CORPORATE ASSISTANCE
Compliance Management for Business Owners

The Connection between Qualified Plans and Corporate Veil Piercing

Introduction

Many owners of privately held businesses establish "qualified plans" as a means to provide tax-advantaged retirement benefits to themselves and their employees. These plans come in several varieties, such as pension, profit sharing, 401(k), and stock bonus/ownership.

Qualified plans allow the employer a tax deduction for contributing to the plan, and employees do not pay taxes on plan assets until these assets are distributed. In 1974, Congress passed the Employee Retirement Income Security Act (ERISA). In fact, the term "qualified plan" typically means a benefit plan that adheres to ERISA, a hefty federal statute providing a host of rules governing qualified plans.

With all the rules governing qualified plans, violations inevitably occur. Further, a qualified plan represents a significant asset related to the parent company. These facts raise two very important questions for business owners:

- If my corporate veil is pierced, can creditors get access to my qualified plan assets?
- If my company violates qualified plan rules, can I as the owner be held personally responsible?

As this article will demonstrate, there is a significant connection between qualified plans and veil piercing. Business owners need to be aware of this connection and govern their businesses accordingly.

The Good News

Prior to ERISA, retirement plans were frequent targets for auditors and litigators. Using a variety of theories, creditors attempted to garnish pension benefits to pay different claims. Why? To paraphrase bank robber Willie Sutton, "That's where the money is".

The 1974 ERISA legislation contained strong "anti-alienation" provisions. In simple terms, this means that the law was written to prevent qualified plan money from being separated from its intended beneficiaries, the pensioners. ERISA's anti-alienation characteristics have been reaffirmed in multiple court cases.

One of the most famous cases is Patterson v. Shumate, where the U.S. Supreme Court unanimously concluded that ERISA protects pension benefits from creditors. The justices wrote, "[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. If exceptions to this policy are to be made, it is for Congress to undertake that task." [Patterson, 504 US 753, 766 (1992), quoting Guidry, 493 US 365, 376 (1990)]

This is good news for business owners who establish qualified plans. If you fail to maintain proper corporate governance, and an audit or litigation results in piercing your corporate veil, you can still expect that your ERISA-qualified plan will be protected against the veil piercing claim. While your other personal and business assets will stand exposed, qualified money is protected.

The Bad News

But not all the news is good. ERISA also contains a lot of regulations governing setup and administration of qualified plans. Some plans may be administered incorrectly and thereby violate ERISA rules. Even if a 3rd party administrator was used, ERISA tends to place primary responsibility for violations on the employer.

Further, a qualified plan represents a significant financial commitment by the employer. Regular contributions must be made for participating employees. The plan itself invests in assets that are subject to market risk. Regular distributions must also be made to those employees who are in the distribution phase.

Businesses can experience financial troubles that make it difficult for them to make required plan contributions on behalf of their employees. Uncontrollable stock market events or poor investment decisions can decrease the plan's assets, creating a risk of insolvency. In short, business owners can find themselves in a variety of situations where they are in violation of ERISA rules or unable to make required contributions.

If you're a business owner of a company with a qualified plan, and you experience any of the above problems, you need to understand your risk of personal liability.

At retirement, employees expect to receive payments from the pension plan to which the employees and employer made contributions. However, an employee may not receive payment if the plan lacks sufficient assets to distribute funds, or if the employer decides to terminate the plan. An employer can terminate a plan if careful analysis of the plan's financial statements reveals a strong indication of either current or future insolvency.

Obviously, employees become disgruntled at the prospect of not receiving retirement payments, and as a consequence, they analyze ERISA to determine what causes of action they can bring against the corporation and related parties to recover payments.

ERISA includes language stating that employers have certain responsibilities for ERISA plans over which they have influence. This has been widely argued to mean that employees can hold both employers and shareholders personally liable for ERISA plan claims.

The ERISA – Veil Piercing Linkage

When ERISA-related liability claims come up, courts use the traditional veil piercing tests to determine whether to hold a shareholder liable for delinquent ERISA payments. The fundamental factors of these tests include: a shareholder having complete control of the corporation; the shareholder performing improper acts; and the shareholder's improper acts harming a third party.

Unfortunately for both employers and employees, the wording of ERISA leaves a lot of room for interpretation. ERISA places primary responsibility on employers, and does not explicitly address rules on holding shareholders personally liable for failures of ERISA plans. There has been a push in the legal community for Congress to amend ERISA to remedy this defect.

A developing trend among the courts is to impose liability on shareholders and directors. The trend is to adopt the "liberal" veil-piercing standard. This standard attempts to hold shareholders liable for outstanding liabilities by completely disregarding the corporate form as if limited liability did not exist.

The rationale for holding a shareholder liable under this test is that the shareholder exerted tremendous control on the corporation sufficient to qualify as an "employer" under ERISA rules, even if the shareholder did not have a day-to-day operating role with the company. The underlying justification for this test is that a shareholder who has the freedom and power of running a corporation must assume the risks associated with that power.

For instance, the U.S. District Court in the District of Massachusetts imposes responsibility for pension liability on individuals who make important and influential corporate decisions, especially those concerning the pension plan.

As with any complex issue, courts lack consistency in the analysis and resolution of veil piercing cases arising from ERISA disputes. This means business owners must assume that they are at personal risk from an ERISA veil piercing claim.

What Can You Do?

To minimize their risk from ERISA veil piercing claims, business owners must attack the problem from both directions. They need to take pains to make sure their ERISA plans are being properly managed, and also maintain a high standard of corporate governance for the business entity.

- Take the time to set up your plan correctly – setting up qualified plans and managing the associated assets is big business. There are a host of service providers in this industry looking for new clients. Evaluate service providers carefully. Find out about their track record. How long have they been in business? How many plans do they manage? Have they ever gotten into trouble because of mismanagement? A little caution up front will help prevent major problems downstream.
- Make sure your plan is regularly audited and review the results – reputable providers will have a well-established process to ensure plans they manage remain in compliance with all laws and regulations. They should provide you a formal report at least annually certifying that the plan is compliant. Take the time to read and understand any documentation you receive.
- Manage your corporate veil effectively – in many cases, courts reviewing ERISA-related veil piercing claims refuse to "pierce the veil" because of an ERISA problem unless there is some other demonstrable defect in the company's corporate governance. If plaintiffs can point to governance failures unrelated to the ERISA claim, they are much more likely to prevail. Protect yourself by maintaining a high standard of corporate governance.

Nobody wants to be caught on the wrong end of an ERISA claim. Take care in how you set up and manage your qualified plan.

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