which exempts "a payment under a stock bonus, pension, profit-sharing, annuity, or similar plan or contract on account of illness, disability, death, age, or length of service."

The Fifth Circuit recently addressed the exemptability of IRAs in *In re Carmichael*.⁽⁴⁰⁾

The debtor in *Carmichael* elected for the federal exemptions, which he was apparently able to do under Texas law, and claimed his IRA as exempt under Section 522(d)(10)(E). The Fifth Circuit held that IRAs were encompassed by the "similar plan or contract" language of Section 522(d)(10)(E). After analyzing the statutory language, the Fifth Circuit stated:

[T]o conclude that IRAs are not

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